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United States-United Kingdom Arbitration concerning Heathrow Airport User Charges (United States-United Kingdom): Award on the First Question (revised 18 June 1993)

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Award on the First Question

Decision of 30 November 1992
(Revised 18 June 1993)

Sentence arbitrale rendue relativement
à la première question

Décision du 30 novembre 1992
(Revisé le 18 juin 1993)

UNITED STATES-UNITED KINGDOM ARBITRATION CONCERNING HEATHROW AIRPORT USER CHARGES, AWARD ON THE FIRST QUESTION RAISED IN AN ARBITRATION UNDER ARTICLE 17 OF THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND AND THE GOVERNMENT OF THE UNITED STATES OF AMERICA CONCERNING AIR SERVICES ("*BERMUDA 2*"), DECISION OF 20 NOVEMBER 1992 (REVISED 18 JUNE 1993)

ARBITRAGE ENTRE LES ÉTATS-UNIS ET LE ROYAUME-UNI CONCERNANT LES REDEVANCES D'USAGE À L'AÉROPORT DE HEATHROW : SENTENCE ARBITRALE RENDUE RELATIVEMENT À LA PREMIÈRE QUESTION SOUMISE À L'ARBITRAGE AUX TERMES DE L'ARTICLE 17 DE L'ACCORD ENTRE LE GOUVERNEMENT DU ROYAUME-UNI DE GRANDE-BR`ETAGNE ET D'IRLANDE DU NORD ET LE GOUVERNEMENT DES ÉTATS-UNIS D'AMÉRIQUE RELATIF AUX SERVICES AÉRIENS (« *BERMUDES 2* »), DÉCISION DU 20 NOVEMBRE 1992 (REVISÉ LE 18 JUIN 1993)

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AWARD

rendered by

Professor Isi Foighel, Dr. jur., President
Fred F. Fielding Esquire
and
Mr. Jeremy Lever Q.C.

November 30, 1992
(revised June 18, 1993)

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CHAPTER 1

THE ARBITRATION PROCEDURE

I. The Request

1.1 The present Arbitration arises under the Air Services Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland (Her Majesty's Government or "HMG") and the Government of the United States ("USG")[1] done at Bermuda July 23, 1977, as subsequently amended. That agreement is generally referred to as "Bermuda 2" (to differentiate it from the earlier U.S.-U.K. Air Services Agreement, or "Bermuda 1" of February 11, 1946) and will be so referred to in this Award.

1.2 The full text of Article 10 of Bermuda 2 (User Charges), Article 16 (Consultation), Article 17 (Settlement of Disputes), Article 19 (Termination) and Article 21 (Entry into Force), together with the Preamble and the relevant definitions contained in Article 1 (Definitions), are to be found in **Appendix I** to this Award.

1.3 On December 16, 1988, the U.S. Department of State sent a letter to the British Ambassador to the United States, requesting arbitration pursuant to Article 17 of Bermuda 2 with respect to "the continuing dispute between our Governments concerning the user charges imposed by the British Airports Authority and subsequently by BAA plc on U.S. airlines and of the conduct of the British Government in relation thereto." On December 22, 1988, HMG, by a diplomatic Note agreed to accept the request for arbitration. British Airports Authority and its successor BAA plc are generally both referred to without distinction in this Award as "BAA": see further paragraphs 2.1 *et seq*. of Chapter 2, below.

II. Constitution of the Tribunal

2.1 On February 26, 1989, USG nominated Fred F. Fielding, Esquire, a national of, and resident in, the United States, as arbitrator and HMG nominated Mr. Jeremy Lever, Q.C., a national of, and resident in, the United Kingdom, as arbitrator. The two arbitrators nominated by the respective Governments agreed on the appointment of Professor Isi Foighel, Dr. jur., a Judge of the European Court of Human Rights and a national of, and resident in, Denmark, as the President of the Tribunal; and on May 5, 1989, Professor

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[1] The Parties are mentioned in the text here in alphabetical order; the Treaty was made and signed in duplicate and, in accordance with normal practice, the U.K. text of the Treaty (as published in the U.K. Treaty Series) lists the Government of the United Kingdom first, whereas the U.S. text of the Treaty (as published by the U.S. Department of Transportation) lists the Government of the United States first. Both texts use U.S. orthography and, accordingly, the text of this Award also does so.

Foighel was duly appointed as President of the Tribunal. By letter dated June 27, 1989, the two Governments appointed Mr. G.W. Maas Geesteranus, a national of, and resident in, The Netherlands and former Legal Adviser to the Dutch Foreign Ministry, to perform the functions of the Registrar of the Tribunal. Pursuant to requests of April 3, 1989 from the two Governments, the Secretary General of the Permanent Court of Arbitration, in a letter dated April 14, 1989, agreed to offer logistical assistance to the Tribunal by placing the offices and staff of the Permanent Court of Arbitration at The Peace Palace in The Hague, The Netherlands, at the disposal of the Governments for the use of the Tribunal. The Tribunal records its appreciation of the assistance given to it by the Permanent Court of Arbitration throughout the procedure.

III. The Procedure

Tribunal sessions

3.1 The Tribunal has held seven sessions in The Hague, the first six of which were concerned with procedural questions:

on June 28 and 29, 1989 (first session);
on August 24, 1989 (second session);
on November 14, 1989 (third session);
on May 1, 1990 (fourth session);
on June 15, 1990 (fifth session);
on May 7, 1991 (sixth session); and
on July 2 through to August 2, 1991, that is, 5 weeks, sitting four days a week (the substantive hearing).

The Tribunal also met without the Parties in Denmark from April 5 to April 15, 1991 in a special meeting and since August 2, 1991, has met on a number of occasions for the purposes of deliberation.

Terms of Reference

3.2 The purpose of the Tribunal's first session was to clarify the issues to be arbitrated, after the Parties had failed to reach complete agreement on the precise Terms of Reference, and had requested the Tribunal to define them. In its Decision No. 1, dated June 29, 1989, the Tribunal decided that the Terms of Reference should be as follows:

1. The Tribunal is requested to decide whether, in relation to the charges imposed for the use of London Heathrow Airport upon airlines designated by the Government of the United States of America under Article 3 of the Air Services Agreement, done at Bermuda on July 23, 1977, the Government of the United Kingdom have failed to fulfil their obligations under Article 10 of the said Air Services Agreement, interpreted having regard to, *inter alia*, the Memorandum of Understanding between the two Governments on Airport User Charges of April 6, 1983, in any of the charging periods beginning on or after April 1, 1983.

2. If the answer to the foregoing question is in the affirmative, the Tribunal is further requested to decide what, if any, remedy or relief should be awarded.

A copy of Decision No. 1 is to be found at **Appendix II** hereto; the Decision itself summarizes the differences of view with regard to the Terms of Reference of the Tribunal as between the Parties and it explains the reasons why the Tribunal formulated its Terms of Reference in the manner in which it did.

3.3 The Parties agreed at the first session that: "The hearing on the merits will be limited to the issue of liability and all appropriate forms of relief stemming from six years of Heathrow user charges, commencing April 1, 1983. Upon the issuance of the Tribunal's final award concerning these issues, the Parties will attempt to resolve by agreement any question of the award's application to any subsequent period up to the date of the Tribunal's final award. The position of the charges on and after April 1, 1989 is reserved."

The Tribunal Rules of Procedure

3.4 At the first session of the Tribunal, pursuant to the substance of Article 17(3) of Bermuda 2, the Parties presented to the Tribunal draft "Tribunal Rules of Procedure" (hereafter "RP"). Those Rules were largely modelled on the Rules of the International Centre for the Settlement of Investment Disputes ("ICSID") and were adopted by the Tribunal substantially in the form proposed. A copy of the Tribunal Rules of Procedure, as amended, is to be found at **Appendix III** hereto. The RP included, in particular, the following Rules.

3.5 **RP, Rule 11(1)** (based on ICSID Rule 20) provides for the President to seek the views of the Parties about, in particular, the number of the pleadings and the time limits within which they are to be filed; **RP, Rule 11(2)** provides that in the conduct of the proceedings the Tribunal shall apply any agreement between the Parties on procedural matters. It was pursuant to **RP, Rule 11** that the Tribunal directed that the written pleadings should comprise a first memorandum by USG as the claimant, a memorandum in answer by HMG, and, at the option of USG, a memorandum in reply and, at the option of HMG, a memorandum in rejoinder, rather than the single memoranda, to be delivered at the same time by each of the Parties, as envisaged by Article 17(4) of Bermuda 2 itself. **RP, Rule 14** (based on ICSID Rule 26(1) and (2)) empowers the Tribunal, and in certain circumstances the President, to set and to extend time limits. **RP, Rule 15** (based on ICSID Rule 29) provides that, unless the Parties otherwise agree, the proceeding shall comprise two distinct phases: a written procedure followed by an oral one.

3.6 **RP, Rule 17** (based on ICSID Rule 33) provides for the giving of directions to the Parties requiring them to communicate to the Tribunal and to each other, in particular, precise information regarding the evidence that they intend to produce, together with an indication of the points to which such evidence will be directed.

3.7 **RP, Rule 18(1)** (based on ICSID Rule 33(1)) provides that the Tribunal shall be the judge of the admissibility of any evidence adduced and

of its probative value. **RP, Rule 18(2) and (3)** (based on ICSID Rule 33(2) and (3)) is in the following terms:

> (2) The Tribunal may, if it deems it necessary at any stage of the proceeding
>
> (a) call upon the Parties to produce documents, witnesses and experts; and
>
> …
>
> (3) The Parties shall cooperate with the Tribunal in the production of the evidence and in the other measures provided for in paragraph (2). The Tribunal shall take formal note of the failure of a party to comply with its obligations under this paragraph and of any reasons given for such failure.

RP, Rule 19 (based on ICSID Rule 35) provides for the examination of witnesses and experts.

3.8 **RP, Rule 22** (based on ICSID Rule 38) is to the following effect:

(1) that when the presentation of the case by the Parties is completed, the proceeding shall be declared closed and

(2) that, exceptionally, the Tribunal may, before the award has been rendered, reopen the proceeding on the ground that new evidence is forthcoming of such a nature as to constitute a decisive factor, or that there is a vital need for clarification on certain specific points.

3.9 **RP, Rule 26** (based on ICSID Rule 47, modified) prescribes the form of the award and, in particular, that it shall contain a statement of the facts as found by the Tribunal, the submissions of the Parties and the decision of the Tribunal on every question submitted to it, together with the reasons upon which the decision is based.

3.10 **RP, Rule 26A**, as inserted, with the agreement of the Parties, by Decision No. 14 of the Tribunal of May 8, 1991, provides that nothing in the Rules shall be understood as excluding the power of the Tribunal, after having consulted with the Parties, to limit its initial award to one or more specific issues only, reserving its decision with respect to any remaining issues in dispute for a further award or awards and contains consequential provisions in respect of the declaration under RP, Rule 22 that the proceeding is closed and in respect of the form of the award as prescribed by RP, Rule 26. **RP, Rule 26A** was inserted consequentially on the Tribunal's decision to separate the procedure in connection with the first of the questions in its Terms of Reference (whether or not there had been a breach of the Treaty) from the second of those questions (if there had been a breach, what relief or remedies should be given): see further paragraph 3.15 of this Chapter, below.

3.11 **RP, Rule 28**, as amended, with the agreement of the Parties, by Decision No. 7 of the Tribunal of June 2, 1990, provides that:

– not later than 10 weeks (originally 2 weeks) prior to the hearing each Party shall provide to the Registrar and to the other Party particulars of its witnesses and a written statement of their testimony, such

written statements being required to support or address positions taken by a Party in its written pleadings;

– not later than 14 days (originally 2 days) prior to the hearing each Party shall provide to the Registrar and to the other Party particulars of any additional witness that it wishes to call to rebut positions taken or information provided in a witness statement of the other Party and a written summary of the testimony of the rebuttal witness.

The filing of written pleadings

3.12 As required by Decision No. 2 of the Tribunal dated June 29, 1989 (as varied by Decision No. 3 of August 24, 1989, Decision No. 5 of March 23, 1990, Decision No. 6 of May 18, 1990, Decision No. 10 of November 1, 1990 and Decision No. 11 of February 28, 1991, being Decisions taken by the Tribunal or the President exercising his powers under RP, Rule 14(2), all of which, at the request of one or both of the Parties, extended time limits that had previously been set), written pleadings bearing the following dates were filed as follows:

(a) Memorandum of the United States ("U.S. I"): December 15, 1989;

(b) Her Majesty's Government's Submission ("U.K. I"): May 31, 1990;

(c) Reply Memorandum of the United States ("U.S. II"): November 9, 1990;

(d) Respondent's Memorandum in Rejoinder produced by HMG ("U.K. II"): March 15, 1991.

USG's written pleadings (without the Exhibits to them) run in the aggregate to over 650 pages and HMG's written pleadings (without the Annexes to them) run in the aggregate to over 1,000 pages. The Exhibits to U.S. I and U.S. II number 436 in all and fill 9 large arch-files; the Annexes to U.K. I and U.K. II number 275 in all and fill 5 large arch-files. Additionally, pursuant to requests made by USG, HMG delivered a number of sets of Further and Better Particulars of its written pleadings running in the aggregate to over 100 pages.

Lists of issues

3.13 By Decision No.9 of the Tribunal dated June 15, 1990, the Tribunal indicated to the Parties that they were free to deliver to the Tribunal a List or Lists of main issues, prepared jointly or severally, if either or both of them saw fit to do so. Each Party delivered its own List of Issues, as follows:

HMG: April 3, 1991;
USG: April 7, 1991.

Filing of evidence

3.14 Also by Decision No.9 of the Tribunal, the Tribunal ruled that each Party should file its *principal evidence*, as contemplated by RP, Rule 28, by

April 15, 1991 (extended by Decision 12 of the Tribunal of April 12, 1991, to *May 3, 1991*) and any *counter-evidence* by *June 14, 1991*. This was supplemented by Decision No.13 of the Tribunal of May 14, 1991, whereby the Tribunal ruled that, if any witness of either Party desired to comment upon counter-evidence filed by the opposite Party, a *supplementary written statement* containing the comments in question should be filed not later than June 24, 1991; otherwise it would not be open to the witness to make such comments in his direct testimony without leave of the Tribunal, which would not be given save in exceptional circumstances.

General arrangements for the substantive hearing; and separation of the questions of liability and of relief and remedies

3.15 Lastly by Decision No.9, the Tribunal ruled that a hearing on the substance would be held at The Hague, commencing on July 2, 1991; by agreement between the Parties, that hearing would occupy 4 days a week for 5 consecutive weeks. The Parties left it to the Tribunal to allocate the available time between them in a fair way. The Tribunal ruled that, without prejudice or restriction as to how the Parties chose to present their cases, the Tribunal's initial decision on the substance would be limited to liability and, in the event of a finding of liability, the Tribunal would give further directions for the determination of remedies.

Treatment of the issue of exhaustion of local remedies at the hearing on the substance

3.16 By a Minute dated April 12, 1991 and consequentially on the separation, by Decision No.9, of the questions of liability and of relief and remedies, the Tribunal suggested to the Parties that, if either of them wished to supplement its written pleadings by oral argument on the exhaustion issue at the hearing on the substance that was due to commence on July 2, 1991, such oral argument should be confined to the effect, if any, of any non-exhaustion of any local remedies on the answer that the Tribunal should give to the first of the questions that its Terms of Reference required it to answer, namely the question whether there had been a breach or breaches of the Treaty.

Absence of objections to, or in connection with, the conduct of the Arbitration

3.17 Also by the Minute dated April 12, 1991 the Tribunal recorded its intention to afford to the Parties, at the forthcoming sixth session of the Tribunal on May 7, 1991, an opportunity to indicate whether they had any (and if so what) objection in relation to or in connection with the, conduct of the Arbitration generally, or observance by the Tribunal of all essential procedural requirements in particular, up to that date. In the course of the sixth session on May 7, 1991 both Parties indicated that they had no such objection.

Exclusion from evidence of the quinquennial Report of the U.K. Monopolies and Mergers Commission on BAA

3.18 It was a matter of some concern to the Tribunal that, under the U.K. regulatory régime established for BAA, the U.K. Monopolies and Mergers Commission ("the MMC") was about to complete its first quinquennial review of BAA and to transmit its resulting report to the U.K. Civil Aviation Authority ("the CAA") which would in turn transmit the Report to the U.K. Secretary of State, with the result that by the commencement of the hearing that was due to commence, and in fact commenced, on July 2, 1991, HMG but not USG would probably be in possession of the MMC's Report. The Tribunal deemed it desirable that before that state of affairs had arisen a decision should have been taken as to whether or not the Tribunal might receive, and properly refer to, the MMC's Report and, if the Tribunal might do so, then under what conditions and for what purposes. Accordingly, by its Minute dated April 12, 1991, the Tribunal requested the Parties to consider together and, if possible agree, how the Report of the MMC was to be treated.

3.19 Pursuant to that request the Parties notified the Tribunal at the Tribunal's sixth session on May 7, 1991 that they had agreed that the Tribunal should not receive evidence of the contents of the MMC's Report or otherwise refer to its contents in relation to any issue before the Tribunal in the Arbitration, and that the Parties might not directly or indirectly put in evidence or in any other way rely upon the contents of the Report; and the Tribunal included a ruling to that effect in Decision No.13 of the Tribunal.

Conduct of the substantive hearing

3.20 At the conclusion of its sixth session the Tribunal, by Decision No.13 dated May 14, 1991, gave further directions for the conduct of the substantive hearing in July 1991. Pursuant to the discretion entrusted to it by the Parties (see paragraph 3.15 above), the Tribunal allocated the available time at the substantive hearing to each of the Parties equally, with consequential directions as to what time was to be imputed to each Party.

3.21 Subject to fitting in, at a convenient time, oral submissions on the effect, if any, of any non-exhaustion of local remedies on the answer that the Tribunal should give to the first of the questions that its Terms of Reference required it to answer, the Tribunal ruled that the substantive hearing should be conducted as follows, each Party being free (i) to allocate its time as between the different parts as it pleased and (ii) not to avail itself at all of one or more of the enumerated opportunities:

(a) Opening by USG.

(b) Opening by HMG.

(c) Direct examination (which expression includes examination-in-chief, using English terminology), cross-examination and re-direct

examination (which expression includes re-examination, using English terminology) of:

(i) USG's witnesses;

(ii) HMG's witnesses;

(iii) any rebuttal evidence permitted by the Tribunal to be given (see paragraph below).

(d) Closing speech by HMG.

(e) Closing speech by USG.

(f) With leave of the Tribunal, any comment by HMG on any new point made in USG's closing speech that HMG could not reasonably have anticipated in its closing speech.

3.22 With regard to "rebuttal evidence" of the kind referred to at paragraph 3.21(c)(iii) of this Chapter, above, the Tribunal ruled that USG might call such evidence only with leave of the Tribunal, which would be given only subject to the satisfaction of stringent conditions. USG did not in fact apply to call any such rebuttal evidence and the expression "rebuttal evidence" was sometimes used to describe the "supplementary written statements" which Decision No.13 also permitted the Parties to file by June 24, 1991, by way of comment on the counter-statements of the other Party (see paragraph 3.14 of this Chapter, above).

3.23 By Decision No.13 the Tribunal further:

(a) ruled that oral direct testimony should not go beyond the witness's written statement or statements unless, exceptionally, the Tribunal gave leave; and

(b) limited the documents that could be put, without leave of the Tribunal, to witnesses in cross-examination.

3.24 Finally Decision No.13 of the Tribunal recorded that the Parties had, by agreement, stipulated to the authenticity of all documents that they had produced or might produce and that such documents should therefore be treated as authentic for the purposes of the hearing that was due to commence on July 2, 1991.

Discovery and production of documents

3.25 Much of the interlocutory work before the Tribunal concerned discovery of documents, almost entirely by HMG at the request of USG.

3.26 An indication of the extent of that work is given by the fact that, in addition to hearing the Parties orally in connection with questions relating to discovery at five of the interlocutory sessions of the Tribunal, the Tribunal also had the benefit of receiving written briefs on the subject from USG running to over 150 pages with exhibits and annexes running to over 500

pages and from HMG briefs running to over 100 pages with exhibits and annexes running to over 500 pages. HMG produced many documents at the request of USG without the intervention of the Tribunal; the Tribunal sought to assist the Parties to achieve mutually acceptable solutions; and on a number of occasions it made requests of HMG, with a view to completing the discovery process satisfactorily.

3.27 Many of the documents produced by HMG were procured by it for the purposes of the Arbitration from BAA. The documents disclosed by HMG included:

(a) all the documents that had been disclosed by HMG and by BAA in the course of the 1980-83 litigation referred to at paragraphs 3.1 *et seq*. of Chapter 2, below; and

(b) numerous documents that were the subject of specific requests by USG.

3.28 The documentary material before the Tribunal included the "Joint Record", comprising documents, including some of the documents disclosed on discovery, placed by the Parties jointly before the Tribunal. The Joint Record filled seven large arch files which contained, in particular:

I. *Regulatory framework* (UK legislation; Bermuda 2; relevant U.K. governmental "White Papers"; 1983 Settlement Agreement; 1983 inter-Governmental MoU; U.K. Ministerial statement on RPI-1 and the permission to levy charges).

II. *Inter-Governmental correspondence* (including diplomatic Notes and memoranda of inter-Governmental consultations).

III. *BAA documents* (initial charges proposals to airlines and final charges 1983/84 - 1988/89; BAA Annual Reports and Accounts 1983/84 - 1988/89; Heathrow Airport Limited Annual Accounts 1986/87 - 1988/89).

IV. *BAA documents* (Patterns of Traffic; Policies and Programmes; 1987 Privatization Prospectus).

V. *BAA documents* (Medium Term Consultation Papers, 1983/84).

VI. *Papers to BAA Boards on Airport Charges* (1982 - 1986).

VII. *Papers to BAA Boards on Airport Charges* (1986 - 1988).

3.29 One of the difficulties in relation to discovery was that, potentially anywhere in the files of BAA or, less probably, of HMG, further documents up to 10 years old or even more, that might be relevant to some issue in the Arbitration, might exist. As a practicable solution to that difficulty and to ensure a "level playing field" in the Arbitration, the Tribunal made, among other orders relating to discovery, the following three:

(i) By *Decision No. 4 of November 14, 1989*, the Tribunal ruled that:

(a) by virtue of RP, Rule 18 (see paragraph 3.7 of this Chapter, above), read in the light of Articles 10 and 17 of Bermuda 2, the Tribunal had power if necessary at any stage of the proceedings, *inter alia*, to call upon the Parties to produce documents; and

(b) HMG should identify in writing as soon as practicable any documents in its possession, custody or power falling within any of the categories requested by USG to the date of Decision No. 4, if such documents had been used by HMG in connection with the performance of its obligations under Articles 10 and 16 of Bermuda 2, unless such documents had already been produced by HMG, and should then either forthwith produce any such further documents to USG or state the reason why HMG should not be called upon to produce them.

(ii) By *Decision No. 8 of June 15, 1990*:

(a) The Tribunal requested HMG to produce to USG not later than July 27, 1990, documents in the possession, custody or power of HMG that came into existence between January 1, 1979 and March 31, 1989, not being merely documents in the public domain, that relate to:

– the profitability of BAA or any of its operations,

– the user charges made by BAA or

– annual consultations between BAA and the airlines,

unless the document was entirely irrelevant to Heathrow. However, such documents were covered by the Tribunal's request only if:

(1) they had already been discovered by HMG for its own purposes in this Arbitration or

(2) they had been used by HMG in connection with the performance of its obligations under Bermuda 2.

(b) The Tribunal further requested HMG to produce documents that would have been covered by (a) above but for the fact that they were not in the possession or custody of HMG, being documents that had been reviewed by BAA in connection with this Arbitration and/or had been inspected or used by HMG or its independent advisers for the purposes of this Arbitration.

(c) As under Decision No. 4, the Tribunal gave HMG leave to object to production of any document falling within the request, on identifying the document in question and stating the ground on which HMG objected to produce it.

(iii) By *Decision No. 16 of June 13, 1991*:

the President, having conferred with the other members of the Tribunal, up-dated Decision No. 8 by extending it to documents discovered by HMG for its own purposes in this Arbitration in the interval between the two Decisions.

For the purposes of Decisions Nos. 8 and 16, "document" was expressly defined to include a document in any form including machine-readable form.

3.30 Although HMG did not concede that documents in the possession of BAA and not of HMG were in the "power" of HMG within the meaning of the requests made by the Tribunal, it gave effect to the requests in the same way as it would have done if the Tribunal had ruled that that was so. Accordingly, the Tribunal had no occasion to give a ruling in that connection.

3.31 The extent of the discovery that the Tribunal requested HMG to make was wide. The power to make those requests was conferred on the Tribunal, by agreement between the Parties, by RP, Rule 18; but the Tribunal notes that it was substantially influenced to *exercise the discretion* thus conferred on it by the existence of Article 10(5) of Bermuda 2 (the Parties' duty to use their best efforts to encourage the exchange of necessary information between their airport operators and the other Party's designated airlines) and by the fact that USG's complaints in the Arbitration include a complaint of breach by HMG of Article 10(5).

3.32 On June 3, 1991, i.e. one month before the hearing on the substance of the first question referred to the Tribunal (liability) was due to commence, USG filed a "Request ... that the Tribunal address [HMG's] failure to produce certain information regarding HMG's case". The Request ran to 25 pages, with 19 supporting annexes running to over 150 further pages. USG requested the Tribunal:

(1) to direct HMG to respond without delay to USG's extensive requests for further and better particulars with respect to the testimony contained in the written statements which had by then been filed by HMG;

(2) to make one of HMG's witnesses, a government official, available for deposition to which he should bring all documents relied upon in preparing his testimony or to respond without delay to written questions to be submitted by USG;

(3) if HMG provided responses to USG's requests for further and better particulars of testimony but not in time for USG to use them in its rebuttal testimony (due to be filed on June 14, 1991), to permit USG to supplement or amend its rebuttal testimony notwithstanding any other deadline;

(4) if HMG failed to respond at all to USG's requests for further and better particulars of testimony, to alter the timetable and the procedural directions for the substantive hearing that the Tribunal had given on June 15, 1990 and May 14, 1991, and/or to draw adverse inferences against HMG or to give no weight to the testimony as to which HMG had not given the discovery sought;

(5) to give no weight to an Annex to U.K. II relating to congestion in the terminals at Heathrow or to evidence to a similar effect or to assume that, if more complete documentary records were made available, they would support USG's position on terminal capacity.

3.33. On June 13, 1991, having considered USG's Request that has just been described, the written representations of HMG and a further written submission by USG, the Tribunal, by Decision No. 16, ruled in substance as follows:

(1) If USG contended that HMG had failed to deliver any of the relevant further and better particulars requested by USG, being particulars which, according to USG, ought to have been delivered, USG was free to make submissions as to the consequences of such failure in the course of the substantive hearing.

(2) The Tribunal would take account of all submissions by either Party as to lack of particularity of the evidence of any witness tendered by the opposite Party and lack of supporting documentation therefor, when assessing what if any probative value the Tribunal would attach to any such evidence.

(3) The Tribunal saw no sufficient reason to vary its earlier Decisions in so far as those Decisions provided for the conduct of the substantive hearing.

(4) The Tribunal reserved for decision in its first Award:

   (a) the question of what if any adverse inferences were to be drawn against either Party by reason of its not having provided information for the purposes of the Arbitration or by reason of its having so provided information too late for it to be used effectively;

   (b) the question whether either Party had failed to disclose material that it ought to have disclosed and if so how, if at all, such non-disclosure affected the weight, if any, to be attached to evidence tendered by that Party; and, in particular

   (c) the question of what weight, if any, was to be attached to the disputed Annex to U.K. II and to any evidence that might be relied on by HMG to the effect that managers reported congestion in the terminals and the question whether any

assumptions should be made that would support USG's position on terminal capacity.

3.34 As to paragraph 4(a) of Decision No. 16, the inferences drawn by the Tribunal from the evidence and its availability or otherwise adequately appear in the body of this Award. As to paragraph 4(b) of Decision No. 16, the Tribunal finds no reason to hold that either Party failed to disclose material that it ought to have disclosed. As to paragraph 4(c) of Decision No. 16, the Tribunal has found it unnecessary to refer to the disputed Annex to U.K. II for the purposes of arriving at the findings of fact necessary for this Award.

Provision of material by the Parties to the Tribunal after the substantive hearing

3.35 The Tribunal further considered an application by USG, that the Parties should be free to file "post-hearing briefs" after the substantive hearing. HMG opposed that application on the grounds first that delivery of post-hearing briefs was incompatible with the Tribunal Rules of Procedure, secondly that delivery of such briefs could generate further controversy, resolution of which could raise intractable problems, and thirdly that general considerations of convenience militated against reception of such briefs by the Tribunal in the circumstances of the present Arbitration.

3.36 Decision No. 16, though stopping well short of permitting the filing of post-hearing briefs after the substantive hearing, provided that each Party should be free but not bound to supply to the Tribunal in writing not later than August 29, 1991 a copy of the transcript of its final speech annotated, so as to show only and without raising any new point, the relevant references to the relevant documentary material that was before the Tribunal, being material on which the Party had relied in support of any assertion or contention contained in the final speech. Both Parties availed themselves of this opportunity and the procedure operated smoothly and proved helpful to the Tribunal.

Pre-hearing motions, principally to exclude evidence or use of documentary material

3.37 By letter to the Tribunal dated June 21, 1991 HMG indicated that it intended to apply to the Tribunal at the substantive hearing to reject as inadmissible the evidence of Mr. Alan Newham, Mr. John Saunders and Mr. Jeffrey Shane proposed to be tendered by USG on the ground that their written testimony had been filed by USG as counter-evidence on June 14 (received by HMG on June 17) but was, by reason of its content, principal evidence which, as such, should have been filed by May 3, 1991. HMG also objected to the admission of the evidence of Mr. Saunders on the ground that it did not comply with the requirements of RP, Rule 28 which requires written statements to "support or address positions taken by a Party in its [written pleadings]".

3.38 By letter dated June 30, 1991, amongst other things USG denied that any of the written testimony filed by it on June 14 as counter-evidence should

have been filed by May 3 as principal evidence; by the same letter, with reference to the documents that might be used by HMG in cross-examination, USG reverted to the question of what, as it maintained, had been inadequate discovery of documents relating to terminal capacity. USG also contended that the working papers of HMG's expert witnesses on the issue of profitability should be made available to USG and it stated that USG was considering whether to apply for the disallowance of all or part of the evidence of those witnesses; and it contended that if HMG persisted in a claim, based on "public interest immunity", not to produce certain documentary material relevant or potentially relevant to the evidence of one of its witnesses, the relevant passages of that witness's testimony should be disallowed, or if such passages could not be cleanly excised from the remainder, the whole of the testimony should be disallowed. (Since HMG subsequently waived its claim not to produce the material in question, the intervening steps leading up to that end-result, and hence the admission, without objection by USG, of the evidence of the official in question are not considered further in this Award.) Lastly, USG's letter raised the question of precisely what documents could in general be put to witnesses in cross-examination. On the following day, HMG, by letter, disputed the foundations of USG's letter.

3.39 By a memorandum in writing dated July 1, 1991, the Tribunal informed the Parties of the way in which it proposed to proceed, subject to representations to the contrary that the Parties might choose to make at the hearing: accordingly, the Tribunal's proposals were, and were expressed to be, provisional until the Parties had waived or exercised the opportunity to address the Tribunal orally in respect of their applications.

3.40 The Tribunal's proposals, which (subject to limited exceptions that are described below) were effectuated without objection by the Parties, were as follows:

(i) With regard to HMG's application, the Tribunal intended to hear the testimony of Mr. Newham, Mr. Saunders and Mr. Shane without prejudice to whether the evidence was properly admissible as rebuttal testimony or should be excluded: in other words, the Tribunal would hear the testimony *de bene esse* (to use the Common law expression); and in its first Award, the Tribunal would include a ruling as to the admissibility or otherwise of the evidence and, if it held that the evidence was inadmissible, in whole or in part, it would, to the extent that it was inadmissible, totally exclude it from the consideration of the Tribunal.

(ii) The documents relating to terminal capacity referred to by USG might be used in cross-examination by HMG but the significance and weight, if any, to be attached to them would be carefully weighed by the Tribunal when it came to prepare its first Award; and the Parties would be free to address the Tribunal, in the course of their speeches in relation thereto, if they so wished.

(iii) With regard to use of documents in cross-examination generally, documents annexed by any witness to his written testimony might be used in cross-examination of any witness without limitation.

(iv) With regard to the way in which the Tribunal would treat the evidence of expert witnesses whose working papers had not been made available to the other Party, the Tribunal's general approach would continue to be to hear all the evidence placed before it by either Party; the Tribunal would then decide in its first Award what weight, if any, was to be attached to that evidence having regard to all the relevant circumstances, including any failure by the Party whose evidence it was to make available relevant documentary information to the other Party. Here again the Parties would be free to address the Tribunal with regard thereto in the course of their speeches.

The substantive hearing

3.41 The substantive hearing was held in The Peace Palace, The Hague. The actual hearing, excluding out-of-Court conferences between the Parties' Agents and Counsel with the Tribunal, occupied some 109 hours, spread over July 2-5, 9-12, 16-19, 23-26, 30-31 and August 1 and 2, 1991.

3.42 USG called 6 witnesses and HMG called 11 witnesses. The table below shows the names and position of each witness, a brief indication of the subject matter of his evidence and whether, in so far as his testimony was written, it was filed as principal evidence ("P"), or counter-evidence ("C") or by way of supplementary written statement - referred to at the hearing as rebuttal evidence ("R").

				Written testimony		
	USG's Witnesses			**P**	**C**	**R**
1.	Richard A. BREALEY[1]	Professor, London Business School	Economic rate of return and cost of capital	*	*	*
2.	Lawrence KOLBE	Principal, Brattle Group of Cambridge, Mass.	Calculation of economic rate of return and cost of capital	*	*	*

[1] Professor Brealey's written evidence was prepared jointly with Professor Myers, but only Professor Brealey gave evidence orally.

	USG's Witnesses			**P**	**C**	**R**
3.	Alan D. H. NEWHAM	Chartered Accountant; Partner, Ernst & Young, New York.	Accounting rate of return		*	*
4.	John A. SAUNDERS	Former TWA passenger manager at T3, Heathrow	Terminal 3 usage		*	
5.	Michael E. LEVINE	Dean & Professor of Management Studies, Yale University School of Organizational Management	Structure of user charges: economic theory and practical application at Heathrow	*	*	*
6.	Jeffrey N. SHANE	U.S. Assistant Secretary of Transportation for Policy & International Affairs	U.S. policy and inter-Governmental negotiations		*	

	HMG's Witnesses			**P**	**C**	**R**
1.	Timothy G.R.L. LAWRENCE	Chartered Accountant; Partner, Coopers, Lybrand & Deloitte, London	Accounting rate of return	*	*	
2.	Julian R. FRANKS	Professor of Finance, London Business School	Economic rater of return and cost of capital and their calculation	*	*	

	HMG's Witnesses			P	C	R
3.	Jan COOPER	Associate Professor of Finance & Research Fellow, London Business School	Calculation of cost of capital		*	
4.	Alfred E. KAHN	Professor of Political Economy (Emeritus) Cornell University	Economic principles of efficient charging for airports	*	*	*
5.	Eric F. TRACEY	Chartered Accountant: Partner, Touche Ross & Company; Auditor to BAA	BAA's Accounts and their relevant implications	*(2)	*	*
6.	Roderick D. JONES	Chartered Surveyor; Partner, Drivas Jonas	Valuation and revaluation of BAA properties	*		*
7.	Steven O. GUNDERS	Partner & Director of New York operations, Deloitte & Touche	Comparisons of user charges at Heathrow and at other major airports	*		
8.	Anthony T. BAKER	Assistant Secretary of the UK Department of Transport	U.K. policy; inter-Governmental negotiations; HMG's "best efforts"	*		

	HMG's Witnesses			P	C	R
9.	Wynne PRICE JONES	Chartered Surveyor; Partner, Coopers, Lybrand & Deloitte	Structure of user charges: economic theory and practical application at Heathrow	*		
10.	Donald W. TURNER	Chartered Civil Engineer; former BAA Board member (1975-1985)	BAA's policy and practice, 1983-85	*	*[1]	
11.	Richard L. EVERITT	Solicitor; BAA Board Member (1986-)	BAA's policy and practice 1986-89	*	*[1]	

[1] Joint statement

3.43 In the course of the hearing, a number of procedural applications were made and these are dealt with in this Award in the course of reviewing the evidence and documentary material before the Tribunal. Wherever either Party objected to the reception or use of such evidence or material and we do not expressly deal with that objection in this Award, it is because either the Tribunal has excluded from consideration the evidence or material in question without prejudice in the result to the Party who relied on that evidence or material or the Tribunal has reached a conclusion adverse to the Party that objected to the use of the documents or material without the need to have recourse to the contested evidence or material.

The time for rendering an award and for consequential steps

3.44 Article 17(5) of Bermuda 2 provides, so far as is relevant, that the Tribunal shall attempt to render a written decision within 30 days after completion of the hearing and that the decision of a majority of the Tribunal shall prevail. On May 7, 1991 the Parties agreed that in the circumstances of the present Arbitration, that provision can reasonably be interpreted to allow the Tribunal to attempt to render a written decision on the first of the questions referred to the Tribunal (as to the severance of the first and second questions, see paragraph 3.15 of this Chapter, above) within 6 months after completion of the substantive hearing on August 2, 1991. At the same time the Parties agreed that in the circumstances of the present Arbitration they should be free to request clarification of that written decision within 8 weeks after that decision has been rendered and that the Tribunal should issue such a

clarification within 8 weeks of any such request; and that agreement was reflected in an amendment (made by Decision No.15 of the Tribunal, dated May 14, 1991) to RP, Rule 30, which contains the Rule of Procedure that governs the giving of supplementary decisions of the kind contemplated by Article 17(6) of Bermuda 2. The Parties acknowledged that neither of them would raise any objection to use of the newly agreed and prescribed time limits in connection with the written decision to be rendered following on the substantive hearing of July 2 through to August 2, 1991.

3.45 On September 17, 1991, after completion of the substantive hearing, the Tribunal advised the Parties by letter that it thought that it could be assisted if they were to furnish it with certain further information and invited the Parties to make any proposals that they might wish for enabling the Tribunal to be supplied with that information. That request and the Parties' responses are described at paragraphs 8.10 - 8.12 of Chapter 7, below.

3.46 At the same time as signing this Award, the Tribunal, pursuant to its earlier Decision No. 9, took a further decision (Decision No. 18), giving preliminary directions for the further procedure for determination of relief and remedies.

CHAPTER 2

THE HISTORY OF, AND BACKGROUND TO, THE PRESENT DISPUTE

I. The making of Bermuda 2

1.1. The Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States concerning Air Services was signed at Bermuda on July 23, 1977. It replaced the Final Act of the Civil Aviation Conference held at Bermuda from January 15 to February 11, 1946 and the annexed agreement between HMG and USG relating to Air Services between their respective Territories. The 1946 Agreement is commonly called "Bermuda 1" and the 1977 Agreement, pursuant to which the present Arbitration is held, is commonly called "Bermuda 2".

1.2. Bermuda 1 was signed against the background of the Convention on International Civil Aviation, opened for signature at Chicago on December 7, 1944, commonly called "the Chicago Convention", which was ratified by both the United States and the United Kingdom. Article 15 of the Chicago Convention prohibits *inter alia* discrimination by a contracting State against aircraft of other contracting States through their being charged more for the use of airports in the first State than national aircraft of the same class engaged in similar operations or, as to aircraft engaged in scheduled

international air services, than national aircraft engaged in similar international air services.

1.3. In the Bermuda 1 Final Act USG and HMG reaffirmed their adherence to the principles and purposes set out in the preamble to the Chicago Convention; and Article 3(1) of Bermuda 1 provided, with regard to user charges, simply that:

> The charges which either of the Contracting Parties may impose, or permit to be imposed, on the designated air carrier or carriers of the other Contracting Party for the use of airports and other facilities shall not be higher than would be paid for the use of such airports and facilities by its national aircraft engaged in similar international air services.

1.4. Paragraph 9 of the Bermuda 1 Final Act recorded the Parties' intentions that there should be regular and frequent consultation between their respective aeronautical authorities and that there should thereby be close collaboration in the observance of the principles and the implementation of the provisions of the Final Act, the Agreement and the Annexes, but the Agreement itself contained no provisions for consultation, or the provision of information, about user charges and no provisions for arbitration to resolve disputes.

1.5. In 1976, for reasons with which the Tribunal is not concerned, HMG gave notice to terminate Bermuda 1; hence the negotiation of Bermuda 2 in June and July 1977. Since the relevant provisions of Bermuda 2 are fully described in later Chapters of this Award, they are not described here.

1.6. According to non-contentious evidence given by Mr. Jeffrey N. Shane, who testified to the Tribunal in his capacity as Assistant Secretary of Transportation for Policy and International Affairs for the U.S. Department of Transportation, the United States had user charges provisions in some sixty-six of its bilateral agreements; there had been a progression in the quality of the kinds of provisions that had been incorporated in such agreements over time. In the earlier years, the language was essentially simple and was exclusively concerned to prevent discrimination by either party against the airlines of the other party in the establishment of charges for services of airports. A more extensive provision had then been evolved, "which included not only the question of non-discrimination but also the importance of establishing charges that were just and reasonable".

1.7. Finally, such provisions came to be expressed, as in Article 10 of Bermuda 2, in more elaborate terms which tried to articulate, to some extent, what just and reasonable meant. Besides Bermuda 2, the United States had a few additional bilateral agreements which had that more extensive formulation, along the same lines as, but not identical to, Article 10 of Bermuda 2.

II. BAA

2.1. Before recording salient features of the history relevant to the present dispute, it will be helpful to give a brief description of BAA and its business.

It should be noted, first, that references in this Award to "BAA" in respect of the period prior to August 1, 1986, relate to the British Airports Authority and those in respect of the period from August 1, 1986 onwards relate to BAA plc (public limited company) and, where relevant, its subsidiaries. Immediately before BAA plc succeeded to the British Airports Authority the Authority was restructured. Airport assets, including runways and terminals, and liabilities were transferred to seven subsidiary airport companies, one of which was Heathrow Airport Limited.

2.2. The British Airports Authority was wholly owned by HMG, as was BAA plc until July 1987, when its entire share capital was sold to the public under a public offering for a total consideration of some £1225 million (payment of £725 million of which was deferred until May 1988). At that time, i.e., in the middle of the Arbitration period, BAA's principal activities, so far as relevant to the Arbitration, were described as follows by the public Offer for Sale:

> **Principal activities**
>
> **Introduction**
>
> BAA's principal business is the ownership and operation of seven international airports in England and Scotland. In the year ended 31 March 1987 a total of 55.3 million passengers used BAA's airports. Of this total, 44.2 million passengers travelled on international flights. In terms of the number of international passengers handled, BAA is the world's leading international airport group and Heathrow, with 26.1 million international passengers in the year ended 31 March 1987, is the world's busiest international airport.
>
> BAA's business is capital intensive. Operating BAA's airports involves the construction and maintenance of terminal buildings, runways, roads and car parks as well as the provision of a wide range of services to airlines and their passengers. BAA plans and develops its airports to meet forecast demand.
>
> The safety of operations and the security of passengers, aircraft and the airport environment are of prime importance. In the year ended 31 March 1987, BAA employed over one third of its staff on safety and security functions, chiefly in the fire services and in controlling access to restricted areas and searching departing passengers.
>
> BAA makes available an extensive range of retail services in its airports. These include duty and tax-free shops, specialist shops and restaurants. These services are mainly operated under concession arrangements. BAA also lets premises on airport sites to airlines and others. These commercial activities generate just over half of BAA's revenues.
>
> Many activities at BAA's airports are the responsibility of others. The [Civil Aviation Authority] currently provides air traffic control. HM Government is responsible for immigration and customs controls. Airlines and other parties provide many services for passengers, such as check-in and baggage-handling, and are responsible for aircraft maintenance and operation. Approximately 90 per cent. of the 74,000 people who work at BAA's airports are employed by airlines, concessionaires and other parties.
>
> **The airports**
>
> *Heathrow*
>
> Heathrow Airport is the world's busiest international airport. It handles more international passengers than any other airport and more passengers than any airport outside the United

States. Its airline traffic consists almost entirely of scheduled flights. It handled 546,000 tonnes of cargo and 72,000 tonnes of mail in the year ended 31 March 1987.

The airport has two main runways and a cross runway which is used for a small proportion of aircraft movements. It has four passenger terminals, Terminal 4 having opened in April 1986. Heathrow is linked to Central London via the underground system and has direct access to the motorway system.

Over 70 airlines operate from Heathrow to more than 200 destinations worldwide. British Airways is the principal user of Heathrow, accounting for 46 per cent. of the passengers using the airport in the year ended 31 March 1987. The next eight largest users accounted for 20 per cent. of passengers with each carrying between 2 and 5 per cent.

Key information on Heathrow for the last five years is:

	Year ended 31 March				
	1983	1984	1985	1986	1987
Revenues (£ million)	189	205	229	247	269
Passenger (million)	26.3	27.0	29.9	31.4	31.7
Air Traffic Movements or ATMs (‘000)	252.8	263.3	274.2	258.7	292.3
BAA employees (average number)	3,622	3,572	3,511	3,579	3,743

Gatwick

Gatwick Airport is the world’s third busiest airport in terms of the number of international passengers handled. In the year ended 31 March 1987 a total of 58 per cent. of passengers travelled on charter flights and 42 per cent. on scheduled flights.

Gatwick has one main runway and an emergency runway. It has one passenger terminal and a second is under construction, the first phase of which is due to be opened in early 1988. Gatwick has a frequent and rapid railway link to Victoria Station, London and direct access to the motorway system.

British Caledonian Airways, Dan Air and British Airways (including British Airtours) are the main users of Gatwick and each accounted for about 15 per cent. of passengers using the airport in the year ended 31 March 1987.

Key information on Gatwick for the last five years is:

	Year ended 31 March				
	1983	1984	1985	1986	1987
Revenues (£ million)	53	68	82	96	110
Passenger (million)	11.3	12.7	14.2	15.2	16.6
ATMs (‘000)	132.6	136.0	141.0	151.0	155.2

BAA employees (average number)	1,259	1,270	1,289	1,316	1,392

Stansted

Stansted Airport is being developed to become London's third airport. It has a single runway and one passenger terminal. In the year ended 31 March 1987 a total of 75 per cent. of passengers using Stansted were carried on charter flights. Stansted also has a developing network of scheduled services within the United Kingdom and Europe. The largest user of Stansted is Air U.K., accounting for 22 per cent. of passengers in the year ended 31 March 1987. Stansted has direct access to the motorway system.

In June 1985, following a public enquiry, BAA was granted planning permission for the development of a new terminal at Stansted to accommodate 15 [million passengers per annum or "mppa"]. A condition of the planning permission required the development to be phased. The first phase is due to open in 1991 by which time British Rail intends to have linked the new terminal to Central London. In the White Paper, HM Government undertook that the first phase would be limited to about 7 to 8 mppa and accordingly the Secretary of State has set a limit of 78,000 passenger ATMs per annum at Stansted, corresponding to this first phase of development. Increases in the limit on ATMs will require Parliamentary approval.

Key information on Stansted for the last five years is:

	Year ended 31 March				
	1983	1984	1985	1986	1987
Revenues (£ million)	2.3	2.9	3.7	3.9	4.7
Passenger (million)	0.30	0.36	0.55	0.50	0.56
ATMs ('000)	7.7	8.6	12.8	14.1	16.8
BAA employees (average number)	173	174	181	187	197

2.3. The Offer of Sale then listed and described BAA's other, Scottish, airports, namely:

- Glasgow
- Edinburgh
- Prestwick
- Aberdeen

2.4. So far as relevant to the Arbitration, the Offer of Sale described BAA's competitive position as follows:

BAA handled 73 per cent. of the passengers and 85 per cent. of the cargo tonnage that passed through all United Kingdom airports in the year ended 31 March 1987.

Heathrow, Gatwick and Stansted primarily serve passengers travelling to and from the South East of England. Also serving this market is Luton Airport, which handled two million passengers in the year ended 31 March 1987, mainly on charter services. London

City Airport (Stolport), a short take-off and landing airport under construction in London's docklands, is due to open in Autumn 1987 and will offer some domestic and European short haul services. It is expected to have a capacity of around 1 mppa.

About 23 per cent. of Heathrow's passengers and 10 per cent. of Gatwick's passengers are "interlining": that is, using the airport as a connection point between their originating airport and ultimate destination. Heathrow has considerable advantages as an interlining airport as it has scheduled services to over 200 destinations, while Heathrow and Gatwick together have scheduling services to over 250 destinations. The main competition to Heathrow and Gatwick for interlining traffic comes from continental European airports, principally Paris, Amsterdam and Frankfurt, and to a lesser extent from airports further afield.

….

There is also some competition from other forms of transport. Air services to the Continent compete to some extent with cross-channel ferries, and will compete with the Channel Tunnel when it is opened. Domestic air services compete with road, rail and ferry services.

2.5. With regard to BAA's revenues, the Offer for Sale stated that:

BAA's revenues have been divided into two categories, each accounting for about half of total revenues. Traffic revenues are derived principally from airport charges. Commercial revenues comprise concession income, primarily derived from sales of goods and services to passengers, and rents and charges for services paid by airlines and other airport tenants.

BAA's revenues for the last five years were:

	Year ended 31 March				
	1983 £ million	1984 £ million	1985 £ million	1986 £ million	1987 £ million
Traffic revenues	149	167	183	198	212
Commercial revenues:					
Concession income	84	99	119	134	158
Rents and services	47	50	60	64	69
	280	316	362	396	439

Passenger traffic

A key determinant of both traffic and commercial revenues is the number of passengers who pass through the airport terminals. Passenger traffic at BAA's airports has grown considerably over the last two decades …

At BAA's airports, annual growth in passenger numbers has averaged 6.4 per cent. since 1966, indicating the strong underlying trend in passenger growth. The rate of growth has varied, generally in line with economic cycles, but growth has been interrupted on only two occasions: during the oil crisis in 1974 and the economic recession in 1980 and 1981. BAA's airports serve a wide geographical spread of routes. Their passenger traffic comprises a mix of United Kingdom and foreign residents and of business and leisure

passengers. As a result of this diversity, passenger traffic as a whole has shown a marked resilience when downturns have occurred in particular markets.

Passenger traffic at Heathrow has grown by an average of 5.0 per cent. per annum since 1966, whereas Gatwick has seen a much faster average growth rate at 12.3 per cent. per annum over the same period. The difference in growth rates reflects, in part, decisions to exclude most charters from Heathrow and to develop schedules services at Gatwick. Passenger traffic at the Scottish airports has shown steady growth averaging 5.2 per cent. per annum since 1966.

Traffic revenues

BAA's traffic revenues are mainly earned as follows:

(a) landing charges: BAA charges aircraft operators fixed fees and/or fees which vary with the weight of each aircraft. The level of these charges at the South East airports varies between peak and off peak periods;

(b) passenger charges: BAA generally charges aircraft operators a fee based on the number of departing passengers on each aircraft. This fee varies at the South East airports between peak and off peak periods; and

(c) aircraft parking charges: BAA charges fees which are based on the weight of the aircraft and the duration an aircraft is parked. At Heathrow the charge varies between peak and off peak periods.

These charges are the subject of price regulation at the South East airports, …. In the year ended 31 March 1987 these charges accounted for 37 per cent. of total revenues. Charges at the Scottish airports are not subject to price regulation.

In addition to these charges, BAA levies fees for particular services to aircraft operators, including the provision of apron services such as passenger loading bridges and electricity supplies to parked aircraft. …

BAA's traffic revenues for the last five years were:

	Year ended 31 March				
	1983 £ million	1984 £ million	1985 £ million	1986 £ million	1987 £ million
Landing charges	49	41	41	40	44
Passenger charges	65	87	99	110	114
Aircraft parking charges	26	28	30	33	34
	140	156	170	183	192
Apron and other services	9	11	13	15	20
	149	167	183	198	212

ATMs [Air Traffic Movements]

The number of ATMs at an airport directly affects revenues from landing and parking charges and indirectly affects revenues from passenger charges. At airports such as Heathrow and Gatwick, where the runways are close to being fully utilised for many hours of the day, growth in passenger numbers will increasingly depend on growth in the average number of passengers carried per ATM and the greater use of off peak periods. …

Commercial revenues

BAA's revenues from commercial activities at its airports have grown consistently over the last five years and have increased as a proportion of total revenues from 46.8 per cent. in the year ended 31 March 1983 to 51.7 per cent. in the year ended 31 March 1987. Commercial revenues comprise concession income and revenues from rents and services.

Concession income

Concession income is generated from the provision of goods and services for passengers. BAA considers that the most profitable method of managing its retail operations is to appoint concessionaires rather than to operate them itself. Major concessions are normally granted for five years, following competitive tenders from a range of suitable companies. Tenderers are normally required to bid on the basis of the percentage of turnover which they will pay to BAA for a licence to operate a particular concession.

BAA's objective is to maximise its income whilst having regard to the quality of service provided to passengers. It works with concessionaires to promote sales and arranges advertising and promotional campaigns. …

Over the last five years concession income comprised:

	Year ended 31 March				
	1983 £ million	1984 £ million	1985 £ million	1986 £ million	1987 £ million
Duty and tax free shops	48	56	69	77	88
Car parking	12	14	17	19	25
Other shops	7	9	10	11	12
Catering	5	5	6	8	9
Car rental	4	4	5	6	7
Other services	8	11	12	13	17
	84	99	119	134	158

Duty and tax free shops

Duty free goods, such as wines, spirits and tobacco, are sold free of excise duty and value added tax (VAT) to departing international passengers. Tax free goods, such as perfumes, watches and cameras, are sold free of VAT to departing international passengers. Almost 20 per cent. of United Kingdom perfume sales in the year ended 31 December 1986 were made at BAA's tax free shops.

Duty and tax free goods are sold from shops which are usually located in the international departure lounges on the "airside" of each airport (those areas accessible only to international passengers with boarding cards). One concessionaire is appointed to operate the duty and tax free shops in each terminal.

BAA maintains control over the range of merchandise in each shop together with the prices at which certain goods are sold. For the sale of standard brands of spirits and tobacco products, BAA's policy is to require concessionaires to offer a minimum saving of 37.5 per cent. on average high street prices for each product, although in practice savings in excess of this level are made on some products. For tax free goods BAA required the concessionaire to sell its products at a price not exceeding the price charged at high street shops, less VAT. Perfumes, however, must be sold at a discount of at least 20 per cent. to the high street retail price. Regular surveys of prices in high street shops are carried out by BAA to check that prices charged by concessionaires are in accordance with BAA's pricing policy.

During the five years ended 31 March 1987 there has been a substantial increase in BAA's revenues from tax free goods, which have grown at an average of 26 per cent, per annum. …

2.6. The Offer for Sale then described other sources of revenue derived from car parks, other shops, catering, car rental concessions, and "other services" and continued as follows:

Rents and services

Rents are derived from leases and tenancy agreements of property and land at BAA's airports which are let for a wide variety of purposes associated with airport operations. These include aircraft maintenance, cargo handling, baggage handling, offices, warehousing and hotels. BAA also charges for the provision of certain services to tenants under these lease and tenancy agreements. In the year ended 31 March 1987, approximately 16 per cent. of BAA's revenues were derived from rents and services.

Revenues from rents and services over the last five years were:

	Year ended 31 March				
	1983 £ million	1984 £ million	1985 £ million	1986 £ million	1987 £ million
Rents	23	25	34	38	43
Services	24	25	26	26	26
	47	50	60	64	69

The leases of premises in and around the passenger terminals tend to be for short periods in order to maintain flexibility to develop the terminals. The principal exception is the accommodation occupied by British Airways in Terminal 4 at Heathrow which is let for a term of nine years, the rent being subject to review at three yearly intervals.

Elsewhere at the airports, the terms of lettings vary significantly. A number of the leases of accommodation in the maintenance areas at Heathrow and Gatwick and the cargo areas at Heathrow are long leases at low rents and some of these continue into the next century. The rents payable are well below current market rates, in some cases with infrequent rent reviews and in others with rent increases to predetermined levels.

It is now the general policy of BAA that, where land or buildings are let on long leases, there should be rent reviews at regular intervals. At each review the rents payable will

reflect the open market rental value of the land or property which is the subject of the lease. Rents payable for hotels let by BAA at Heathrow, Gatwick, Glasgow and Aberdeen are based upon a percentage of the turnover achieved by the hotel operator.

….

2.7. The Offer for Sale then noted, with regard to Operating Costs that:

The opening of new passenger terminals significantly increases BAA's operating costs, mainly because staffing levels increase and depreciation charges begin. This can be seen in the results for the year ended 31 March 1987, the year in which Terminal 4 at Heathrow was opened.

….

2.8. With regard to Police Services the Offer for Sale stated that:

BAA has, since 1 April 1983, met the full cost of the policing of its airports. … Before that date about 50 per cent. of police costs were met from a Government security levy.

2.9. With regard to the accounting conventions used by BAA and its trading profits, the Offer for Sale contained the following passage:

Depreciation and loss on disposal of fixed assets

BAA produces its main accounts on a current cost basis because of the capital intensive nature of its business and the long lives of its assets. The principal effect of this policy is that the calculation of depreciation in the current cost accounts is based on the replacement cost of the relevant assets. Consequently this depreciation charge is higher than on an historical cost basis. Losses on disposal of fixed assets have varied between £1 million and £4 million over the five year period ended 31 March 1987.

Trading profits

BAA's trading profits, extracted from the Accountants Report, for the last five years were:

	Year ended 31 March				
	1983 £ million	1984 £ million	1985 £ million	1986 £ million	1987 £ million
Current cost					
Trading profit/(loss)					
Traffic	(24)	(26)	(21)	(24)	(36)
Commercial	63	78	96	111	131
	39	52	75	87	95
Pro forma historical cost					
Trading profit/(loss)					

Traffic	3	2	8	7	(9)
Commercial	71	87	102	122	140
	74	89	110	129	131

…

The loss on traffic activities in the year ended 31 March 1987 reflects the effect on operating costs and depreciation of the opening of Terminal 4 at Heathrow.

Passengers and airlines using BAA's airports are the main sources of both traffic and commercial revenue. Traffic and commercial activities are not independent. Consistently with HM Government's international obligations, both types of revenues are taken into account in regulating airport charges at the South East airports. ….

2.10. Finally, with regard to "Structure and Organisation", the Offer for Sale observed that:

The day to day management of each of the South East airport companies [Heathrow Airport Limited, Gatwick Airport Limited and Stansted Airport Limited] is the responsibility of the Managing Director of the relevant airport company. However, the South East airports are together regarded as a single system serving the South East of England. This system approach is recognised in the pricing formulae which control the increase in airport charges at the three airports overall, as well as at Heathrow and Gatwick individually, and also in the policies for airport charges and airport development adopted by the Group. ….

2.11. Certain of the statistical information contained in the Offer for Sale is in the following tables so as to provide the information for the whole of the Arbitration period (and for the year immediately preceding the start of that period).

Heathrow

	Year ended 31 March						
	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Revenues (£M)	189	205	229	247	169	309	344
Passengers (M)	26.3	27.0	29.9	31.4	31.7	35.6	38.0
ATMs ('000)	252.8	263.3	274.2	285.7	292.3	310.4	330.4

BAA (total)

	Year ended 31 March						
	1983	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Revenues (£M)	280	316	362	396	439	523	641
Passengers (M)	43.4	45.9	50.9	53.4	55.3	63.7	68.0

ATMs ('000)	558.9	579.5	602.9	619.3	626.3	680.0	714.9
Profit*(£M)	71	84	104	122	124	166	198

* Note: Profit before tax under the historical cost convention, as restated for earlier years in BAA's Report and Accounts for the year ended March 31, 1989. Accounts on a current cost accounting basis ceased to be prepared after 1988.

III. The 1980 spike in Heathrow charges and the 1980-83 litigation and its settlement

3.1. Having provided a general description of BAA, the Tribunal can now continue its account of the relevant history following on the making of Bermuda 2. In November 1979, two-and-a-half years after the making of Bermuda 2, BAA announced very large increases in user charges for the charging year 1980/81, i.e. the year that commenced on April 1, 1980, which had the effect of raising charges to the U.S. carriers at Heathrow, namely PanAm and TWA, by some 60 per cent. - 70 per cent. The announcement of the increases led to inquiries and expressions of concern by USG to HMG. The charges for the following charging year were increased by a further 12 per cent. overall. At some point in 1980 (apparently before November of that year), 18 international airlines, including TWA, commenced proceedings in the High Court of Justice in London against the Secretary of State for Trade (who was at that time the Secretary of State responsible for civil aviation) and BAA; PanAm, with whom TWA subsequently joined, commenced parallel proceedings against the Secretary of State for Trade and BAA. The proceedings concerned only user charges at Heathrow.

3.2. By common points of claim served on May 1, 1981, which were amended on 5 February 1982 and re-served on May 6, 1982, the plaintiffs sought a number of declarations and damages against the Secretary of State and BAA; injunctions against BAA; and repayment by BAA of "excess user charges". In reliance on English statutory provisions, European Community law and common law, the plaintiffs contended that any charges imposed by BAA should be fair, just and reasonable; reasonably calculated to facilitate the discharge of BAA's duties under the Airports Authorities Act 1975; and non-discriminatory. The plaintiffs also contended that BAA was bound to make Heathrow available to all operators (or all aircraft of other States party to the Chicago Convention) on equal terms and conditions; PanAm and TWA further relied on a duty deriving from Bermuda 2 to impose airport charges that were just and reasonable, reflecting but not exceeding the full cost to BAA of providing appropriate facilities and providing for a reasonable rate of return on assets after depreciation.

3.3. The principal group of plaintiff airlines contended that a reasonable rate of return at Heathrow would and should have been no greater than 6 per cent. (on a Current Cost Accounting - or CCA - basis); PanAm contended that

such reasonable rate of return would and should have been no greater than 4 per cent. CCA.

3.4. Although the actions gave rise to interlocutory proceedings in the High Court, the Court of Appeal and the House of Lords between April 1982 and March 1983, they never came on for trial since they were settled. The settlement was embodied in a Memorandum of Understanding and Settlement Agreement, made between the Secretary of State for Trade and BAA, on the one hand, and the airline plaintiffs, on the other hand, entered into on February 22, 1983.

3.5. After referring to the actions in the High Court, the Agreement ("the Airlines Settlement Agreement") recorded that:

> II. The parties desiring that in their common interests the BAA and the Airlines shall in future work more closely together, and having discussed the matters which are the subject of the dispute, now have a better understanding of each others' situation. They have as a result of such discussions agreed upon the termination of both of the said actions, and the BAA and the Airlines have agreed upon the arrangements as to the future which are recorded below.
>
> III. The Airlines acknowledge that the BAA's acceptance of these arrangements is, as it must be, given within the framework of, and subject to all duties and powers from time to time applicable to the BAA (including the BAA's statutory duty to provide adequate facilities for consultation for all users of BAA's airports and other persons or bodies specified in Section 2(8) of the Airports Authority Act 1975). The Airlines are happy to accept that, subject thereto, it is the intention of the BAA to implement and give effect to them. The BAA for its part is happy to accept that the Airlines will collaborate to that intent with the BAA.

3.6. The Airlines Settlement Agreement then set out the following "Arrangements as to the future":

> (1)(a) The BAA and the Airlines will seek a better mutual understanding of each others' situation through improved consultative arrangements and exchanges of information (recognising that the BAA will include the other airline users of the BAA's airports in such consultative arrangements) including greater collaboration with the Airlines and other airline users in forecasting those elements which are significant in the determination of user charges; in pursuance thereof, in each year the BAA shall seek to agree with the Airlines and other airline users on a schedule for consultations and the topics to be considered. In so far as the parties provide information to each other pursuant to these Arrangements each party reserves its position as to the relevance and utility of such information.
>
> (l)(b) The BAA shall be consulted early in the planning stages about the Airlines' forecasts relating to future types, characteristics and numbers of aircraft expected to be used, the expected growth of passengers and cargo to be handled, the special facilities required at BAA's airports and other relevant matters.
>
> (1)(c) The Airlines and the other airline users of the BAA airports shall be consulted early in the planning stages of any capital projects that might result in significant changes to user charges.
>
> (l)(d) The BAA shall seriously consider the information, comments and alternate proposals provided by the Airlines, or any of them, who shall give explanations for their proposals.

(1)(e) The BAA shall give explanations for its ultimate decisions on those proposals, including (if those proposals are rejected) its reasons.

(1)(f) The BAA will, if, in pursuance of its powers and duties, it anticipates changing any policy in a manner which may significantly affect these Arrangements, use its best endeavours to give notice thereof to the Airlines and consult with them in relation thereto.

(l)(g) In the consultation process the BAA will give its forecasts on the impact of each proposed charge on the revenue of each terminal and, on request by individual airlines (unless impracticable due to lack of time or information or unless insignificant), the forecast effect on that airline.

(2) The BAA recognises that the weight element of the landing charge is presently partly related to ability to pay and the BAA intends (subject to Paragraph III above) progressively to reduce in importance this element in the BAA's charges in order better to reflect costs.

(3) The BAA intends (subject to Paragraph III above) to develop its parking charges so as more closely to reflect the relative costs by aircraft type and/or category of type of supplying parking facilities and parking services. The BAA intends to consider introducing a differential between pier and remote stands designed to reflect the costs to airlines of coaching operations.

(4) Subject to Paragraph III above, changes to the structure and level of user charges should be implemented as soon as reasonably practicable but in a gradual manner.

(5) The BAA intends (subject to Paragraph III above) to continue to treat the commercial revenues of the BAA on the same basis as hitherto. Both parties recognise that a change to this basis would have a serious impact on charges.

(6) The BAA notes the concern of the Airlines that there should be observance of the statements published from time to time by ICAO and the provisions of the international obligations of the United Kingdom concerning user charges.

(7) The BAA and the Airlines both recognise that heavy capital expenditure may justify recourse to external borrowing.

(8) The discuss have hitherto failed to produce agreement on a number of matters, a number of which are recorded below, it being the intention of both the BAA and the Airlines that if the process of consultation does not resolve the differences between them, the BAA shall endeavour to ensure that any principles adopted by the BAA should be applied in an equitable manner.

(8)(a) The BAA as at present advised proposes to continue to impose differentials in charges between peak and off-peak traffic in the belief that such differentials are appropriate to reflect costs, but recognising the serious concern of the Airlines as to a charging structure based on peak pricing, is prepared to review its structure. In such review, both parties wish seriously to address the matters in issue while recognising each other's present position. Such review will be conducted in collaboration with the Airlines and other airline users and otherwise in accordance with Paragraph III above, and will, in particular, include study of:-

(i) the effect of peak charges upon patterns of demand and, in particular, upon the difficulties of scheduling out of the peak;

(ii) the problems associated with objectively identifying any particular users as being responsible for "peak costs";

(iii) the definition of peak, shoulder, and off-peak periods by the BAA for charging periods;

(iv) analysis of the costs brought about by peak, shoulder, and off-peak traffic;

(v) the proper differential in charges (if any) as between peak and off-peak users or as between peak users;

(vi) forecasts and analysis of traffic by peak, shoulder and off-peak periods;

(vii) costs of capital projects that would result in significant changes in user charges;

(viii) the extent to which all users should appropriately contribute to capital costs associated with increased demand.

(8)(b) The Airlines note that in determining user charges, the BAA propose (subject to Paragraph III above) to move progressively towards a structure related to marginal costs (including where appropriate long run marginal costs). The Airlines regard long run marginal cost pricing as irrelevant and inapplicable to the fixing of user charges and reserve the right to maintain this position. If marginal cost calculations are used in the setting of proposed charges, the BAA in its consultations will, if so requested, disclose basic forecasts and assumptions used in those marginal cost calculations and such calculations.

(8)(c) The Airlines note that in determining user charges the BAA proposes (subject to Paragraph III above) to continue to treat its South East airports as a system. The Airlines do not accept the correctness of this treatment, and reserve the right to maintain this position, and further take the view that

(i) cross-subsidisation (either of operating losses or capital expenditure) between airports should be avoided;

(ii) the rate of return earned at any airport is a matter of legitimate concern to users and should not exceed reasonable levels.

3.7. The Airlines Settlement Agreement then continued as follows:

<u>SETTLEMENT AGREEMENT</u>

1. In the light of the foregoing arrangements, the parties agree that:-

(1) the Airlines will discontinue [their] Actions [in the High Court] and the BAA and the Secretary of State agree to such discontinuance with no order as to costs;

(2) the Airlines undertake to bring no or no further proceedings, whether in England or in any other jurisdiction, against the BAA or the Secretary of State in respect of:-

(a) any of the user charges in issue in the said actions;

(b) any of the user charges up to and including 31 March 1983;

(c) any of the user charges for the period 1 April 1983 to 31 March 1984, provided that the charges implemented for that period are substantially the same as those proposed to date in consultation and provided that the BAA continues in that year to identify and account for the security charge separately;

(d) any of the user charges taking effect from 1 April 1984 prior to that date;

(3) the Airlines further undertake:-

(a) as may be appropriate, to inform their respective Governments of the terms of the settlement of the said actions;

(b) in the case of PanAm, TWA and Flying Tiger, neither to urge nor procure [USG] to make or proceed with any claim against [HMG] under [Bermuda 2] in respect of:-

(i) any of the user charges in issue in the said actions;

(ii) any of the user charges up to and including 31 March 1983;

(iii) any of the user charges for the period 1 April 1983 to 31 March 1984, provided that the charges implemented for that period are substantially the same as those proposed to date in consultation and provided that the BAA continues in that year to identify and account for the security charge separately.

(c) in the case of PanAm, TWA and Flying Tiger, to take no steps to promote the process of arbitration under the provisions of the Bermuda 2 Agreement in respect of any of the user charges taking effect from 1 April 1984 prior to that date;

(d) in respect of the user charges referred to in paragraphs 1(2)(a)(b) and (c) above (in the case of (c) subject to the provisos therein contained) not to urge or procure any other Government or any institution of the European Economic Community to make or proceed with any claim against Her Majesty's Government or the BAA.

(4) The Airlines see no reason to contemplate further challenges to any user charges whilst the Arrangements recorded herein are working satisfactorily to the BAA and the Airlines.

2. ….

3. The provisions of the Settlement Agreement shall in all respects be governed by English law.

4. ….

5. The Memorandum of Understanding and Settlement Agreement will take effect when a Memorandum of Understanding has been entered into between [HMG] and [USG] which includes:-

(a) an acknowledgement that [USG] will not proceed to an arbitration with [HMG] under Bermuda 2 in relation to the fulfilment by [HMG] of its obligations under Articles 10 and 11 of Bermuda 2 in respect of the period up to and including 31 March 1983;

(b) a statement as to the policy of the Secretary of State in relation to the borrowing of the BAA which both Governments are content to have recorded in the said Memorandum.

3.8. Paragraph 5, to which reference has just been made, was included in the Airlines Settlement Agreement at the instance of HMG which, of course, did not wish to find that it had settled the airlines litigation only to be confronted with arbitration under Bermuda 2. That possibility was avoided when, on April 6, 1983, some six weeks after the making of the Airlines Settlement Agreement, representatives of USG and HMG signed a Memorandum of Understanding in Washington ("the intergovernmental

Memorandum of Understanding" or "MoU"). A copy of the MoU in its entirety is to be found in **Appendix IV** to this Award.

3.9. As foreshadowed in paragraph 1(3)(b)(iii) of the "Settlement Agreement" section of the Airlines Settlement Agreement, the user charges introduced by BAA for the year commencing April 1, 1983 were substantially the same as those that had been proposed in the course of the prior consultations and BAA continued, in that year, to identify and account for the security charge separately.

3.10. On April 18, 1983, the U.K. Secretary of State for Trade wrote to the Chairman of BAA; the Secretary of State welcomed the steps that BAA had taken to adjust the structure of its traffic charges, particularly at the South East Airports (namely, Heathrow, Gatwick and Stansted) to reflect more closely the structure of costs incurred; he expressed concern about BAA's decision to recover security costs by a uniform charge at BAA's Scottish and South East Airports respectively; and, pursuant to paragraph 5 of the intergovernmental MoU, he *commended* to BAA the last three of the four views expressed by USG about the structure of charges at Heathrow, as recorded in that paragraph and *drew to BAA's attention* all of USG's views; the Secretary of State asked BAA to ensure that those views were fully taken into account in the collaborative review of its charging policy that it was about to undertake with its airline customers.

3.11. As appears more fully from Chapter 6 of this Award, below, following the 1983 settlement, BAA embarked on a review of the structure of its user charges and made further changes in them, in particular at Heathrow, in following years.

IV. Subsequent diplomatic demarches

4.1. The subsequent history of the diplomatic demarches leading up to the present Arbitration may be summarised as follows. On April 13, 1984, the U.S. Deputy Assistant Secretary for Transportation and Telecommunications sent a letter to the U.K. Department of Transport, which had by then become the responsible U.K. government department, referring to the intergovernmental MoU and to the Airlines Settlement Agreement, and expressing his pleasure that the situation had improved. Nevertheless, he expressed continuing concern with respect to the issue of peak charges and consultative arrangements between the airlines and BAA. He enclosed a letter from PanAm and TWA to BAA, dated March 8, 1984, expressing their concerns, and he requested HMG's opinion on that letter, and an indication of HMG's plans for future implementation of the MoU.

4.2. In his answer, the Under-Secretary, International Aviation Directorate of the Department of Transport stated that he had some difficulty in understanding the airlines' allegation that BAA had neither sought to discuss airline comments nor satisfactorily explained its 1984 charges, since the letter from PanAm and TWA enclosed with USG's letter was precisely a

response to BAA memoranda on such matters. He stated that he was satisfied that BAA was meeting its obligations under the Airlines Settlement Agreement. As to the peak charges, he stated that, if the progress with the review of those charges had been slower than the U.S. carriers had expected, that might be due in part to the fundamentally different views about the economic principles on which BAA's charges were based (PanAm and TWA espoused "accounting costs", whereas BAA espoused "economic costs", as a basis for the charging structure). Nevertheless, he stated that the BAA had made some changes, in particular regarding the weight-related element of the charges, and that HMG would continue to monitor the consultative arrangements closely.

4.3. In a diplomatic note of January 2, 1986[1], USG expressed its concern that the terms of the intergovernmental MoU had not yet been fully implemented, in particular in relation to the issues of peak pricing and meaningful consultations between BAA and the airlines. HMG's intention to privatize BAA had by then been announced and USG further emphasized its wish that, in the privatization, the terms of the Airlines Settlement Agreement should be maintained.

4.4. On February 14, 1986, with further reference to the impending privatization of BAA, USG sent a diplomatic note to HMG, in which it expressed its general support for the private sector, provided that enterprises operated in a competitive environment or that, in the absence of true competition, adequate regulatory safeguards existed. USG expressed its concern that the safeguards provided for by the Airports Bill were focused on remedial action, rather than on prohibiting abuse in the first place. USG referred to, and questioned, several provisions contained in the Bill. It stated that the central issue was whether the Bill provided adequate means for ensuring that the obligations arising from the MoU would be maintained. USG therefore requested confirmation that the U.K. Civil Aviation Authority ("the CAA") could and would enforce such obligations. USG also referred to the provisions of Clause 38(3) of the Bill, which seemed to permit an airport operator, during an investigation by the Monopolies and Mergers Commission ("the MMC"), to continue conduct that had been found objectionable by the CAA. USG inquired whether HMG's international obligations would be considered by the MMC as part of such an investigation and whether private airport operators would be obliged to consult with users in setting charges as required by Bermuda 2 and the settlement agreement.

4.5. In a diplomatic note to USG, dated March 7, 1986, HMG referred to bilateral air services consultations between British and U.S. officials, which had taken place in London on February 24-28, 1986. It confirmed that the present facility for consultation between BAA and its users would continue:

[1] HMG has no evidence of ever having received this note.

the Airports Bill would extend the provisions for consultation then contained in Section 25 of the Civil Aviation Act 1982 and would provide that the CAA should perform its duties taking into account HMG's international obligations and that the MMC should be guided by the CAA's objectives. In addition, the London Airports would be subject to two tiers of economic regulation: first, a 5-yearly limit on the level of charges, and secondly, the CAA's power to impose conditions on airport operators in order to prevent or remedy objectionable conduct on their part.

4.6. The 5-yearly limit, established by the Airports Act 1986, on BAA's user charges operated by means of an RPI-X régime. Under that régime, which is discussed more fully later in this Award, the average user charge, expressed per passenger, is not allowed to rise by more than the increase in the U.K. Retail Price Index ("the RPI") minus X. On December 1, 1986, HMG announced that the value of X for the first quinquennium would be 1. In consequence, if, for example, the RPI were to rise by 5 per cent in a year, the maximum increase, permitted for that year, in the average user charge, expressed per passenger, both at the South East airports collectively and at Heathrow (and Gatwick) individually would be 4 per cent. The RPI-1 régime was to apply, and in fact applied, for the first time to user charges for the charging year 1987/88, even though, at the start of that year (April 1, 1987), BAA was still wholly owned by HMG.

4.7. Against that background USG, in a paper provided to HMG on January 13, 1987 and entitled "Talking Points", expressed its concern that, in particular at Heathrow, the existing level of charges bore little relation to actual costs, with allowance for a reasonable rate of return. As to structure, USG stated that existing practices at Heathrow did not meet the requirements of either Article 10 of Bermuda 2 or the intergovernmental MoU, including the allocation of costs and revenues between international and domestic services. Furthermore, the peak charges did not reflect objective costs obtained by generally accepted accounting principles.

4.8. Two days later, on January 15, 1987, PanAm and TWA publicly expressed their great dissatisfaction with the pricing régime at Heathrow and announced that, unless they were able to obtain speedy and satisfactory relief, they would feel compelled to seek "appropriate remedies". It was said that these could include resumption of litigation in the U.K. courts or a direct request to USG to seek consultation with HMG, leading to arbitration, as provided for in Bermuda 2.

4.9. It seems that representatives of the two Governments evidently met on February 17, 1987, and that the U.K. delegation then handed to the U.S. delegation a paper in which HMG gave its reasons for maintaining that BAA's user charges at the South East airports were not unreasonably high and that privatization and price regulation should ensure further increases in efficiency in the future. More specifically it argued that the RPI-1 formula would ensure that airlines would not only retain the benefits of the real reduction in average

charges that had taken place over the previous 5 years, but that, on average, they would enjoy further real reductions over the next 5 years.

4.10. As to allegations that had been made by PanAm and TWA, HMG stated that BAA's charges were low compared with other international airports, that its return on capital (on a CCA basis) was below the U.K. average, and that the charging level was necessary to allow new investment. HMG stated that in establishing the RPI-1 formula, future revenues and costs had been taken into account. Finally, HMG noted that if, in the out-turn, charges exceeded the limit, e.g. because inflation in the coming year had been overestimated, an obligation to make repayments, coupled with a penal rate of interest, would make up for this.

4.11. As to the structure of charges, HMG referred to a new safeguard introduced for dissatisfied airlines, namely the procedure for making complaints to the CAA. HMG contended that the present price formula was fully consistent with HMG international obligation, and that the value of "X" had been set taking into account all airport activities and thus applying the "one-till" principle.

4.12. On March 16, 1987, USG gave HMG a paper which indicated that USG, having evaluated the information that had been provided to it (probably in the course of the February working session), remained concerned about the regulatory mechanism for, as well as the level and structure of, user charges at Heathrow. In particular, USG expressed concern that the RPI-1 price-cap would permit BAA to raise average user charges per passenger even if costs, net of commercial income, per passenger had fallen. When, as appeared to be the case, trading profit per passenger at Heathrow exceeded the net expense per passenger, USG had to question whether the requirements of Article 10 of Bermuda 2 were being complied with, particularly when coupled with the 10 per cent. CCA rate of return for a monopoly provider cited in the information provided to USG by HMG. USG also found particularly troubling what it described as cross subsidization from the proceeds of peak charges at Heathrow of major capital developments at Gatwick and Stansted. USG further complained that the off-peak passenger charge at Heathrow was insufficient to cover the costs associated with operation of the airport during the off-peak period and that the peak itself did not cover all periods of comparable activity. In addition, if both arrivals and departures were considered, so as to provide a more complete picture of the terminal usage pattern, the period would, USG said, need to cover virtually all day-time hours. USG therefore proposed a widening of the peak, levying terminal charges on both arriving and departing passengers and reducing the level of peak charges to take account of their much wider application. Finally, USG stated that the calculation of the peak parking charge had never been satisfactorily explained and expressed concern about the sufficiency of the process of consultation by BAA airlines after BAA's privatization.

4.13. On March 31, 1987, HMG responded by offering a fresh review, to be undertaken by BAA covering the level and structure of parking charges, the definition of peak periods with particular reference to peak passengers and the possibility of introducing shoulder charges (i.e. charges intermediate between peak and off-peak charges).

4.14. In April 1987, as privatization of BAA drew close, the differences between USG and HMG were addressed at more senior levels of government. On April 8, 1987, the U.K. Secretary of State for Transport discussed the dispute with the U.S. Secretary of Transportation. It seems clear that as a result of their discussions, USG deferred a formal request for consultations under Bermuda 2 in order to avoid any potential negative repercussions on the privatization of BAA, which was due to take place, and took place, in July 1987. Additionally, HMG's earlier suggestion of a review appears to have been endorsed, subject to the Secretary of State telling BAA that he would be prepared to give it directions if that was necessary to ensure that HMG's international obligations were fulfilled. The review in question was conducted for BAA by Coopers and Lybrand who reported in July 1987, more or less at the moment when BAA was privatized. The review is discussed in Chapter 6 of this Award, below. It is sufficient here to say that the review did not enable any of the outstanding matters in dispute to be resolved by agreement.

4.15. In August 1987 BAA made preliminary proposals for user charges for 1988/89. By letter dated October 8, 1987 USG, having studied the proposals, indicated to HMG that, absent significant modifications in the final proposal, user charges must again inevitably become a contentious issue between the governments. USG referred to its paper of March 16, 1987, referred to above, and indicated that it was looking for significant movement in the highlighted areas. The letter ended by emphasizing the gravity with which USG then viewed the situation and expressing the hope that when the parties met on October 20, the U.K. delegation would be able to report progress that would allay USG's concerns.

4.16. The discussions on October 20 failed to resolve the parties' differences and on October 30, 1987, USG made a request, pursuant to Article 16 of Bermuda 2, for formal consultations such as are required by Bermuda 2 as a precondition for arbitration under Article 17.

4.17. On November 19, 1987, HMG agreed to the requested consultation, whilst expressing itself to be satisfied that BAA's charges had been fully consistent with the principles referred to in Article 10 of Bermuda 2, as elaborated in the MoU. At about the same time BAA circulated its airport charges proposals for 1988/89 as part of the process of consulting airlines.

4.18. On January 5, 1988 the U.S. Secretary of Transportation wrote to the U.K. Secretary of State for Transport stating that USG was very concerned by the failure of BAA to propose significant change to the Heathrow charges for the 1988/89 charging year. USG had been responsive and sensitive to British concerns about privatization; now that the formal consultation

procedure under Bermuda 2 was to take place (on 7 and 8 January), the Secretary of Transportation was looking to the Secretary of State to ensure that what USG regarded as HMG's commitment for reform was fulfilled.

4.19. Neither the meetings on January 7 and 8 nor subsequent proposals and counter-proposals resolved the differences between the parties. On March 4, 1988, the U.K. Foreign Secretary sent a message to the U.S. Deputy Secretary of State expressing the hope that (contrary to indications to the contrary given by USG at the meetings in January), USG was not contemplating retaliatory action and expressing the view that a continuation of the dispute would have serious consequences for the Parties' aviation relationship and that that would have a further impact on their political relationship; HMG had used its best efforts to find a solution to the dispute in full accordance with its obligations. "If however the United States believes that [HMG is] in breach of the Bermuda 2 Agreement" the Foreign Secretary continued, "then the remedy lies therein, in other words in arbitration."

4.20. Nevertheless efforts to find a negotiated solution continued, including debates between economists appointed by each of the Governments, but to no avail. The charges actually introduced by BAA for the charging year 1988/89 differed from those proposed by further reducing the parking charge and further increasing the peak runway charge. Those changes, together with the action taken on the various issues that the Parties had agreed BAA should review during 1987, represented, in the view of HMG communicated to USG on March 21, 1988, substantial changes to the benefit of U.S. airlines.

4.21. USG did not agree with that view; and under cover of a letter dated June 28, 1988 the U.S. Secretary of Transportation sent to the U.S. Secretary of State, as required by Section 11 of the U.S. International Aviation Facilities Act, a report in which the Secretary of Transportation had determined that charges imposed by BAA on U.S. airlines at Heathrow unreasonably exceeded comparable charges for furnishing airport property in the United States and were otherwise discriminatory in that they violated the requirements of Article 10 of Bermuda 2. Pursuant to the statute, the letter continued, the next step was for the Department of State, through negotiations to urge HMG to eliminate the inconsistencies between the requirements of HMG's bilateral obligations and the structure and level of charges at Heathrow. Failing a satisfactory response from HMG, the Secretary of Transportation indicated his intention to impose an "offsetting charge" of $1550 on British airlines for each scheduled roundtrip transatlantic combination flight that they operated to the United States.

4.22. The report that accompanied the Secretary of Transportation's letter maintained that -

- the per passenger trading profit at Heathrow exceeded net costs per passenger by 100 per cent. and had increased by over 20 per cent. from 1982 to 1986;

- BAA's accounting rate of return overall and at Heathrow was excessive in that it exceeded specified U.K. industrial averages notwithstanding the relatively low risk attached to BAA's operations;
- the differential between domestic and international terminal charges was greater than could be justified and was, in effect, discriminatory;
- the RPI-1 price-cap régime left BAA free to increase the average user charge per passenger even if the average cost per passenger, net of commercial income, had increased by a lesser amount or not at all;
- peak periods were wrongly and inconsistently defined;
- the use of average revenue yield from user charges rather than of user charges themselves for the purposes of applying the RPI-1 price-cap régime was inconsistent with sound economic principles since it prevented users from benefiting to the full extent if they shifted from peak to non-peak periods;
- use by BAA of Current Cost Accounting standards was inappropriate in assessing BAA's rates of return;
- Current Cost Accounting standards could not now be considered to accord with generally accepted accounting practices in the U.K. and their use was therefore impermissible for the purposes of Bermuda 2;
- user charges at Heathrow for typical operations of a relevant kind significantly exceeded the corresponding charges at U.S. airports currently serving British airlines and the disparity, when considered in conjunction with the analysis of the relationship of Heathrow charges, revenues and costs, was *prima facie* evidence of charges exceeding costs at Heathrow.

4.23. In subsequent diplomatic contacts, HMG indicated that retaliatory action of the sort proposed by the U.S. Secretary of Transportation would prompt "an equal and appropriate" U.K. response. At consultations held on July 19 and 20, 1988, it was agreed that there were differences of substance between the two Governments which were unlikely to be resolved to the satisfaction of the Parties by further consultations under Bermuda 2. On July 20, 1988, HMG drew USG's attention to the U.K. statutory procedure whereby the U.S. airlines could lodge a complaint with the U.K. CAA.

4.24. The joint HMG/USG Memorandum of the Consultations held on July 19 and 20, 1988, recorded USG's intention to consider what course of action to take, including the possibilities of imposing compensatory charges as a proportionate counter-measure and of arbitration. HMG said that it considered the imposition of charges inappropriate and unacceptable and that, if USG insisted on taking action, the appropriate means of settling the dispute was to make use of the arbitration procedures in Article 17 of Bermuda 2.

4.25. On December 16, USG duly made a formal request that the dispute be submitted to arbitration in accordance with those procedures. On December 22, 1988, HMG formally accepted the request for arbitration.

CHAPTER 3

THE ALLEGED FAILURE TO EXHAUST DOMESTIC REMEDIES

I. General arguments of the Parties

The general arguments advanced by HMG *for the applicability of the local remedies rule*

1.1 HMG pleaded that USG's claims were inadmissible since PanAm and TWA had not exhausted the remedies available to them under English law for the redress of their grievances. The following points were made in support of that contention.

1.2 A distinction was to be drawn between, on the one hand, cases of direct injury to another State and, on the other hand, cases of diplomatic protection, in which the interests of a national of the claimant State were affected and the legal interest of the claimant State was derivative. In cases of the latter kind, the long-established rule requiring the exhaustion of domestic remedies applied. The International Court of Justice had explained the rationale for the rule as follows:

> "before resort may be had to an international court in such a situation, it has been considered necessary that the State where the violation occurred should have an opportunity to redress it by its own means, within the framework of its own legal system"

Switzerland v. United States of America (preliminary objections), 1959 I.C.J. Rep. 6, 27 [hereinafter referred to as "*Interhandel"*].

1.3 Although claims that were restricted to requests for declaratory relief might escape the application of that rule, the inclusion of a claim for damages would bring the rule into operation (*Elettronica Sicula S.p.a. (ELSI*), Judgment, 1989 I.C.J. Rep. 15, 50-51 (hereinafter referred to as "*ELSI*"). In the present case, USG's claim in respect of Article 10(1)-(3) of Bermuda 2 initially comprised exclusively a claim to damages, the damages being quantified by reference to the injury alleged to have been suffered by the U.S.-designated airlines; the position was not altered by USG's later reformulation of its claim as a request for a declaration that it was entitled to compensation.

1.4 Although USG had claimed to be representing its own interests and to be seeking compensation for its own injuries, it had admitted that in reality its claim was made in exercise of its right of diplomatic protection when it stated:

> "The provisions of Bermuda 2 and the MoU at issue in the present arbitration do not bear directly on the financial interests of either the United States or the United Kingdom. Rather,

> they are aimed at the protection of each country's designated carriers in their dealings with the other country's airport authorities."

1.5 In the context of the present Arbitration and in the light of the very specific submissions made in USG's First Memorandum, it was not possible for the Tribunal to find a dispute over alleged violation of Bermuda 2 resulting in direct injury to USG, being a dispute that was both distinct from, and independent of, the dispute over the alleged violation of rights of the U.S. airlines.

1.6 USG's claim to be asserting its own rights under Bermuda 2 was unconvincing and unsupported by authority. The type of relief sought had to be closely analyzed, by considering the object of the claim and not merely its formulation. (Meron, *The Incidence of the Rule of Exhaustion of Local Remedies*, 35 Brit. Y.B. Int'l L. 83, 87 (1959) (hereinafter referred to as Meron).) C.F. Amerasinghe, Local Remedies in International Law, 128-129 (1990) (hereinafter referred to as Amerasinghe) puts the matter as follows:

> "It is the 'real objects and interests' which are the essence of the injury committed or the right violated that govern the answer to the question whether local remedies should have been exhausted.
>
> "It is also the essence of the substantive right violated, as determined by the objects and interest promoted therein, that is of importance"

1.7 Applying these tests, the "real substance" of USG's claims was the demand for compensation for the U.S. airlines; the "real object" pursued by USG in negotiating Article 10 of Bermuda 2 was the protection of U.S. airlines from what it considered to be excessive and/or discriminatory user charges levied at airports outside the U.S., and it was the interests of the U.S. airlines that USG was thereby seeking to protect. USG had not claimed, and could not claim, direct monetary loss and *necessarily* had to measure compensation, as it did, by referring to the airlines' monetary loss.

1.8 The *Case concerning the Air Services Agreement of March 27, 1946, United States v. France*, 54 I.L.R. 304 (Dec. 9, 1978) (hereinafter referred to as "*Change-of-Gauge*"), on which USG relied, was distinguishable. In the present case, unlike the *Change-of-Gauge* case, (a) the arbitration clause had been unilaterally invoked by one of the parties; (b) the Tribunal had to decide not pure questions of law but mixed questions of law and fact; (c) a claim for compensation had been presented; and (d) nothing put in issue or affected, directly or indirectly, the *conduct* (emphasis in original) of air services under Bermuda 2, Article 10 being completely unrelated to the conduct of air services.

1.9 Although USG had sought to argue that it was the direct injury to the U.S. which predominated, it was the alleged injury to the U.S. airlines which colored and pervaded its claims.

The general arguments advanced by USG *against the applicability of the local remedies rule*

1.10 USG advanced the following general arguments in support of its contention that the rule requiring exhaustion of domestic remedies was not applicable in the present case.

1.11 USG had made "three essential requests" to the Tribunal, namely: (a) for a declaration as to the content of HMG's obligations; (b) for a declaration that HMG had violated those obligations during the Arbitration period and for specific guidance to enable the Parties to avoid disputes in the future; and (c) for compensation.

1.12 In the Arbitration USG was asserting its own rights under Bermuda 2 and was entitled to damages in its own right. The hallmark of diplomatic protection was the derivative nature of the interest of the espousing State, which in such a case "has no direct interest in the claim apart from the interest of its national whose cause is thus espoused" (Meron at 87- 88). In the present case the rights invoked existed only by virtue of a treaty and by their very nature ran only in favor of the State involved.

1.13 Designation of an airline was granted, and might be taken away, by its State and the "rights" of a designated airline under Bermuda 2 stood on a different footing from private rights of aliens *vis-â-vis* host governments that could provide the basis for derivative international claims. By designating airlines for the purposes of Bermuda 2, the U.S. had merely allowed them to serve as recipients of rights that continued to belong exclusively to the U.S. Even if a suit by the designated airlines might yield a result "equivalent" to vindication of USG's position before an international tribunal, such an argument could not sustain application of the local remedies rule, for the airlines could not claim in the domestic proceedings to represent the position of the U.S. The use by USG of those airlines' monetary loss as the measure of USG's damages could not transform its direct interest into a derivative one. The rights and remedies available under Bermuda 2 were those of the Contracting States and only they could enforce them.

1.14 In all the cases cited by HMG in which the local remedies rule had been applied, no independent injury to the State was present, but merely an injury to the State's interest in the enforcement of a rule concerning the treatment of its citizens as aliens abroad. Application of the rule in the present case would be contrary to justice and judicial efficiency and to the interests of both parties in the final settlement of the dispute. The U.S. had a direct and independent interest in the functioning of the air services system generally and this applied also to the future.

1.15 The present case was analogous in all important respects to *Change-of-Gauge*, in which the arbitral tribunal held that the fundamentally inter-State character of the rights conferred by an air services agreement precluded application of the local remedies rule. It had further observed that the

distinction between "cases of diplomatic protection" and "cases of direct injury" must turn "on the *juridical* character of the *legal relationship* between States which is invoked in support of the claim" (emphasis in original) and that the local remedies rule could apply only to an obligation "*concerning the treatment of aliens*" (emphasis added by USG). In *Change-of-Gauge*, the obligation imposed by an air services agreement had been held to fail all aspects of this test: first, because the right to conduct air services was "a right granted by one *government* to the other *government*" and the designated carriers themselves enjoyed no rights whatsoever under the agreement; and secondly, because the obligations at issue were not concerned with "the treatment of aliens" but with "*the conduct of air transport services*" (again original emphasis). HMG's argument that the present case could be distinguished from *Change-of-Gauge* on the ground that the provisions of Article 10 of Bermuda 2 concerned not the conduct of air services but the treatment of nationals (i.e. the designated airlines) was not valid: the provisions of the treaty formed a "bundle" and they had been negotiated and should be enforced together.

1.16 Even if USG's claims *included* claims on behalf of US airlines, the local remedies rule did not bar this arbitration: where, as here, the direct interest and injury of the U.S. predominated, the entire case should be retained and adjudicated: see Meron at 86; *The S.S. Wimbledon*, 1923 P.C.I.J. (Ser. A) No. 1 6-8, 33; *Costa Rica Packet*, discussed in J. Chappez, La Règle de l'Epuisement des Voies de Recours Internes 44-75 (1972).

II. Specific arguments of the Parties

Specific arguments advanced by USG *against the applicability of the local remedies rule*

2.1 USG contended further that for the following reasons HMG was in any event precluded from relying in the present case on the rule requiring exhaustion of domestic remedies.

2.2 The provision for consultations "*at any time*" contained in Article 16 of Bermuda 2 and the provision in Article 17 that if "*any* dispute" (emphasis added by USG) remained unresolved, it should be arbitrated at the request of either party were inconsistent with application of the rule.

2.3 HMG had agreed to arbitrate, first during consultations (when it in fact urged USG several times to follow this course) and secondly when the Tribunal's terms of reference were being drawn up. USG had made it clear from the beginning that its claims included a claim for compensation and it was on that basis that the parties had agreed to arbitrate. Moreover, reparation was an indispensable complement of a failure to apply a convention (see *Factory at Chorzow (Jurisdiction)*, Judgment No. 8, 1927 P.C.I.J., Ser. A. No. 9, 21; *British Property in the Spanish Zone of Morocco*, 2 R.I.A.A. 615, 641 (1925) (Huber J.); and *Restatement (Third) of the Foreign Relations Law of the United States*, para. 901 (1987)). USG had explained its intention to seek

compensation through one avenue or another (for example, by the threatened unilateral imposition of retaliatory user charges).

2.4 In January 1989, i.e. after the request by USG for arbitration had been made, HMG had expressly recognized that if the Tribunal found violation of the Treaty, USG could then present its claims for damages and it had agreed to arbitrate "all issues", knowing that USG's right to compensation was one of the issues.

2.5 HMG's denial of an agreement to arbitrate the question of compensation was in any event irrelevant since, following Decision No. 9 of the Tribunal, the present phase of the Arbitration was concerned only with the question whether HMG had fulfilled its obligations under Article 10 of Bermuda 2.

2.6 The first indication that HMG intended to plead a failure to exhaust domestic remedies came in HMG's First Memorandum and this was "simply too late": an estoppel may arise from silence when something ought to have been said (*ELSI*, 1989 I.C.J. Rep. at 44, para. 54).

2.7 HMG had referred to oral statements reportedly made by the then U.S. Deputy Assistant Secretary for Policy and International Affairs for Transportation at the Department of State, Mr. Jeffrey Shane, in January 1988 to the effect that "USG would only come government to government if the airlines had exhausted their means" and that "USG would not consider it appropriate to go to CAA [the Civil Aviation Authority] themselves, but would satisfy themselves that their airlines had used all the procedural opportunities to resolve their concerns first". In the view of USG, even if, which was denied, such statements were in fact made, "in all likelihood Mr. Shane was referring to the airline participation in the BAA review that was ongoing at that time"; it was implausible in the extreme to suppose that USG would not seek action from HMG or pursue its own remedies unless the U.S. airlines had exhausted their local remedies.

HMG's *counter-arguments to the specific arguments advanced by USG against the applicability of the local remedies rule*

2.8 HMG denied that it was precluded, either by reason of the terms of Bermuda 2 or by its own conduct, from relying on the rule requiring exhaustion of local remedies. In this connection HMG made the following points.

2.9 The exclusion of the rule required express words in a treaty and was not to be implied (*ELSI* 1989 I.C.J. Rep. at 42, para. 50).

2.10 HMG had not agreed to arbitrate all issues, including compensation: the record of the pre-arbitral consultations under Article 16 of Bermuda 2 did not support USG's contention that "compensation" was discussed at that time.

2.11 The record of the discussions on January 26, 1989, on procedural aspects of the Arbitration (which in any event took place after USG had invoked the arbitration clause) did not establish that HMG had waived any objection on the basis of non-exhaustion; it showed rather that HMG had contemplated an arbitration providing guidance for the future interpretation and application of Article 10 of Bermuda 2 and not one dealing with any remedy or relief.

2.12 HMG's agreement to the Tribunal's terms of reference without raising the issue of non-exhaustion did not operate as an estoppel, since it was only in USG's First Memorandum that it became clear that a claim for compensation was being made on behalf of the U.S. airlines.

2.13 Although silence might give rise to an estoppel in certain circumstances, the record of the consultations showed that USG was aware of the need to exhaust domestic remedies, the existence and availability of which had been drawn to its attention by HMG on several occasions.

2.14 Far from HMG's conduct at the consultation stage having estopped it from relying in the Arbitration on the exhaustion rule, Mr. Shane's statements, referred to at paragraph 2.1 above, acknowledged the need for the U.S. airlines to exhaust their local remedies.

III. The submissions of the Parties as to what local remedies were available in the U.K. to the U.S.-designated airlines and as to the adequacy of those remedies

3.1 *HMG* contended that the following remedial courses were open to the U.S.-designated airlines in the U.K.:

(a) resumption, subject to appropriate reformulation, of the 1980-1983 litigation, referred to at paragraph 3.1 et seq. of Chapter 2, above, which included a claim that BAA was a monopolist and that as such it had acted unlawfully at common law if it imposed excessive or unreasonable charges;

(b) a request to the Civil Aviation Authority that it should exercise its powers under section 41(2) of the Airports Act 1986 (read in conjunction with section 48 and with the Civil Aviation Authority (Economic Regulation of Airports) Regulations 1986) to impose conditions on BAA because of its adoption of improper practices of a kind described in section 41(3) of the 1986 Act;

(c) as regards the period after the privatization of BAA, a request to the Secretary of State to give an appropriate direction to BAA pursuant to section 30(3) of the Airports Act 1986 in order to discharge, or to facilitate the discharge of, the international obligations of the United Kingdom i.e. under Bermuda 2;

(d) an action for breach of BAA's duty under section 2(8) of the Airports Authority Act 1975 and subsequently under section 35 of the Civil Aviation Act 1982, as amended by the Airports Act 1986, being a duty to provide adequate facilities for consultations, which, according to HMG, included a duty to provide such information as might be necessary to permit an accurate review of proposed user charges.

3.2 In commenting on that contention, *USG* submitted that, for a local remedy to be relevant for the purposes of the local remedies rule:

(a) its existence must be proved by the party relying on the local remedies rule;

(b) it must address the merits of the issues in the arbitration;

(c) it must cover the same issues;

(d) it must cover all the issues;

(e) it must not compel additional issues to be raised;

(f) it must not be discretionary;

(g) it must lead to the same relief.

In support of that submission USG relied on, in particular, *Finland v.Great Britain (Claim of Finnish Shipowners*) 3 R.I.A.A., 1502 (1934), *Greece v. United Kingdom* (the *Ambatielos* case) 12 R.I.A.A., 118-119 (1956) and the *ELSI* case.

3.3 USG submitted that for a variety of reasons none of the local remedies relied on by HMG satisfied all of the necessary conditions and that, for that reason also, the local remedies rule was here inapplicable.

IV. The International Law Commission's draft Articles on State Responsibility

4.1 Both Parties referred to the draft Articles on State Responsibility, as provisionally adopted in first reading by the International Law Commission in 1977. Article 22 of those draft Articles requires the exhaustion of local remedies in relation to an "obligation of result" but not in relation to an "obligation of conduct". Neither Party made submissions as to the application of such a distinction in the present case.

V. The question whether the Tribunal should express any conclusion in relation to exhaustion in the present Award

5.1 Paragraph 3.16 of Chapter 1, above refers to the Tribunal's Minute of April 12, 1991, in which the Tribunal suggested that any argument on the exhaustion issue at the hearing that was to commence on July 2, 1991, should be confined to the effect, if any, of any non-exhaustion of any local remedies on the answer that the Tribunal should give to the first of the questions that its

Terms of Reference require it to answer (whether there has been a breach of the Treaty).

5.2 USG adhered to its view that no question of exhaustion could arise in relation to the first question and that the issue of exhaustion could therefore be wholly deferred until the stage when, if at all, the second question, of relief or remedies, came to be addressed, although USG left open the possibility of the Tribunal rejecting the objection of non-exhaustion of local remedies at the present stage.

5.3 By contrast, HMG was of the view that the question of exhaustion had to be addressed at this stage and that it would be legally wrong and practically inconvenient to defer consideration of the question of exhaustion until the second stage of the arbitration, assuming that that stage was reached.

VI. Exhaustion: the decision of the Tribunal in relation to the general arguments of the Parties

The appropriate stage for deciding the exhaustion issue

6.1 In the judgment of the Tribunal, the following reasons oblige it to consider at this stage whether HMG's plea of non-exhaustion of local remedies in itself precludes the Tribunal from answering in favor of the U.S. the first of the questions referred to it (whether the U.K. has committed any breach or breaches of Article 10 of Bermuda 2).

6.2 It would be legally inappropriate for the Tribunal to grant to USG declaratory relief if the local remedies rule is here applicable and has not been complied with, since in that event either USG's claim to a declaration would be inadmissible or an essential ingredient of USG's cause of action, on which its claim is based, would be absent.

6.3 To answer the first question (and to do so in favor of the U.S.) without prejudice to the application or otherwise of the local remedies rule would create serious doubts, pending delivery of a further Award, as to the legal status and effect of the first Award.

6.4 Considerations of convenience and the principle of economy of procedure militate against reserving the exhaustion issue, since if the Tribunal concludes that the local remedies rule precludes it from making a declaration on the first question in favor of USG, the present Award would end the proceedings.

The contents of the local remedies rule

6.5 The rule of exhaustion of domestic remedies is generally acknowledged as a customary rule of international law, has been codified in conventions such as the European Convention on Human Rights (Article 26) and has been recognized by international courts and tribunals: see, for example, the *Interhandel* case, where the International Court of Justice held

that a plea of non-exhaustion went not to the jurisdiction of the tribunal but to the admissibility of the claim.

6.6 There is wide support for the view that a distinction is to be drawn between cases of diplomatic protection, on the one hand, and cases of direct injury where the State is protecting its own interests, on the other hand, and that the applicability of the rule of exhaustion is excluded in cases in the second category: see, for example, the Opinion of Judge Read in the *Norwegian Loans* case, 1957 I.C.J. Rep. at 9; the Opinion of Judge Armand-Ugon in the *Interhandel* case, 1959 I.C.J. Rep. at 87-89; the *Change-of-Gauge* case, 54 I.L.R. at 324; and Amerasinghe at 112-113 (citing numerous authorities in support).

6.7 Where a claimant State expressly sues in right of diplomatic protection, an examination of the local remedies, if any, that were available to its national, whose cause it is espousing, is an inevitable element in the process of ascertaining whether the local remedies rule affords a defence to the defendant State. By contrast, where the claim made by the claimant State is one of direct injury and involves no injury to any of its nationals as such, it is possible to exclude the local remedies rule from consideration as a possible defence without there being any need to examine the availability or nature of local remedies, since the rule does not require a claimant *State* to have recourse to the domestic remedies available under the legal system of another State. An intermediate case, that has generated considerable commentary by learned writers, arises where the claimant State sues for breach of a treaty but the breach of the treaty in itself involves an injury to one or more of its nationals.

6.8 There is, moreover, less consensus on the definition of "direct injury". Thus, for example, Meron considers that the classification of a case depends on two main factors, namely the subject of the dispute and the nature of the claim; on the latter point, it is essential to determine the real interests of, and objects pursued by, the claimant State and to look to the true substance, rather than the formulation, of the claim: Meron at 86-90. Cançado Trindade likewise refers to the claimant State's "real interests and objects" as a test for classification: A.A. Cançado Trindade, the Application of the Rule of Exhaustion of Local Remedies 173 (1983). Amerasinghe, for his part, argues that it is necessary to determine "the nature of the injury or right violated" on which the claim is based: Amerasinghe at 128-130.

6.9 In its most recent decision concerning the exhaustion of local remedies, in the *ELSI* case (involving, like the present arbitration, an allegation of breach of treaty), the I.C.J. stated (1989 I.C.J. Rep. at 42-43, para. 51):

> "The Chamber, however, has not found it possible in the present case to find a dispute over alleged violation of the [Friendship, Commerce and Navigation Treaty between the United States and Italy] resulting in direct injury to the United States, that is both distinct from, and independent of, the dispute over the alleged violation in respect of Raytheon and Machlett [two U.S. companies that allegedly had been injured through acts that violated the Treaty]."

Thus, the most relevant consideration for the I.C.J. is whether or not the State's claim before the international adjudicatory body is distinct from and independent of that of its nationals.

Whether the local remedies rule is applicable, having regard to the general principles of international law

6.10 In determining whether or not USG's claim is to be regarded as "distinct and independent", in the sense contemplated by the I.C.J., the Tribunal has first examined the subject matter of the dispute.

6.11 In the present case the subject matter of the dispute is the alleged violation of a Treaty that creates rights and obligations between the two States concerned. The Treaty, Bermuda 2, governs the conduct of air services, a matter which is by its nature a State prerogative; furthermore, it was intended as a comprehensive code for the operation of such services, with the result that it must be seen as a whole, from which component parts, such as Article 10, cannot be severed. It is true that the Treaty contains references to designated airlines but it does not thereby confer independent rights on such airlines or alter the fact that the rights that it enshrines are those of the Contracting Parties. In all those respects, the situation obtaining in the present case is similar to the situation that obtained in the *Change-of-Gauge* case, 54 I.L.R. at 304, where the tribunal considered that the claim being pursued by the United States was direct and independent. What is more, the dispute is not confined to the past, it being in the interest of USG to obtain a solution which will also relate to the interpretation and application of Bermuda 2 in the future, at which time the identity of the designated airlines may have changed.

6.12 In paragraph 3.1 *et seq*. of Chapter 5, below, the Tribunal has come to the view that *the State's obligation to use its best efforts* to ensure that user charges are just and reasonable to those airlines is independent of actual prejudice to them. Nevertheless, because, as USG's damages claim shows, USG's claim is so intimately bound up with alleged prejudice to the U.S.-designated airlines, the Tribunal deems it prudent to test whether, even by asserting that there has been a breach of Bermuda 2, USG is really making a claim that the U.S.-designated airlines could have made for themselves. That test is to be made by comparing the claims of breach of the Treaty made in this Arbitration with any claims the U.S. airlines might have made for themselves in the U.K.

6.13 In this connection, the Tribunal observes at the outset that, whilst USG alleges breach of treaty, the U.S. airlines could not make such an allegation in domestic proceedings, Bermuda 2 not being incorporated into English law.

6.14 In so far as the proceedings brought by the U.S. airlines took the form of resumption of the 1980-1983 litigation, the principal ingredient of the claim would be that BAA was abusing a monopoly position by imposing excessive or otherwise unfair charges; and in so far as the procedure followed

by the U.S. airlines took the form of a request to the CAA to take action under section 41(2) of the Airports Act 1986, the taking by the CAA of remedial steps would depend on its being satisfied that the BAA had engaged in a course of conduct involving unreasonable discrimination or unfair exploitation of bargaining power. In either of those cases the procedure followed by the U.S. airlines would differ, not only as to persons but also as to substance, from a governmental claim that HMG had failed to use its best efforts to ensure that user charges comply with the specific requirements laid down by the last phrase of Article 10(1) and by Article 10(3) of Bermuda 2. Similarly, a claim by the airlines that BAA had not fulfilled its statutory duty to provide adequate facilities for consultation with respect to matters affecting the airlines' interests would be different, both as to parties and as to content, from USG's assertion in these proceedings that HMG has failed to encourage consultations between BAA and U.S. airlines using Heathrow.

6.15 On the other hand, a claim by the U.S. airlines, whether in the courts or in a request to the CAA, that BAA was imposing on them charges higher than those imposed on U.K.-designated airlines operating similar international services would be substantially the same as to content as a claim by USG against HMG that there had been a breach of the requirements of Article 10(2) of Bermuda 2 (which is mandatory: see Chapter 8, below), even though the parties would be different.

6.16 In connection with Article 10(5) of Bermuda 2 (provision of information), it is true that the U.S. airlines might allege that, inherent in BAA's statutory duty to consult, there was an obligation, owed by BAA to the airlines, that required BAA to supply to the airlines sufficient information to enable them to make relevant representations, at least to the extent necessary to ensure that the consultation process as a whole did not result in unfairness (*cf.* paragraphs 2.1.11 and 2.2.3-2.2.9 of Chapter 9, below). But again such a duty would not be coterminous, either as to the persons by whom and to whom it was owed or as to its contents, with the duty owed by HMG to USG under Article 10(5) of Bermuda 2, to use its best efforts to encourage, amongst others, BAA to exchange with, amongst others, the U.S.-designated airlines "such information as may be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in [Article 10 of Bermuda 21]".

6.17 There remains for consideration a possible request by the U.S. airlines to the Secretary of State that he give an appropriate direction to BAA, pursuant to section 30(3) of the Airports Act 1986, in order to discharge or facilitate the discharge of the international obligations of the U.K., i.e. under Bermuda 2. That power first became exercisable on September 8, 1986 (see section 85(4) of the 1986 Act), so that its existence cannot in any event provide a foundation for a plea of non-exhaustion of local remedies before that date. That important point apart, it appears to the Tribunal that such a request by the airlines would not be substantially different as to content from

the claim of breach of Treaty made by USG in the present Arbitration (as to which, see, however, paragraphs 6.37 *et seq.* of this Chapter, below).

6.18 Although examination of the nature of USG's claims and of the airlines' potential claims reveals that they overlap to a certain extent, at the same time they present significant differences; and taking the case as a whole and undivided into its constituent parts, the Tribunal is of the opinion that the predominant element is the direct interest of the U.S. itself. Thus, examination of the subject matter of the dispute as a whole indicates that, notwithstanding section 30(3) of the Airports Act 1986, USG's claim is properly to be regarded as distinct and independent.

6.19 Accordingly, application of the general principles of international law underlying the local remedies rule leads to the conclusion that it does not preclude the Tribunal from answering the first of the questions referred to it in the affirmative, if it would otherwise do so.

Whether the local remedies rule is applicable, having regard to the particular circumstances of the case

6.20 It would be sufficient for the Tribunal to dismiss the plea of non-exhaustion of local remedies, on the general grounds set out above. But in deference to the arguments of the parties and for the avoidance of doubt, the Tribunal believes that it is right that it should state its further conclusion that, even if the plea would otherwise be available to HMG, it is not available to it in the particular circumstances of the present case.

6.21 The Tribunal does not base that conclusion on the words of Bermuda 2 itself. It is true that Article 17 thereof provides without qualification that, if the parties do not by agreement refer an unresolved dispute for decision to some person or body, "the dispute shall at the request of either Contracting Party be submitted to arbitration in accordance with the procedures set forth below." However, in the judgment of the Tribunal, the mere use of that formula as such does not exclude the application, in a subsequent arbitration, of the rule requiring exhaustion of local remedies, if that rule would otherwise apply. As the I.C.J., stated in the *ELSI* case, referring to the rule of exhaustion of local remedies:

> ".... the Chamber finds itself unable to accept that an important principle of customary international law should be held to have been tacitly dispensed with, in the absence of any words making clear an intention to do so"
> I.C.J. Rep. at 42.

6.22 The Tribunal's conclusion that the plea of non-exhaustion is not available to HMG in the particular circumstances of this case is based on the conduct of HMG prior to the making by USG of its request for arbitration and on the probable ineffectiveness of any remedy under section 30(3) of the Airports Act 1986 (see section 6.17 of this Chapter, above).

6.23 The relevant history begins with a written message sent on March 4, 1988, from the British Foreign Secretary, Sir Geoffrey Howe, to the U.S.

Deputy Secretary of State, Mr. John C. Whitehead. In the judgment of the Tribunal the message is of considerable legal significance. It opened with Sir Geoffrey "[underlining] the strength of [the U.K.'s] view and [it's] wish for a political solution". Sir Geoffrey then referred to the U.K.'s "latest proposals", with which the Tribunal is not concerned, and ended in the following terms:

> "I hope in particular that you are not contemplating any retaliatory action. ... A continuation of the dispute would have serious consequences for our aviation relationship, which we thought we had stabilised a year ago. This in itself would have a further impact on our political relationship.
>
> "HMG has used its best efforts to find a solution to this dispute in full accordance with our international obligations. If, however, the United States believes that we are in breach of the Bermuda 2 Agreement, then the remedy lies therein, in other words in arbitration."

6.24 The Tribunal considers that it would be incompatible with Sir Geoffrey's message if the local remedies rule were to be applied, in the Arbitration that is in fact taking place, so as to leave the dispute continuing, with the risk of the feared serious consequences for the Parties' aviation and political relationship to which he referred. USG was entitled to rely on his message as showing that a request by it for arbitration would lead to proceedings culminating in an award that would be at least declaratory of the substantive rights of the parties. In the Tribunal's judgment, nothing that happened between March 4, 1988, and USG's request for arbitration under Bermuda 2 on December 16, 1988, alters that conclusion.

6.25 Sir Geoffrey's expression of anxiety about the possibility of USG contemplating retaliatory action proved to be prescient since by mid summer 1988 the U.S. Secretary of Transportation had prepared a report for the purposes of section 11 of the U.S. International Aviation Facilities Act. In that report he determined that charges imposed by BAA upon U.S. airlines at Heathrow "unreasonably [exceeded] comparable charges for furnishing airport property and [were] otherwise discriminatory in that they [violated] the requirements of Article 10 of [Bermuda 2]". The Secretary of Transportation proposed that, if HMG were to "fail to respond satisfactorily", he would then make "a formal determination of an appropriate level of offsetting charges to be imposed on British Airlines serving the U.S."; he indicated his provisional conclusion that such offsetting charges should be set at a level of $1550 for each round trip transatlantic combination flight flown by British airlines to the United States. The Secretary of Transportation transmitted his report to the U.S. Secretary of State under cover of a letter dated June 28, 1988.

6.26 On June 30, 1988 the U.S. Embassy in London delivered to the U.K. Foreign and Commonwealth Office a diplomatic Note. The Note included a request, pursuant to Article 16 of Bermuda 2, for formal consultations with HMG in order to resolve the dispute under Bermuda 2 with respect to the airport user charges imposed on U.S. carriers by BAA and thereby, if possible, "to avert the need for recourse to other procedures, including the procedures of Article 17 of the Agreement."

6.27 The report of the Secretary of Transportation must have been speedily transmitted to HMG since, under cover of a letter dated July 8, 1988, the British Embassy in Washington sent to the U.S. State Department a commentary on the report prepared by BAA.

6.28 On July 14, 1988 the Maritime, Aviation and Environment Department of the U.K. Foreign and Commonwealth Office delivered a diplomatic Note to the U.S. Embassy in London. The Note referred to the Embassy's Note of June 30, 1988, and stated:-

> "The British Government sincerely hope that the matter can be resolved through consultations, and have endeavoured thus to resolve it over the years. If this is, however, not possible the British Government are, as has been made plain on several occasions, ready for the dispute to be submitted to arbitration. If, therefore, the United States Government remain dissatisfied with the result of formal consultations the British Government would propose that the two Governments refer the dispute to arbitration in accordance with the procedure already established in Article 17, paragraph 2, of the Agreement."

6.29 The Note continued that HMG had learnt with deep concern of the determination by the Secretary of Transportation that the user charges in question were contrary to Bermuda 2 and of his proposal to impose surcharges "at the very time that the two Governments were seeking to resolve the dispute in good faith, in accordance with the procedures established by the Agreement." The substance of the Note concluded as follows:-

> "The British Government nevertheless assumes that no unilateral measures will be taken pending the outcome of the formal consultations or arbitration. But should this not be the case the British Government reserves the right to take all such measures as it is entitled to in accordance with international law in response to such a breach of its rights under the Agreement, including measures to recover from the United States airlines concerned any off-setting charges which may be imposed on British airlines.
>
> "The British Government agrees that the formal consultations should take place in London on 19 and 20 July 1988."

6.30 At the end of the formal consultations a jointly prepared Memorandum recorded that the consultations had confirmed that there remained differences of substance between the parties. The U.S. delegation indicated that USG would consider what course of action to take, including the possibilities of imposing compensatory charges as a proportionate counter-measure and of arbitration. The U.K. delegation maintained that the imposition of offsetting charges on British airlines would be inappropriate and unacceptable: HMG was not in breach of Bermuda 2 and the imposition of such charges by USG would contravene not only that Agreement but also Article 15 of the Chicago Convention. The U.K. delegation stated that HMG's intention would be to respond to any such action with proportionate counter-measures in the form of offsetting charges on the U.S. airlines concerned. It is also noted that the U.S. airlines concerned had not made use of their opportunities to seek remedy under U.K. domestic legislation (recourse to the Civil Aviation Authority under the Airports Act 1986). In answer, the U.S. delegation, having essentially restated USG's position, added that having regard to Bermuda 2 and to the intergovernmental Memorandum of

Understanding, USG "viewed the matter as one to be resolved on an intergovernmental basis."

6.31 The Memorandum then records that:

> "The United Kingdom delegation emphasized that the appropriate means of settling disputes of this nature was to make use of the arbitration procedures in Article 17 of the U.K./U.S. Air Services Agreement. The United Kingdom Government was ready for the dispute to be submitted to arbitration and would be prepared to agree terms with the United States Government at any time. The United States delegation indicated that it had hoped to resolve this dispute through consultations, and was not in a position to discuss arbitration at this time."

The Memorandum concludes by recording that assurances were requested and given to the effect that USG would not impose offsetting charges without giving HMG a further opportunity to make representations to it.

6.32 As already noted, USG formally requested arbitration pursuant to Article 17 of Bermuda 2 on December 16, 1988, and on December 22, 1988, HMG "accepted", without qualification, the request for arbitration.

6.33 In the judgment of the Tribunal, HMG's words and conduct, commencing with the message of March 4, 1988, from the British Foreign Secretary and including what the U.K. delegation is formally recorded as having said at the conclusion of the formal consultations on July 20, 1988, are inconsistent with the raising by HMG, in the present Arbitration, of a plea of non-exhaustion of local remedies as a bar to the Tribunal answering the first of the questions referred to it in the affirmative, if the Tribunal would otherwise do so.

6.34 In particular, the statement made by the U.K. delegation at the conclusion of the formal consultations, that the U.S. airlines had not made use of their opportunity to seek local remedies was a statement of fact. It did not indicate that, despite what the British Foreign Secretary had said in March 1988, by July 1988 HMG regarded exhaustion of local remedies as a condition precedent to an arbitration that would lead to a declaration of the Parties' rights.

6.35 The Tribunal is also of the view that whether or not, prior to December 16, 1988, USG had in fact relied on HMG's words and conduct as showing that a request by USG for arbitration would lead to arbitral proceedings culminating in an award that would be at least declaratory of the substantive rights of the parties, USG did so rely on HMG's words and conduct when it made its request for arbitration on December 16, 1988.

6.36 In these circumstances, the Tribunal finds it unnecessary to form any concluded view about what, if anything, was said about exhaustion of local remedies by Mr. Jeffrey Shane in January 1988 (see paragraph 2.7 of this Chapter, above). The statement anteceded the important message of March 4, 1988, from the British Foreign Secretary to the U.S. Deputy Secretary of State and there is nothing to suggest that that message is to be read in a qualified

fashion having regard to the reports of the earlier statement attributed to Mr. Shane. Secondly, even assuming that the reports accurately reflected what Mr. Shane said, his statement could not create a foundation for the application of the local remedies rule if no such foundation existed independently in international law. Thirdly, the statement attributed to Mr. Shane manifestly lacked the characteristics necessary to create an estoppel such as to prevent USG from disputing a plea of non-exhaustion by HMG and there is no evidence that HMG relied on the statement in taking or not taking any steps in relation to the dispute thereafter: indeed HMG's pleadings do not seek to contend that the statement formed the basis of an estoppel. For those reasons the question of what was said by Mr. Shane in January 1988 is irrelevant to the issue that is presently before the Tribunal.

6.37 Lastly, with regard to the relevance of the particular circumstances of this case to the applicability of the rule requiring exhaustion of local remedies, it is appropriate to refer to a further condition that must be satisfied if the local remedies rule is to preclude one State from obtaining a remedy in international law to which it would otherwise be entitled, and that condition is not here satisfied. The condition in question is that the local remedy relied on should be an effective remedy.

6.38 In the present case the Tribunal has had no difficulty in concluding that the remedy afforded by section 30(3) of the Airports Act 1986, referred to at paragraph 6.17 of this Chapter, above, cannot be regarded as an effective remedy.

6.39 In this connection the Tribunal first notes that section 30(3) does not create a complaints procedure, i.e. by giving to a person aggrieved *locus standi* to make a complaint such as the Secretary of State would have a legal duty even to consider.

6.40 Secondly, and related to the first point, the exercise of the power conferred on the Secretary of State by section 30(3) is discretionary. HMG submitted to the Tribunal that nevertheless the exercise by the Secretary of State of the discretion thus vested in him was capable of being subjected to judicial review if, for example, the Secretary of State's refusal to exercise the discretion was manifestly unreasonable in the sense that no reasonable person in the position of the Secretary of State, directing his mind to relevant considerations and not to irrelevant considerations, could have decided not to exercise the discretion. In answer to that submission USG contended that the English courts would be unable to engage in such a process in the circumstances of the present case since they would not review the question of what were the international obligations of the United Kingdom, *in casu* under Bermuda 2 and that whether or not there had been a breach of those obligations could be determined in only one forum, *in casu* this Tribunal.

6.41 In the judgment of the Tribunal USG's submissions on this question are correct. A relatively recent statement of English law, citing older authority,

is to be found in the judgment of Lord Denning MR in *Blackburn v. Attorney-General* [1971] 2 All E.R. 1380, 1382; [1971] 1 W.L.R. 1037, 1039:

> "Even if a treaty is signed, it is elementary that these courts take no notice of treaties as such. We take no notice of treaties until they are embodied in laws enacted by Parliament, and then only to the extent that Parliament tells us. That was settled in .... *Rustomjee v. Reginam* (1876) 2 QBD 69. Lord Coleridge CJ said:
>
> > 'She [i.e. the Queen] acted throughout the making of the treaty and in relation to each and every of its stipulations in her sovereign character, and by her own inherent authority; and, as in making the treaty, so in performing the treaty, she is beyond the control of municipal law, and her acts are not to be examined in her own Courts."

Reference may also here be made to Halsbury's Laws of England, 4th edition, volume 18, paragraphs 1413 and 1414.

6.42 Since therefore the English Courts could not interpret Bermuda 2 nor make findings as to its breach or potential breach, the English Courts could not assess the reasonableness or otherwise of a refusal by the Secretary of State to give directions to BAA under section 30(3) of the Airports Act 1986; and in the circumstances of the present case that would effectively preclude judicial review of such a refusal at the suit of the U.S. airlines.

6.43 It follows that, although it would undoubtedly have been open to the U.S. airlines to request the Secretary of State to exercise his powers under section 30(3) of the 1986 Act, they would have had no effective legal remedy if the Secretary of State had declined to exercise those powers. That being so, any "remedy" under section 30(3) would have been purely discretionary. It is conceded by HMG that, for the purposes of the exhaustion rule: "[The] remedies to be exhausted are those of a *legal* nature. Purely discretionary or *ex gratia* remedies do not require to be exhausted" (original emphasis), citing case law of the European Commission and Court of Human Rights. Citing further such case law, HMG also concedes and avers that "the exhaustion of a domestic remedy is ... not required if the applicant party can prove that in the particular circumstances such remedy will probably prove ineffectual or inadequate".

6.44 In the present case, even if, as HMG avers, the burden of proof on this issue is on USG, the Tribunal is satisfied that a request by the U.S. airlines to the Secretary of State that he exercise his powers under section 30(3) would very probably have proved ineffectual. The U.S. airlines had complained to HMG during the arbitration period that user charges at Heathrow did not satisfy the requirements laid down by Article 10 of Bermuda 2; USG had also done so and before finally resorting to arbitration had, as already noted, threatened countermeasures and gone through the consultation procedure prescribed by Bermuda 2. It would be unrealistic to suppose that, if the U.S. airlines had written formally to the Secretary of State requesting him to exercise his powers under section 30(3) of the Airports Act 1986, as HMG suggests that they ought to have done, the Secretary of State would have given more serious consideration than he may already have done to the possibility of his exercising the powers in question.

6.45 Accordingly the Tribunal concludes that section 30(3) of the Airports Act 1986 would not have provided an effective local remedy.

6.46 It follows from the foregoing that HMG's preliminary plea of non-exhaustion of local remedies, as precluding a finding of breach of the Treaty, is rejected.

CHAPTER 4

THE JURISDICTION OF THE TRIBUNAL IN RESPECT OF THE PERIOD FROM APRIL 1, 1983 TO MARCH 31, 1984

I. Arguments of the Parties

1.1 *HMG* contended that the Tribunal lacked jurisdiction to rule on the question whether HMG was in breach of its obligations under Article 10 of Bermuda 2 in respect of user charges levied in the period from April 1, 1983 to March 31, 1984 ("the user charges for 1983/84"). It relied for this purpose on paragraphs 1(2)(c) and 1(3)(b)(iii) of the Airlines Settlement Agreement (see paragraph 3.7 of Chapter 2, above) in which PanAm and TWA had undertaken not to bring proceedings, and not to urge or procure USG to make any claim against HMG under Bermuda 2, in respect of any of the user charges for 1983/84, provided in each case that the charges implemented for that year were substantially the same as those proposed to date in consultations. Since, in HMG's submission, that proviso was satisfied, the fact that USG had made a claim in respect of the user charges for 1983/84 had put PanAm and TWA in breach of their undertaking in paragraph 1(3)(b)(iii). Furthermore, by giving that undertaking, the two airlines had accepted that the proposed user charges for 1983/84 were just and reasonable and, since those charges had been implemented as proposed, it was not now open to USG to maintain the contrary.

1.2 In its written and oral arguments *USG* did not address HMG's contention. However, in a list of issues, dated April 7, 1991, and filed with the Tribunal (see paragraph 3.13 of Chapter 1, above), USG argued that the year 1983/84 was not excluded from the Tribunal's jurisdiction since (a) USG was not a party to the Airlines Settlement Agreement; (b) USG's right to pursue claims for 1983/84 and subsequent years had been reserved by the intergovernmental Memorandum of Understanding; and (c) the Tribunal's terms of reference encompassed the year 1983/84.

II. Decision of the Tribunal

2.1 The Tribunal observes at the outset that the fact that USG has raised, in the present Arbitration, complaints about the 1983/84 user charges does not of itself establish that PanAm and TWA broke their undertaking not to urge or

procure USG to take such a course. Nor does the fact that those airlines gave, in the Airlines Settlement Agreement, the undertaking which they did necessarily mean that they accepted that the charges in question were just and reasonable, for the undertaking might have been motivated by other considerations.

2.2 It is true that PanAm and TWA were obliged, under the Airlines Settlement Agreement, to inform USG of its terms and that that document did not take effect until the intergovernmental Memorandum of Understanding had been entered into. However, although USG was thus fully aware of the contents of the Airlines Settlement Agreement, USG was not a party to it; accordingly USG's right under Bermuda 2 to refer the question of the user charges imposed at Heathrow airport to arbitrations was in no way restricted by *that* Agreement. Paragraph 4(a) of the intergovernmental Memorandum of Understanding, on the other hand, did impose such restrictions on USG, but they related only to charges in respect of the period up to and including March 31, 1983. The Memorandum of Understanding did not exclude arbitration in respect of subsequent periods, in particular that running from April 1, 1983 to March 31, 1984; indeed, this is confirmed by the United Kingdom's internal commentary on the said paragraph 4(a), which states:

> "We had tried to include an extra year's grace, i.e. up to 31 March 1984 but this was strongly resisted. We were assured, however, that since the BAA charges for 1983/84 had already been announced, there was no danger of the issue being reopened until 1984".

The last phrase of the comment is ambiguous; but even assuming that it meant that USG had said that it saw no likelihood of its desiring to litigate the user charges for 1983/84 if they were such as had been proposed by BAA, USG had nevertheless made clear that it was not willing to give up its legal right to do so.

2.3 The Tribunal therefore concludes that it does not lack *jurisdiction* in respect of the 1983/84 user charges.

CHAPTER 5

QUESTIONS OF INTERPRETATION

I. Introduction

1.1 It is convenient to set out here, for immediate reference, paragraphs (1) - (3) of Article 10 which form the subject matter of the next following discussion.

> (1) Each Contracting Party shall use its best efforts to ensure that user charges imposed or permitted to be imposed by its competent charging authorities on the designated airlines of the other Contracting Party are just and reasonable. Such charges shall be considered just and reasonable if they are determined and

imposed in accordance with the principles set forth in paragraphs (2) and (3) of this Article, and if they are equitably apportioned among categories of users.

(2) Neither Contracting Party shall impose or permit to be imposed on the designated airlines of the other Contracting Party user charges higher than those imposed on its own designated airlines operating similar international air services.

(3) User charges may reflect, but shall not exceed, the full cost to the competent charging authorities of providing appropriate airport and air navigation facilities and services, and may provide for a reasonable rate of return on assets, after depreciation. In the provision of facilities and services, the competent authorities shall have regard to such factors as efficiency, economy, environmental impact and safety of operation. User charges shall be based on sound economic principles and on the generally accepted accounting practices within the territory of the appropriate Contracting Party.

1.2 The Tribunal will consider the issues that arise in the following order:

(i) the meaning of the expression “best efforts” in the context of paragraphs (1) - (3) and (5) of Article 10 of Bermuda 2;

(ii) the question whether the Parties’ obligations under Article 10(1) - (3) are exclusively “obligations of conduct” (to use their best efforts to ensure certain results) or whether they are, or are also to some extent, “obligations of result” (to ensure certain results);

(iii) the question whether the expression “if” in both the places where it occurs in the second sentence of Article 10(1) is to be understood as meaning “if and only if”, so that paragraphs (1)-(3) of Article 10 together exhaustively specify the principles that govern the characterization of user charges as “just and reasonable” or not “just and reasonable”;

(iv) whether, in ascertaining the existence or otherwise of a breach by HMG of its “best efforts” obligation, the Tribunal should start by considering whether the user charges at Heathrow were just and reasonable within the meaning of Article 10(1)-(3) or whether it should start by considering HMG’s efforts;

(v) the question of what user charges are referred to - the totality paid by an airline in user charges on an occasion of use of Heathrow or each element in the totality (the landing charge, the terminal charges and the parking charge);

(vi) the interpretation of the “equitable apportionment” condition contained in Article 10(1);

(vii) the interpretation of paragraph 10(4) (the obligation to encourage consultation); and,

(viii) the interpretation of Article 10(5) (the obligation to use best efforts to encourage provision of information).

1.3 Consideration of the interpretation of Article 10(2) is substantially deferred to Chapter 8 below. Some aspects of the interpretation of paragraph (3) of Article 10 are so intimately connected with the application of Article 10(1) - (3) that consideration of them and of their practical implications is deferred until the Tribunal comes to the application of Article 10(1) - (3).

II. "Best efforts"

(1) Arguments of the Parties

2.1.1 In the submission of USG, an obligation to "use best efforts" represented a substantial commitment, amounting in some circumstances virtually to an obligation to ensure that an act was performed. Both U.S. and English case-law showed that this phrase (and its corresponding English equivalent, "to use best endeavours") required all reasonable steps to be taken. In the present case it required HMG to do its best to achieve Article 10's stated goals.

2.1.2 Furthermore, USG maintained that a "best efforts" obligation was not satisfied, as HMG suggested, merely by establishing domestic administrative machinery by which those goals could be achieved. The issue here was not what domestic machinery existed, but what HMG did or did not do when USG complained of BAA's practices. Thus, if USG's complaints were justified, HMG could not be taken to have exercised its "best efforts" if it could have taken corrective action but, as had happened, did not.

2.1.3 HMG maintained that the obligation incumbent on it to use "best efforts" fell short of a guarantee that user charges would be just and reasonable. In HMG's view, the "best efforts" obligation imposed by Article 10(1) of Bermuda 2 was to be interpreted as requiring each Government to use its best endeavors to have, from its legislature, power to ensure that, where circumstances so required, steps could be taken *vis-à-vis* the competent charging authority to bring about user charges in accordance with Bermuda 2. It was also implicit in that obligation that each Government would use its best efforts to ensure that there was some form of machinery for prompting the taking of such steps in appropriate circumstances. However, without prescribed or objective guidelines as to how "best efforts" were to be measured, there was necessarily a certain margin of appreciation or discretion in the measures which a State might take in fulfilment of the obligation.

2.1.4 At the Tribunal's hearing on the merits of the case, HMG also raised, in relation to USG's plea that the U.K. administrative machinery had not been used when USG complained, what it termed the "threshold issue": since the complaints made by USG during the arbitration period

(a) were not the same as those made by it in the present proceedings and

(b) had anyway been admitted by USG before the Tribunal not to have been in accordance with sound economic principles,

USG had in fact never made a "relevant complaint" such as would have made it necessary for HMG to take steps in pursuance of its "best efforts" obligation.

2.1.5 It was common ground between HMG and USG that throughout the Arbitration period the necessary statutory power to bring about user charges in accordance with Bermuda 2 was in place in the U.K. In the pre-privatization period up to 1986/87, the Secretary of State with responsibility for aviation matters retained power to prescribe charges for the use of airports (Article 73 of the Air Navigation Order 1980 and Article 76 of the Air Navigation Order 1985); subsequently, the powers in force included that vested in the Secretary of State by section 30(3) of the Airports Act 1986, namely power to give directions to any airport operator if the Secretary of State considered such a course necessary or expedient in order "to discharge or facilitate the discharge of any international obligation of the U.K.".

2.1.6 There was one other matter relevant to the topic under consideration where the Parties did not appear to disagree. Shortly after Bermuda 2 had been drawn up, a British Government lawyer prepared a note, for restricted circulation, which discussed the various provisions of Bermuda 2. The note was disclosed by HMG to USG in the course of discovery of documents for the purposes of the Arbitration and USG referred to, and made use of, the note in its First Memorandum. Commenting on Article 10 of the Treaty, the note contains the following passage:

> "Points of special interest are:
>
> "'*Each Contracting Party shall use its best efforts ...*' The general requirement of 'just and reasonable' user charges is no more than a 'best efforts' provision. This recognizes the constitutional difficulty in the U.S., and the policy objection in the U.K. to the imposition of user charges by central government."

Neither Party disputed the correctness of the view expressed in that passage of the note in question.

(2) "Best efforts": findings of the Tribunal

2.2.1 It is clear to the Tribunal that the "best efforts" obligation incumbent on HMG under Article 10(1) of Bermuda 2 cannot be regarded as a promise or guarantee on HMG's part that user charges will in fact be "just and reasonable". Had that been the intention, the words "use its best efforts to" would simply have been superfluous.

2.2.2 On the other hand, the Tribunal cannot subscribe to HMG's view that the "best efforts" obligation is satisfied solely by the existence of a statutory power to take steps to regulate charges and of machinery to prompt the taking of such steps. Such an interpretation, with its overtones of passivity, would not be consistent with the continuous duty to take active steps which the Tribunal sees as flowing from the words "use" and "ensure". Nor is the Tribunal persuaded by HMG's contention, advanced in the context of the "threshold issue", that HMG's obligation to exercise its "best efforts" arose only in the event of receipt of a complaint and did not arise even if complaints

had been made but, as HMG claims, those complaints had been formulated in an unsustainable manner. In the view of the Tribunal, there is nothing in the actual text of Article 10(1) to support HMG's contention to that effect.

2.2.3 Thus, in the judgment of the Tribunal, Article 10(1) and (3) of Bermuda 2 imposes an obligation on the Parties that goes further than requiring them to use their best efforts to have user charges revoked if and to the extent that they are unjust and unreasonable to the designated airlines of the other Party; even more so, it goes further than merely requiring them to ensure that well-founded complaints to that effect are duly remedied: Article 10(1) and (3), on its plain words, creates an obligation that operates even prior to such a situation arising in that it requires the Parties to use their best efforts to ensure that such a situation shall *not* arise.

2.2.4 The Tribunal thus largely agrees with USG's view that Article 10(1) places the Parties under a continuous duty to do their best to ensure that the goals of that provision are attained. That is, however, not an absolute duty, since a Party may be able to point to good reasons that explain why, if the charges imposed on the designated airlines of the other Party were not just and reasonable, that was not due to any lack of required effort on its part.

2.2.5 One such reason would be that, on account of constitutional or other legal constraints, the Party did not possess and could not obtain the necessary statutory powers. However, the fact that a Party possessed all necessary *legal* powers would not have the consequence that a best efforts obligation would lose its character as an obligation of conduct and would necessarily be an obligation of result (as to which, see further paragraphs 2.2.6-2.2.8 of this Chapter, below). On the other hand, if HMG had all necessary legal powers, that fact may require to be taken into consideration in determining whether the obligation of conduct has been complied with.

2.2.6 With regard to the conduct required by the obligation, in the view of the Tribunal a Party is entitled to recognise the normal margin of appreciation enjoyed by charging authorities in relation to the complex economic situation that is relevant to the establishment of charges. But, subject thereto, the Party is obliged to use as much effort as it would if it had an unconditional interest of its own in ensuring that relevant user charges did not exceed what was just and reasonable (e.g. because the Party itself was going to have to meet the cost of the charges): if a Party uses less effort than it would then have used, it cannot claim to have used its best efforts.

2.2.7 A corollary of the foregoing is that the "best efforts" obligation does not require the taking of steps which a reasonable government in the position of the Party would reasonably have believed to be unnecessary in order to ensure that the user charges imposed on the designated airlines of the other Party did not exceed just and reasonable charges. So, for example, HMG could not justifiably be reproached for having failed to use its best efforts to ensure that user charges at Heathrow were just and reasonable, if and to the extent that any unreasonableness of the charges was dependent on facts which

a person with a personal financial interest could not reasonably have been expected to know or to find out.

2.2.8 Similarly, the nature of airport operation is such that the review and modification of user charges may take time. Accordingly, the expression "best efforts" must be read as allowing a Party a reasonable amount of time in which to bring into effect any necessary corrections or adjustments to user charges.

2.2.9 On the other hand, a Party could not excuse a failure on its part to use its best efforts as required by Article 10 of Bermuda 2 on the ground that it was inexpedient to take the required steps or that normal political considerations made it inadvisable for it to do so. In this sense, Bermuda 2 constitutes a significant relinquishment by the two Parties of their right to exercise their normal sovereign powers within their own territory, without reference to the other, so far as the relevant conduct of operators of relevant airports is concerned.

2.2.10 It is also to be observed that if a Party misinterprets Article 10(1) - (3) of Bermuda 2 and for that reason deploys its efforts to a wrong end, then no matter the fact that it acted in the best of faith and no matter that it acted with the greatest energy, it will have failed to discharge its obligations under Article 10(1) - (3) because its best efforts will not have been deployed to the ends laid down by Article 10(1) - (3) on their proper interpretation. The degree of effort required to constitute "best efforts" must in the last resort be a question for determination by an arbitral tribunal established under Article 17 of Bermuda 2 and cannot be left for determination by the Party itself or by a national body of that Party, no matter that the Party believed in good faith that no more was required of it. A Party's "best efforts" may therefore be morally irreproachable but legally defective or insufficient.

III. Whether Article 10(1)-(3) creates entirely obligations of conduct or also obligations of result

3.1 The Tribunal passes next to the question whether paragraphs (1), (2) and (3) of Article 10 create obligations of conduct or obligations of result. In relation to this issue, (as also in relation to the next question of interpretation to be considered at paragraphs 4.1.1 *et seq* of this Chapter, below) it is extremely difficult to interpret Article 10(1) - (3) of Bermuda 2 with due regard to the words used therein but so as to achieve a result that appears sensible. But the Tribunal believes that what follows makes sense of the provisions without doing violence to the words used or arriving at a result incompatible with the Parties' use of those words.

3.2 The Tribunal's approach to this question is colored by three facts:

(a) the very first words of Article 10 are that "Each Contracting Party shall use its best efforts ...";

(b) the Parties' intention, as evidenced by the prominent use of those words and by the almost contemporary note prepared by the British Government lawyer referred to at paragraph 2.1.6 of this Chapter, above; was that the general requirement of "just and reasonable" user charges should be no more than a "best efforts" provision; and

(c) at any rate so far as paragraphs (1) and (3) of Article 10 are concerned, the matter was argued before the Tribunal by both Parties on the basis that the obligation imposed was a "best efforts" obligation.

Having regard to those facts, any interpretation that relegated "best efforts" to minimal significance would be odd, not to say perverse. And an interpretation that treated *both* paragraphs (2) and (3) of Article 10 as imposing on the Parties obligations of result, rather than obligations of conduct, *would* relegate "best efforts" to *minimal* practical significance.

3.3 Thus, if paragraphs (2) and (3) of Article 10 were interpreted as requiring that user charges in each Party's territory should conform to the requirements of those paragraphs, any non-conformity with those paragraphs would itself constitute a breach of the Treaty, irrespective of the *efforts* made by the Party in question to ensure conformity; on the other hand, provided that the charges conformed to the requirements of those paragraphs, they would be deemed to be just and reasonable for the purposes of paragraph (1), provided only that they were also equitably apportioned among categories of users.

3.4 *In practice*, on the interpretation of Article 10(1)-(3) here under consideration, the only circumstances in which a Party's best efforts could be relevant would be where the other Party alleged that, even though the requirements of paragraphs (2) and (3) were satisfied, the first Party had not used its best efforts to ensure that charges were equitably apportioned among categories of users. It seems to the Tribunal that this would relegate "best efforts" to minimal significance.

3.5 In light of the foregoing, the Tribunal rejects any interpretation that would treat *both* paragraphs (2) *and* (3) of Article 10 as creating obligations of result.

3.6 Although paragraph (1) of Article 10 appears to assimilate the status of paragraph (2) and the status of paragraph (3) in the scheme of Article 10 as a whole, the Tribunal has found itself ineluctably driven to the conclusion that paragraphs (2) and (3) are different in their juridical character. For reasons given in Chapter 8 below, the Tribunal has concluded that paragraph (2), *as well as* being relevant to the characterization of charges as just and reasonable for the purposes of paragraph (1), *also* imposes an independent *mandatory obligation* and is in that respect an obligation of result.

3.7 By contrast, paragraph (3) of Article 10 is solely concerned to lay down criteria for the characterization of charges as just and reasonable for the purposes of the "best efforts" obligation contained in paragraph (1) and is

therefore relevant only to the content of the *obligation of conduct* imposed by that paragraph. This must be so if only because neither Party had or has any abstract interest in the airport charging régime operated in the territory of the other Party; each Party's interest is, rather, in the user charges imposed on its own designated airlines when they are using airport facilities in the territory of the other Party. The first sentence of paragraph (1) makes it clear that that is indeed the ambit of the "best efforts" obligation.

3.8 If paragraph (3) were to be interpreted as creating obligations independent of paragraph (1), then, because of the unlimited wording of the paragraph, those obligations would not be so confined and would be required to be performed for the benefit of not only the other Party's designated airlines but also the first Party's own airlines and third countries' airlines. Since such an interpretation would run counter to the evident intention of the Parties, it must be discarded.

IV. Whether Article 10(1)-(3) defines "just and reasonable" for the purposes of Article 10(1)

(1) Arguments of the Parties

(a) The submissions of HMG

4.1.1 In the submission of HMG, the only substantive *requirement* imposed by Article 10 of Bermuda 2 with regard to user charges was imposed by the first sentence of paragraph (1), namely that each Party should use its best efforts to ensure that the user charges imposed on the designated airlines of the other Party should be just and reasonable. Accordingly, HMG contended that the second sentence of paragraph (1) and paragraphs (2) and (3) of Article 10 laid down *sufficient* conditions, the satisfaction of which meant that the just and reasonable quality of such charges could not be disputed by the other Party; but the conditions laid down in paragraphs (2) and (3) were not *necessary* conditions in the sense that, unless they were satisfied, the first Party could not be heard to contend that charges were just and reasonable.

4.1.2 The second sentence of Article 10(1) could not, HMG submitted, properly be read as providing that: "Such charges shall be considered just and reasonable if *and only if* they are determined and imposed in accordance with the principles set forth in paragraphs (2) and (3) of this Article, and if they are equitably apportioned among categories of users" since the text of the Treaty did not contain the italicized words and it was improper to read into the Treaty words that were not there. Thus, while the second sentence of paragraph (1) and paragraphs (2) and (3) of Article 10 provided a Party with, in effect, grounds of defence, they did not lay down an exhaustive definition of "just and reasonable" to the exclusion of its ordinary meaning and it was open to a Party to rely on the ordinary meaning of the expression as well as, or instead of, the meaning provided by the second sentence of paragraph (1) and paragraphs (2) and (3) of Article 10.

4.1.3 It followed, according to HMG, that if user charges at Heathrow were comparable to, or lower than, user charges at other major world airports, that fact could be relied on by HMG as showing that the user charges at Heathrow were just and reasonable, in the ordinary sense, without going into detailed questions of "equitable apportionment", "reasonable rate of return", "sound economic principles" and so on.

4.1.4 The foregoing interpretation, HMG submitted, was borne out by the subsequent practice of the Parties and in particular USG's reliance on international comparisons when, in June 1988, the U.S. Secretary of Transportation Affairs was proposing that USG should levy off-setting charges on U.K. airlines; USG's acceptance of the interpretation was also evidenced by the fact that U.S. airport charges were not fixed in accordance with what either of the Parties now espoused as "sound economic principles".

(b) The submissions of USG

4.1.5 In the submission of USC, HMG's interpretation would eviscerate the meaning of Article 10, notably by rendering virtually meaningless the requirement of equitable apportionment and paragraph (3) of the Article. It was an interpretation that was contrary to the structure and logic of the Article and was not borne out either by the negotiating history or by HMG's own subsequent practice.

(2) Decision of the Tribunal

4.2.1 The Tribunal's approach to the present question is influenced by two of its other, related, findings:

(i) Article 10(2), as well as being relevant to the characterization of charges as "just and reasonable", also imposes on the Parties an independent, mandatory obligation of result: see paragraph 3.6 of this Chapter, above.

(ii) By contrast, despite its apparently imperative drafting, Article 10(3) cannot be so interpreted, since otherwise the evidently intended obligation to use no more than best efforts would have been effectively transmuted into an absolute obligation of result: see paragraphs 3.7-3.8 of this Chapter, above.

4.2.2 Article 10(3) must therefore be interpreted as if it were prefaced by a qualification, governing all that follows, in the following terms: "If user charges are to be considered just and reasonable for the purposes of Article 10(1) ...".

4.2.3 Article 10(3) is therefore, by its nature, definitional and the question is whether it, together with the "equitable apportionment" condition contained in Article 10(1) and the mandatory condition contained in Article 10(2), comprehensively defines "justness and reasonableness" of charges for the purposes of Article 10(1)-(3) or merely specifics conditions, fulfilment of

which creates an irrebuttable presumption that charges are "just and reasonable" but non-fulfilment of which leaves open the question whether charges may not nevertheless be "just and reasonable".

4.2.4 In the judgment of the Tribunal, the second sentence of paragraph (1) of Article 10 and the second and third paragraphs of Article 10 are together intended to define the expression "just and reasonable" where it appears in the first sentence of paragraph (1) of Article 10. The expression "if" is capable of being used exclusively and there were good reasons here for the Parties so to use the expression rather than leaving the position vague and uncertain (both for the Parties themselves in implementing the Treaty and for arbitrators called on to give effect to it).

4.2.5 Moreover, treatment of the second sentence of paragraph (1) of Article 10 and the second and third paragraphs of the Article as providing an exclusive definition of "just and reasonable" is entirely consistent with the scheme of Article 10(1)-(3) as a whole. Those provisions, interpreted in light of the purposes for which they were included in the Treaty and of the Preamble, indicate that the Parties' intention was that, in characterizing charges as just and reasonable or otherwise, the criteria to be applied are economic, qualified if necessary by reference to environmental impact and safety of operation (which were not in issue in the present proceedings), coupled with a provision concerned with discrimination on grounds of nationality, which the Tribunal will treat as a specific economic criterion. (Although the references to environmental impact and safety of operation appear, in paragraph (3), along with efficiency and economy, as matters to which the competent airport authorities are to have regard in relation to *the provision of facilities and services*, rather than directly in relation to the setting of charges, the Parties' intention here was to indicate the criteria to be applied in characterizing airport and air navigation facilities as "appropriate" within the meaning of the first sentence of paragraph (3). The criteria therefore relate indirectly to the characterization of charges as just and reasonable.)

4.2.6 The only basis on which HMG suggested that user charges at Heathrow might be judged to be just and reasonable without reference to the "equitable apportionment" condition contained in the second sentence of Article 10(1) and the conditions contained in Article 10(2) and (3) was that, as HMG contended, the user charges at Heathrow compared favorably (or not unfavorably) with user charges at other airports elsewhere in the world. But, in the judgment of the Tribunal, such a finding would not relieve the Tribunal of the need to consider whether the charges at Heathrow:

(a) contributed to provision for an unreasonably high level of profitability for BAA; or

(b) were based on unsound economic principles or lacked any economic rationale at all; or

(c) were based on accounting practices other than those that were generally accepted within the territory of the United Kingdom; or indeed

(d) involved inequitable apportionment among categories of users.

4.2.7 If it turned out that the charges at Heathrow that were imposed on the U.S.-designated airlines suffered from one or more of those "vices" and that, in consequence, they were higher than they would otherwise have been, those charges would not be saved from characterization as not just and reasonable by reason of their hypothesised comparability with charges at other airports elsewhere in the world. Most obviously, the charges at those other airports might, for example, generate excessive profitability for the airport operator or reflect its higher operating costs or its investment in excessively lavish facilities or be based on economic principles which both HMG and USG recognized to be unsound.

4.2.8 In saying this, the Tribunal has not overlooked the fact that, in proposing the imposition of off-setting charges on U.K.-designated airlines in June 1988, the U.S. Secretary of Transportation Affairs relied in part on alleged international comparisons (see paragraphs 4.21-4.22 of Chapter 2, above). However, he did so because the applicable U.S. domestic legislation provided for the making of such comparisons. The fact that the U.S. legislation did so does not assist the Tribunal to interpret Bermuda 2.

4.2.9 Accordingly, the Tribunal does not accept HMG's contention that the question of whether user charges were just and reasonable could be answered by reference to their comparability with user charges at other airports elsewhere in the world. Other than international comparability, HMG suggested no alternative to the principles referred to in paragraphs (1)-(3) of Article 10, for the purpose of characterizing charges as just and reasonable; and USG contended that there was no alternative for that purpose.

4.2.10 In the circumstances the Tribunal finds that Article 10(1)-(3) contains its own definition of what constitutes justness and reasonableness of user charges for the purposes of the Parties' "best efforts" obligation. The definition requires satisfaction of

(i) the "equitable apportionment" condition in the second sentence of Article 10(1);

(ii) the condition specified by Article 10(2) (which, albeit somewhat anomalously, also has an independent mandatory force); and

(iii) the conditions specified by Article 10(3) (which are essentially definitional in character).

V. The appropriate starting point in the inquiry as to the performance or non-performance of the "best efforts" obligation

(1) The arguments of the Parties

5.1.1 The following question must now be addressed: Is the starting point, from which the Tribunal should proceed, the question whether the actual user charges imposed on the U.S.-designated airlines at Heathrow were just and reasonable (as USG contends) or is it whether, irrespective of the result, HMG used its best efforts to ensure that those charges were just and reasonable (as HMG contends)?

5.1.2 As to whether the correct starting point of any inquiry into fulfilment of the "best efforts" obligation should be the actual user charges or the efforts of the Party in question, the Parties' submissions may be summarized as follows.

5.1.3 According to USG, the only way to determine whether HMG had violated its "best efforts" obligations was to determine "whether or not BAA's [relevant] practices in fact complied with Article 10". If not, there was a breach of the Treaty; on the other hand, if the charges imposed by BAA on the U.S.-designated airlines were in fact equitably apportioned among categories of users and were established within the limits described by paragraphs (2) and (3) of Article 10, it was implicit in USG's submissions that USG would have no cause for complaint, so that it would not then be necessary for the Tribunal to consider what efforts HMG had made to ensure that result.

5.1.4 *HMG* urged that the proper approach was to start with a consideration of the efforts used by HMG and, if those efforts constituted best efforts to ensure that the relevant charges were just and reasonable, there was no need to consider the charges themselves. Alternatively, if the Tribunal followed USG's suggestion of first examining the charges themselves and found that they were not just and reasonable, the question whether, nevertheless, HMG had used its best efforts to ensure that they were would still need to be answered.

(2) Decision of the Tribunal

5.2.1 In the judgment of the Tribunal one cannot decide whether a Party has used its best efforts *as required by Article 10(1)* without first deciding what Article 10(1) and (3) requires; but there is a difference between defining the results that the Parties are required to use their best efforts to ensure, on the one hand, and ascertaining the results that in fact resulted.

5.2.2 Here it is necessary first to recall that the Tribunal has rejected (see paragraph 2.2.2 of this Chapter, above) HMG's contention that all that the "best efforts" obligation required of it was that it should have, from its legislature, power to ensure that, where circumstances so required, steps could be taken *vis-à-vis* the competent charging authority to bring about user charges in accordance with Bermuda 2.

5.2.3 However, HMG went on to draw attention to the various steps that it had taken beyond getting that power from the British Parliament. Whether those steps constituted the best efforts required by Article 10(1) of Bermuda 2 must, in the Tribunal's judgment, depend, first, on whether the steps were correctly directed to ensuring that the user charges in question were just and reasonable within the meaning of Article 10(1) and (3), properly interpreted. In the circumstances of the present case, that question cannot be answered without ascertaining whether the *principles that BAA claimed to be applying* when it set charges were consistent with the conditions contained in Article 10(1) and (3).

5.2.4 If the principles that BAA claimed to be applying were objectionable in the context of the Treaty and HMG failed to take steps to have the "BAA principles" changed so as to accord fully with Bermuda 2, then no matter how great may have been HMG's efforts to see that the BAA principles were applied in accordance with their terms, HMG will be in breach of Article 10(1) and (3) - not because of *insufficiency of effort* but because its efforts will have been *misdirected*. The same is true *a fortiori* in the case of the mandatory requirements of Article 10(2).

5.2.5 If, however, the BAA principles were unobjectionable, in the sense that they were at least compatible with Article 10(1) - (3) of Bermuda 2, it is the *sufficiency* of HMG's efforts to ensure that the required result was actually achieved that is in issue.

5.2.6 In assessing whether "best efforts" that a Party claims that it has made were sufficient, it will be necessary to consider whether a reasonable government, that was correctly interpreting the Treaty, would have believed that effort, beyond such (if any) as was deployed by the Party, was required. That question can be answered only in the light of all the relevant surrounding circumstances, including the actual user charges payable by the designated airlines of the other Party and those proposed by the Party's competent authority.

5.2.7 However, whether one is concerned with the correct direction of a Party's efforts or with the sufficiency of those efforts, what matters is not whether the result that the Party had to use its best efforts to achieve was in fact achieved but whether the Party used its best efforts to achieve that result. An appraisal of those efforts at each point of time will take place against the background of the actual results achieved up to that point of time; and in that sense, but only in that sense, are actual results, as such, relevant. If the result that the Party had to use its best efforts to achieve is in fact achieved, it will often be of only academic interest whether the Party in fact used its best efforts to achieve that result, but that cannot be allowed to alter the legal analysis of the requirements of the Treaty.

5.2.8 In this context the Tribunal accepts a submission made by HMG, with regard to the *level* of charges, to the effect that the reference in Article 10(3) to it being permissible for user charges to "provide *for* a reasonable rate

of return" (emphasis added), indicates that the Treaty is here concerned with the position *ex ante* (as it is to be expected when the relevant charges are imposed) and not with the position *ex post* (as it turns out to be in the event).

5.2.9 Accordingly, to the question whether the Tribunal should start with the just and reasonable quality or otherwise of BAA's actual charges or with the direction and sufficiency of HMG's efforts, the answer is that it must start with the latter; but in the course of appraising the direction and sufficiency of HMG's efforts, it will generally be necessary to examine (a) the actual charges imposed in the past and the results of their imposition and (b) the charges to be imposed in the future and their likely results as they were to be expected in the light of past experience.

5.2.10 It follows that it would be perfectly possible to conclude that a Party was in breach of its obligations under Article 10(1) - (3) of Bermuda 2 without forming any concluded view as to whether the actual charges imposed on the designated airlines of the other Party were more than just and reasonable; and equally it would be perfectly possible to conclude that, even if those charges were more than just and reasonable, the efforts that the Party had made could not fairly be criticized.

VI. The "user charges" that are to be just and reasonable.

6.1 "User charge" is defined by Article 1(o) of Bermuda 2 as meaning "a charge made to airlines for the provision for aircraft, their crews and passengers of airport ... property or facilities, including related services and facilities". It was common ground between the Parties that the expression did not include the charges made to airlines for the provision of e.g. ticket-vending and check-in counters and baggage-handling facilities and that the Tribunal was concerned exclusively with landing (or runway) charges, passenger (or terminal) charges and aircraft parking charges (often called simply "parking charges"). Air jetty charges were not discussed by either Party in the course of the Arbitration (see paragraph 1.19 of Chapter 6 below) and are therefore taken by the Tribunal to be not in issue.

6.2 An issue of considerable potential significance is whether what the Parties are required to use their best efforts to ensure is the just and reasonable character of (a) the total amount charged by airport operators to designated airlines or (b) each element that goes to make up the total. *HMG* expressly contended for the former interpretation in the context of the "equitable apportionment" condition contained in the last phrase of Article 10(1): according to *HMG* what had to be equitably apportioned was the user charges *as a whole*, and not each separate element of the charges (landing charges, passenger charges, etc.); even if one element of the charges bore more heavily on one category of user than on another, there could still be equitable apportionment if *total* charges for each category of user were compared (HMG's emphasis). *USG* implicitly rejected that analysis.

6.3 The expression "user charges" appears in each of paragraphs (1), (2) and (3) of Article 10; semantic considerations alone give one no reason to adopt one interpretation rather than another; and there are cogent practical arguments both in favor of an interpretation that requires each element in the user charge to be just and reasonable and also in favor of an interpretation that requires only the total to be such.

6.4 In favor of the former interpretation is the fact that, if each element of the total, and not just the total, is required to be just and reasonable, the resulting "transparency" will facilitate effective legal review; secondly, the requirement in Article 10(3) that user charges shall be "based on … the generally accepted accounting practices within the territory of the appropriate Contracting Party", which is difficult enough to interpret even if applied to the individual elements of the user charges, becomes even more difficult if it has to be applied to the total.

6.5 On the other hand, especially on a "single till" approach for which, as appears below, USG contended most strongly, it is impossible to calculate the level of profitability generated by individual elements in user charges (e.g. landing charges, passenger charges); and secondly, if a Party is in breach of the Treaty by reason of its failure to use its best efforts to ensure that each element in the user charges imposed on the designated airlines of the other Party is just and reasonable, then even if it had used its best efforts to ensure that the totals were just and reasonable, either:

(a) it would be liable to pay compensation to the other Party by reference to the breach of the Treaty and without reference to the fact that the other elements in the total were on the low side, so that the total was reasonable; or

(b) it would not be liable to pay compensation in those circumstances.

In case (a), the result would itself seem to be not just or reasonable (and, in its written submissions in relation to the appropriate measure of damage for breach of the Treaty, USG does not contend for such a result); case (b), on the other hand, comes to the same thing in practice as accepting that it is the total that must be just and reasonable, irrespective of how it is expressed to have been calculated.

6.6 Whilst recognizing the force of the arguments in favor of the contrary view, the Tribunal is of the judgment that the Treaty is primarily concerned with the total amounts of money that airport operators require the designated airlines of the other Party to pay in the course of some relevant period of time; if, and only if, *the way in which* the total is, and is expressed to be, made up itself leads to designated airlines of a Party incurring a higher total than if the elements in the total were each properly calculated are the elements in the total themselves legally decisive.

6.7 For example, if the *composition of the total charge* has led a designated airline of one of the Parties to alter its method of operation in a

manner that was disadvantageous to it, then that Party will have a valid cause of complaint if the other Party did not use its best efforts to ensure a just and reasonable composition of the total.

VII. Interpretation of the "equitable apportionment" condition

(1) Arguments of the Parties

7.1.1 In the context of USG's claim that user charges imposed at Heathrow airport were designed to favor short-haul operators, especially domestic airlines, at the expense of long-haul operators and were thus highly discriminatory, *USG* contended that the second sentence of Article 10(1) of Bermuda 2 required a fair allocation of charges amongst all categories of users. In *USG's* view, HMG's argument that Article 10 had no application to charges levied in respect of domestic air services was inconsistent with the ordinary meaning of the words used. Whilst Article 10 was concerned with the protection of the designated airlines of either Party and not with the protection of domestic airlines, it nevertheless regulated domestic user charges in so far as they had an impact on the justness and reasonableness of the charges imposed on international users and in so far as was necessary to prevent discrimination against those users. Thus, while HMG was free to subsidize its domestic airlines, it could not require the international airlines to do so through the charges-allocation system.

7.1.2 USG added that it was not contending that a differential in charges between domestic and international users was inherently inequitable. If there was a sound economic basis for imposing a charge that had a greater impact on international users than on domestic users, it would not be inequitable to do so. Nor would there be any objection in principle to charges that distinguished between categories of users on the basis of the costs they imposed on the airport authority.

7.1.3 *HMG*, while conceding that the principles set out in Article 10(3) were *prima facie* applicable to all user charges, did not accept that Article 10 in fact had any application to user charges levied in respect of domestic air services. The expression "categories of users" in the second sentence of Article 10(1) meant users providing international services and this was shown by, *inter alia*:

(a) the preamble to Bermuda 2, which made it clear that the object and purpose of the Treaty was to regulate international services;

(b) Article 2 of Bermuda 2, which provides for the grant of rights for the conduct of international air services;

(c) the reference in Article 10(1) to "designated airlines", being airlines designated to operate international services.

This interpretation was, moreover, confirmed by the U.K.'s near-contemporaneous internal explanatory note on Bermuda 2, excerpts from

which had first been placed before the Tribunal by USG (see paragraph 2.1.6 of this Chapter, above).

7.1.4 HMG went on to point out that the word "equitable" did not mean "equal". Thus, differential charges (such as peak and non-peak prices) were not impermissible if they could be justified as equitable; indeed, this was confirmed by the intergovernmental Memorandum of Understanding (see paragraph 3.8 of Chapter 2, above and **Appendix IV** hereto, in which the two Governments had accepted that peak-pricing was not objectionable in principle.

7.1.5 Finally, HMG observed that if apportionment of charges at Heathrow were such as to favor domestic airlines (which was not the case), then, unless there were justification on cost grounds, the general requirement in the *first* sentence of Article 10(1) would preclude any undue pursuit of policy objectives necessitating imposition of charges for facilities and services provided for international flights while not imposing any for domestic flights, since that would not be just and reasonable.

(2) Decision of the Tribunal

7.2.1 Purely grammatically, the final words of Article 10(1) specify a condition that "[user charges imposed or permitted to be imposed by a Party on the designated airlines of the other Party] are equitably apportioned among categories of users" e.g. that the user charges *imposed on the U.S. designated airlines* are equitably apportioned among categories of users.

7.2.2 However, adopting a purposeful construction one cannot read the "equitable apportionment" condition as requiring merely equitable apportionment *among U.S.-designated airlines*, in so far as they fall into different categories, of the charges imposed on the U.S.-designated airlines. Moreover, the notion of apportionment clearly relates to a step to be taken before, and not after, the imposition of charges, yet grammatically it is charges that *have been* imposed on the U.S.-designated airlines ("such charges") that *are to be* apportioned among categories of users. For both of these reasons, a narrowly grammatical interpretation of the "equitable apportionment" condition must be discarded as untenable.

7.2.3 Bearing in mind that the purpose of Article 10 of Bermuda 2 is to protect the U.S.-designated airlines, the Tribunal considers that the phrase in question means that the share of user charges (the expression "user charges" being understood in the sense ascribed to it in paragraphs 6.1 *et seq.* of this Chapter, above) that they are called upon to pay must be equitable when compared with the share which other users are called upon to pay. This leads to the questions

(a) what is meant by "equitable" and

(b) with which users the comparison must be made.

7.2.4 On the first point, the Tribunal concurs with HMG that "equitable" does not necessarily mean "equal". The condition of equitable apportionment is rather to be understood, first, as requiring equal treatment of "equal situations" (i.e. situations that are equal, applying relevant and objective economic criteria) and, secondly, as requiring that differences in treatment of "unequal situations" should be properly proportioned to the differences in the situations themselves (the principle of proportionality). This is something that the Parties are obliged to use their best efforts to ensure.

7.2.5 The Tribunal now comes to the question whether equitable apportionment is required not only as between international users *inter se* but also as between international users and domestic users, i.e. airlines operating services between points situated within the United Kingdom. As regards the inclusion of such users amongst the "categories of users" referred to in the "equitable apportionment" condition, the Tribunal notes that it has been suggested that Bermuda 2 does not prevent the imposition on U.S.-designated airlines of charges reflecting the cost of providing services in respect of domestic traffic. Thus, Pogue and Davison, "*User Charges in International Aviation*", 73 AM.J.INT'L LAW 42 (1979), a copy of which was placed before the Tribunal by USG, states:

> "Nothing in [paragraph (3) of Article 10 of Bermuda 2] specifically requires charges to a particular carrier, or class of carriers, to reflect only the cost of the services provided to that carrier or class of carriers" (original emphasis).

7.2.6 Whether or not that is a correct interpretation of Article 10(3) standing alone, in the judgment of the Tribunal Article 10(1) and (3) read together prevent charges imposed on international airlines being characterized as just and reasonable if and so far as those charges reflect the cost of providing services in respect of domestic (intra-U.K.) traffic and, in so doing, involve an inequitable apportionment of charges amongst categories of users, including domestic users.

7.2.7 The Tribunal cannot accept HMG's submission to the effect that the words "categories of users", where they appear in the equitable apportionment condition set out at the end of Article 10(1), should be confined to users operating international services. The Tribunal so concludes for the following reasons:

(a) When the drafters of Article 10 intended there to be a limitation to international traffic, they said so expressly (see Article 10(2)).

(b) By its Terms of Reference (see paragraph 3.2 of Chapter 1, above) the Tribunal is to have regard to *inter alia* the inter-governmental MoU of April 1, 1983, in interpreting Bermuda 2. Paragraph 4(d) of the MoU (**Appendix IV** hereto) states:

> "In using its best efforts, HMG expects the charges determined and imposed by the competent charging authorities at the airports served by U.S. carriers to be … equitably apportioned among categories of users …"

There is no indication here that the word "users" is to be confined to international users; and, indeed, such an interpretation would be inconsistent with the ordinary meaning of the sentence, read as a whole.

VIII. The interpretation of Article 10(4) of Bermuda 2

8.1 Article 10(4) of Bermuda 2 provides as follows:-

> "Each Contracting Party shall encourage consultations between its competent charging authorities and airlines using the services and facilities, where practicable through the airlines' representative organizations. Reasonable notice should be given to users of any proposals for changes in user charges to enable them to express their views before changes are made."

8.2 Article 10(4) may be compared with Article 10(5) (see paragraph 9.1 of this Chapter, below) in two respects. First, Article 10(4) requires the Parties *to encourage* consultations, whereas Article 10(5) requires the Parties *to use their best efforts to encourage* exchange of information. It is not obvious what, if any, difference in meaning the difference in drafting was intended to convey: the difference may be attributable to the fact that there should be no substantial obstacles to consultation, and its encouragement should therefore be a straightforward affair; by contrast, if the relevant information is commercially confidential, the Party seeking to encourage its disclosure may encounter invincible resistance. Perhaps the reference to best efforts in relation to encouragement of disclosure of information is intended to recognise that the Party whose efforts to encourage the disclosure have failed will be entitled to say "We did our best and no-one can do more than that".

8.3 Secondly, Article 10(4) expressly refers to the need for "reasonable notice … [to] be given to users of any proposals for changes in user charges", whereas Article 10(5) is concerned with exchange of "such information as may be necessary to permit an accurate review of the reasonableness of the charges ...". Thus, the information that Article 10(4) requires to be provided is information that defines proposals for changes in user charges: the proposals themselves must be adequately described to the airlines so that they know precisely what is being proposed and can comment upon it. By contrast Article 10(5) is concerned with provision of information about facts relevant to review of the proposals rather than about the content of the proposals themselves.

8.4 As Article 10(4) makes clear, the consultations that are to be encouraged include consultations concerning proposals relating to user charges for a future period (and the Tribunal believes that, on a purposive interpretation of the paragraph as a whole, in the context of Article 10 as a whole, such consultations are to be encouraged even where no change from the pre-existing charges is proposed, since the relevant surrounding circumstances may have changed). In cases such as those with which the Tribunal is concerned, where the consultations do concern proposals relating to user charges for a future period, the Tribunal is content to adopt the test laid down by English law for establishing the sufficiency of consultations for

which there is a legal requirement: see paragraph 2.1.11 of Chapter 9, below. Accordingly, the Tribunal holds that the consultations that are here to be encouraged are consultations that satisfy the following conditions:-

(i) consultation must take place at a time when the process of establishing user charges for a future period is still at a formative stage;

(ii) the relevant authority must give sufficient reasons for any proposal to permit of intelligent consideration and response;

(iii) adequate time must be given for consideration and response;

(iv) the product of consultation must be conscientiously taken into account in finalising the actual charges that are imposed; and

(v) the consultation process as a whole must be conducted in such a way as to avoid unfairness.

8.5 Unless at least conditions (i) - (iv) are satisfied, consultations will not be meaningful and the Tribunal accepts USG's submission that the consultations required by Article 10(4) are meaningful consultations. Condition (v) constitutes a general requirement such as will not be satisfied unless the first four specific requirements are satisfied. Condition (v) may be derived in the present context from the general principle that obligations that are accepted under Treaties are to be performed in good faith: it would not be consonant with good faith to encourage a consultation procedure which as a whole resulted in unfairness. However, the obligation to give reasons set out at (ii) falls substantially short of an obligation to provide all such information as may be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in Article 10(1) - (3); such information is to be encouraged to be supplied, by the deployment of best efforts, pursuant to Article 10(5) and not Article 10(4).

IX. The interpretation of Article 10(5) of Bermuda 2

9.1 Article 10(5) of Bermuda 2 provides as follows:-

> "For the purposes of paragraph (4) of this Article, each Contracting Party shall use its best efforts to encourage the competent charging authorities and the airlines to exchange such information as may be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in this Article."

9.2 Although Article 10(5) has, in the judgment of the Tribunal, an objectively determinable substantive content, it is important to note the marked limits of that content. The Parties have not undertaken *to use their best efforts to* ***ensure*** that the competent charging authorities and the airlines exchange information, let alone have they undertaken ***to ensure*** that the competent charging authorities and the airlines do so; they have undertaken only ***to use their best efforts to encourage*** the competent charging authorities and the airlines to exchange the information in question.

9.3 The obligation arising under Article 10(5) is expressed to be "for the purposes of paragraph (4) of [Article 10]". This has several consequences. First, there is no obligation on either Party to use its best efforts to encourage exchange of information otherwise than for the purposes of the consultation process. Secondly, and perhaps of greater practical importance, the reference to paragraph (4) makes it clear that the charges the reasonableness of which is to be reviewed in the light of any exchanged information include charges that are the subject of the consultation process, i.e. proposed charges. That necessarily entails the consequence that the information in question should relate to proposed charges and should therefore include projections relating to the period when the proposed charges will operate and not comprise exclusively historical data as such. This is indeed in part a corollary of the fact that, as HMG pointed out, Article 10(3) lays down that user charges may provide *for* a reasonable rate of return, thereby indicating the prospectivity of any review, in the consultation process, of the level of charges proposed.

9.4 In the judgment of the Tribunal, the information referred to in Article 10(5) is information that is objectively necessary to enable a reasonable person in the position of the recipient accurately to review the reasonableness of the user charges in accordance with the principles set out in Article 10. Each Party is obliged by Article 10(5) to use its best efforts to encourage the provision of such information.

9.5 The Tribunal does not overlook the use in Article 10(5) of the expression "exchange" of information which might be thought to imply that the provision of information by the competent charging authority to the airlines (and *vice versa*) was conditional on the latter providing information to the former. However, there was no evidence that in the present case any failure by the U.S.-designated airlines to provide information to BAA constituted an excuse for any failure, if such there was, on the part of BAA to provide information to the U.S.-designated airlines. In the judgment of the Tribunal, it is only where, as a matter of fact, an exchange of information is necessary to enable one side or the other to make its contribution to the provision of necessary information, that failure by one side to provide necessary information could give the other side's Party an excuse not to use its best efforts to encourage it to provide necessary information.

9.6 The Tribunal observes that it is only by reference to the criteria that are required by Article 10(1) - (3) to be applied in assessing the just and reasonable nature or otherwise of the charges imposed on the designated airlines of the other Party that it is possible to tell what information is objectively necessary to permit an accurate review of the reasonableness of those charges *in accordance with the principles set out in Article 10.*

9.7 In this connection it is necessary to stress that Article 10(5) uses the expression "necessary". It is perfectly possible that information beyond what is necessary might cast light on relevant issues. But the Parties are not obliged to use their best efforts to encourage the provision by their charging

authorities of anything more than is *necessary* to enable a reasonable person in the position of the airlines to conduct an accurate review of the reasonableness of the charges in accordance with the principles set out in Article 10.

9.8 The fact that the review is to be an "accurate" review implies that the information supplied should be quantitative as well as qualitative, so as to enable the observer to form a view about the correctness of the specific charges proposed and not merely about the correctness in principle of the methodology adopted. On the other hand, the expression "review" implies that what is supplied should enable the observer to form a reasonable view rather than the greater amount of information that might be necessary to permit a "determination" of the reasonableness of the charges, i.e. a definitive judgment, which the first two drafts of Article 10 during the negotiation of the Treaty appear to have contemplated. Thus, on the one hand, the information, exchange of which the Parties are obliged to use their best efforts to encourage, must be reasonably specific but, on the other hand, the exchange process must be kept within reasonable bounds and cannot be extended, in scope or time, to an unreasonable degree.

9.9 Lastly, since Article 10(5) is expressed to operate for the purposes of Article 10(4), the exchange which the Parties are to use their best efforts to encourage is exchange in sufficient time to permit the recipient of the information to study and digest it and its implications and, having done so, make a timely contribution to the consultation process.

CHAPTER 6

Because of the length and complexity of this Chapter, the running page headings identify the topics covered, namely:

I. The actual structure of charges

II. The Parties' submissions as to relevant costs

III. International comparisons

IV. The treatment of commercial income

V. BAA's Statement of Principles

VI. The intergovernmental MoU

VII. Conclusions on the SRMC/LRMC controversy

VIII. The relevant questions for decision

IX. Preliminary observations

X. USGs criticisms of BAA's charging structure

XI. Conclusions

(1) Nexus between costs and charges

(2) Alleged discrimination
(3) Imbalance between elements of user charges
(4) The landing charge peak
(5) The composition of runway charges
(6) The terminal charge peak
(7) The composition of terminal charges
(8) Parking charges and the parking charge peak
(9) Non-differentiation of passenger charges by terminal
(10) "One-way" versus "two-way" charging
(11) Remote parking stand rebates
(12) The timing of changes in the charging structure

ARTICLE 10(1) and (3) OF BERMUDA 2 : THE STRUCTURE OF USER CHARGES AT HEATHROW

I. The actual structure of charges

1.1 It is useful to begin by describing the user charges in fact in place at Heathrow during the years commenced April 1, 1980-1988, the last 6 of which comprise the Arbitration period. The first three years of the series, *viz.* 1980/81 - 1982/83, have been included in a number of the statistics because of the evolution of charges in the years immediately preceding the Arbitration period as well as during that period.

(a) BAA's tariffs of user charges at Heathrow

Runway charges

1.2 Table 1.2 below shows the rates of runway charges (in fact, during the whole of the period under review, landing and not take-off charges) at Heathrow during the 9 years commenced April 1, 1980-1988. In some of those years BAA's tariff provided for a rebate for quiet aircraft (certificated as such in accordance with ICAO, Annex 16). In some of the other years, the tariff provided for a surcharge for noisy aircraft (i.e. aircraft not so certified). So far as appears from the evidence, the U.S. airlines' aircraft were, or were generally, quiet aircraft and no criticism has been made by USG of the differentiation of landing charges as between quiet and noisy aircraft. Accordingly, Table 1.2 shows the charges that were applicable to quiet aircraft (i.e. after any applicable rebate and before any applicable surcharge as the case might be.)

TABLE 1.2
LANDING CHARGES (fixed wing aircraft)
(QUIET AIRCRAFT): Pounds Sterling

Year commenced April 1	1980[1]	1981	1982	1983	1984[3]	1985	1986	1987	1988
IN-SEASON PEAK	April to October : the whole time					April to October : 3+2 hours a day[4]			
Fixed wing ≤ 16T	59.50	72	72	72	64[3]				
Fixed wing > 16T									
Fixed charge	76.50	96	96	97.60	93.60[3]	156[5]	160[5]	200[5]	290[5]
Variable charge per tonne> 60T/>50T[2]	3.74	3.84	3.84	1.96	0.94[3]				
OUT-OF-SEASON/OFF-PEAK	November to March : the whole time					April to October : outside peak 5 hours November to March : the whole time			
Fixed wing ≤ 16T	29.75	36	36	36	64[3]	64	66	50	50
Fixed wing ≥ 16T									
Fixed Charge	38.25	48	48	48.80	93.60[3]				
Aircraft ≤ 50T						93.60	96.40	100	100
Aircraft > 50T						156[3]	160[3]	160	175
Variable charge per tonne> 60T/>50T[2]	1.87	1.92	1.92	0.98	0.94[3]				

NOTES :
(1) A short haul rebate of 50% applied in 1980 but in none of the other years shown.
(2) The variable charge per tonne applied to tonnes in excess of 60T in 1980-1982 and to tonnes in excess of 50T in 1983 and 1984.
(3) There was no peak/off-peak differential for landing charges – (a) in 1984 for any fixed wing aircraft; (b) in 1985 and 1986 for fixed wing aircraft over 50T.
(4) 0700-0959 and 1700-1859.
(5) From 1985 onwards there was no differential between *peak* landing charges for – (a) fixed wing aircraft up to 16T and (b) fixed wing aircraft over 16T.

1.3 References to weight of the aircraft are to its maximum total authorized weight, which in general may be taken to be the maximum total weight of the aircraft and its contents, at which the aircraft may take off in the United Kingdom in the most favourable circumstances in accordance with the Certificate of Airworthiness for the time being in force in respect of the aircraft. As can be seen from Table 1.2, in the first 5 of the 9 years (and therefore the first 2 years of the Arbitration period) weight played a significant, though diminishing, role in the calculation of the landing charge: fixed wing aircraft of up to 16 tonnes enjoyed a preferential, fixed, rate at all times and, for aircraft of over 60 tonnes weight in 1980-1982 and of over 50 tonnes weight in 1983 and 1984, a variable charge per tonne was collected in addition to a fixed sum.

1.4 Throughout the 9 years, the runway charges were imposed on landings only; in that sense they were "one-way" charges. It will be observed that in the years commenced April 1, 1980-1983, there was a seasonal (summer/winter) rather than a peak/off-peak differential, the landing charge in the summer months (April- October) being twice the corresponding charge in the winter months (November-March).

1.5 The seasonal differential was expressly recognized by BAA not to be justifiable and was abolished with effect from April 1, 1984. In the charging year that then commenced there was no seasonal or peak/off-peak landing charge differential. Thereafter, the ratio of peak to off-peak landing charges was as shown in Table 1.5 below.

TABLE 1.5

	1985	**1986**	**1987**	**1988**
Fixed wing aircraft ≤ 16T	2.43:1	2.42:1	4:1	5.8:1
Fixed wing aircraft > 16T ≤ 50T	1.67:1	1.66:1	2:1	2.9:1
Fixed wing aircraft > 50T	1:1	1.1	1.25:1	1.66:1

Aircraft parking charges

1.6 Throughout the 9 years commenced April 1, 1980, there was a peak/off-peak differential in the charges imposed for the parking of aircraft at Heathrow (often called simply "parking charges"). The peak charge was throughout calculated as a multiple of the off-peak charge, the multiple being 4 for the years 1980/81-1987/88 and 3 for 1988/89. Table 1.6 below summarises the rates of parking charges at Heathrow for the 9 years in question.

TABLE 1.6
PARKING CHARGES

Year commenced April 1	1980	1981	1982	1983	1984	1985	1986	1987	1988
PEAK (£)	A stand in the passenger terminal area						Central Area/T4 Apron		
	April to October: 4 hours a day (0730-1129)			April to October : 5 hours a day (0730-1229)					April to October: 5½ hours a day (0700-1229)
Multiplier	4	4	4	4	4	4	4	4	3
OFF-PEAK (£) *									
Per tonne per hour	0.18	0.22	0.22	0.23					
First 20 tonnes: per tonne per hour					0.41	0.48	0.50	0.54	
Thereafter: per tonne per hour					0.20	0.20	0.20	0.20	
Fixed charge per hour									10.00
Additional charge per tonne per hour									0.18
REMOTE STAND REBATE Per passenger	–	–	–	–	–	0.30	0.30	0.40	0.40

* No charge was made for parking from 2200-0559 GMT throughout the year.

1.7 As appears from the definition in the Table of the peak, the parking area that attracted the peak charge was changed with effect from April 1, 1986, after which parking at stands outside the Central Area/Terminal 4 Apron ceased to attract application of the peak multiplier even during peak hours. However, within that Area/Apron, stands that were not pier-served, as well as stands that were pier-served, continued to attract application of the peak multiplier during peak hours for the remainder of the Arbitration period. The Table also shows how the method of calculation of the charge varied over the period, beginning with a calculation based entirely on the weight, i.e the maximum authorized weight, of the aircraft and the time for which it was parked.

1.8 In 1980/81-1983/84 parking charges were imposed *pro rata* to the weight of the aircraft. Thereafter, although parking charges applicable to aircraft of different sizes continued to be higher the greater the weight of the aircraft, the differential was less than proportionate to the difference in the weight of the aircraft; this was achieved in the 4 years 1984/85-1987/88 by setting a higher rate per tonne per hour for the first 20 tonnes than for tonnes in excess of 20 and in 1988/89 by making a fixed charge per hour irrespective of the weight of the aircraft, with a single variable per tonne per hour in addition. The peak multiplier applied per minute so that an aircraft that was parked, for example, for half an hour in the peak period and half an hour outside it was charged for half of the hour at the peak rate and for the other half at the off-peak rate. Subject thereto the off-peak rate applied per hour or part thereof so that an aircraft that was parked for 1½ hours off-peak incurred 2 hours off-peak charges.

1.9 Pursuant to paragraph 7.10 of the BAA Conditions of Use for Heathrow, Gatwick and Stansted Airports (1988/89 edition), BAA waived the parking charge at Heathrow in respect of overnight parking. So far as appears from the evidence before the Tribunal, such a waiver was in operation throughout the Arbitration period.

Passenger (or terminal) charges

1.10 The rates at which passenger (or terminal) charges were imposed over the 9 years commenced April 1, 1980, are less easily summarised in a comprehensive way. Tables 1.I0A and B below should be read with the Notes to them and with the following text in order to obtain an understandable and complete picture.

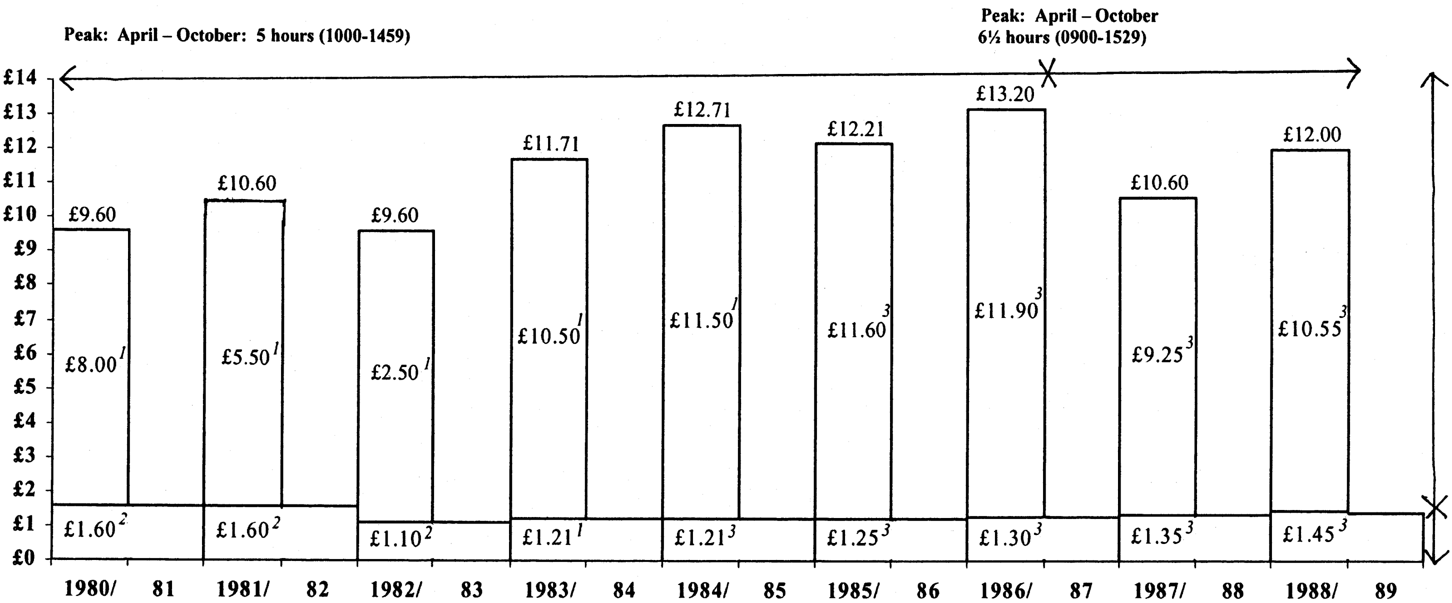
1.11 As appears from Tables 1.10A and B, in the 9 years covered there were peak and off-peak periods for passenger charges. The periods were common to international and domestic traffic until 1988/89. Until then the common peak was confined to the months of April-October; until 1987/88 that common peak was of 5 hours' duration (1000-1459 hours); it was then extended by one hour in the morning and half-an-hour in the afternoon to a total of 6½ hours (0900-1529 hours). In 1988/89 that continued to be the peak for international traffic; but separate peaks, in force throughout the year,

totalling 3 hours per day (April-October : 0700-0829 and 1830-1959; November-March : 0800-0929 and 1930-2059) were introduced for domestic, and only domestic, traffic.

1.12 In the first 3 of the 9 years, and therefore before the commencement of the Arbitration period, no passenger charge was imposed on either international or domestic traffic out of the peak period. However, during those years a National Security Levy was imposed on all passengers *arriving* on aircraft with a weight exceeding 10 tonnes. Subject to that exception, all the charges shown in the Table applied to *departing* passengers. When, in 1983/84, the National Security Levy was discontinued and a passenger charge began to be imposed on passengers departing at off-peak times, the charge was imposed on passengers departing on aircraft with a weight (i.e. a maximum authorized weight) in excess of 16 tonnes, those being the kind of passengers on whom the pre-existing peak passenger charge was imposed. Therefore, in 1983/84, the first year of the Arbitration period, both peak and off-peak passenger charges applied only to passengers departing on aircraft with a weight in excess of 16 tonnes; in 1984/85, the off-peak passenger charge was extended to cover passengers departing on aircraft with a weight in excess of 5 tonnes and in 1985/86 the peak passenger charge was similarly extended. It follows that throughout the Arbitration period the charges here under consideration applied exclusively to departing passengers and from 1985/86 onwards they all applied to all passengers departing on aircraft with a weight in excess of 5 tonnes (the smallest aircraft, e.g. “Executive Jets”, were engaged in “General Aviation”; passengers on such aircraft evidently made no, or no significant, use of the Heathrow terminals). Until 1985/86, passengers on aircraft with a weight of up to 16 tonnes had wholly escaped application of the peak passenger charge and, in the first year of the Arbitration period, also of the non-peak passenger charge.

TABLE 1.10A

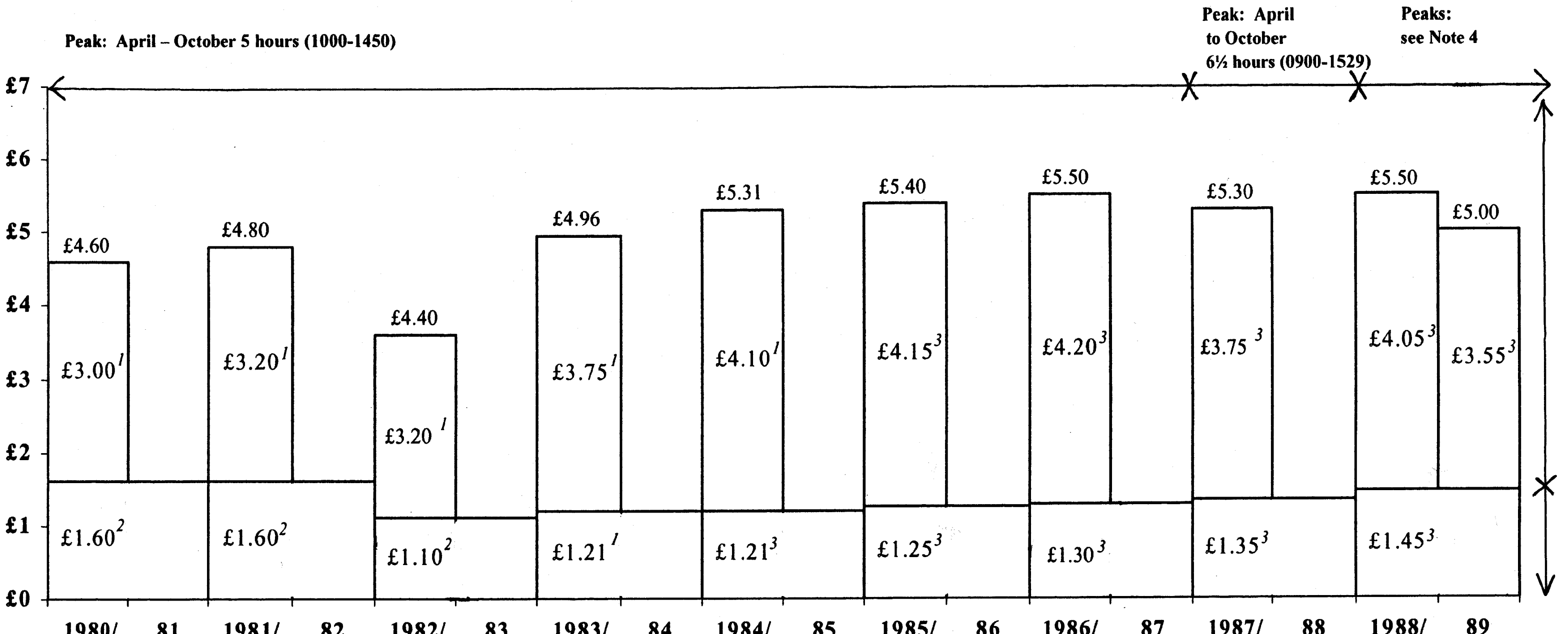
A. PASSENGER CHARGES (INTERNATIONAL)



NOTES:
(1) Departing passengers on aircraft > 16 tonnes.
(2) National Security Levy: Arriving passengers on aircraft > 10 tonnes.
(3) Departing passengers on aircraft > 5 tonnes.
(4) The domestic terminal peaks in 1988/89 were (Mondays to Fridays):

April – October: 3 hours (0700-0829 & 1830-1959)
November – March: 3 hours (0800-0929 & 1930-2059)

TABLE 1.10.B
PASSENGER CHARGES (DOMESTIC)



NOTES:
(1) Departing passengers on aircraft > 16 tonnes.
(2) National Security Levy: Arriving passengers on aircraft > 10 tonnes.
(3) Departing passengers on aircraft > 5 tonnes.
(4) The domestic terminal peaks in 1988/89 were (Mondays to Fridays):

April – October:	3 hours (0700-0829 & 1830-1959)
November – March:	3 hours (0800-0929 & 1930-2059)

(b) Amounts of user charges typically paid

1.13 It is evident from Tables 1.2, 1.6 and 1.10A and B above that each of the three elements of user charges at Heathrow changed substantially both in the three years immediately preceding the Arbitration period and in the six years of the Arbitration period itself. However, merely looking at those Tables one cannot readily determine how the amounts of money that an airline was required to pay by way of user charges in respect of particular operations of one kind or another were affected by the changes in tariffs. In order to see that, the Tribunal has applied the tariffs to five types of "aircraft/operation" of a kind that appear to have been treated by BAA in the 1980s as fairly typical. The "aircraft/operations" are defined in Table 1.13 below.

TABLE 1.13

International or domestic	Aircraft type	Maximum authorized weight (tonnes)	Number of passengers	Aircraft parking time
International	B747	335T	265	4 hours
International	A300	143T	225	2 hours
International	B737	53T	80	1 hour
Domestic	B757	97T	120	2 hours
Domestic	SD330	11T	20	1 hour

1.14 In calculating "peak" parking charges, it has been assumed that:

(a) the B747 was parked for 3 hours in the peak period and for 1 hour in the off-peak period;

(b) the A300 and the B757 were parked for 1½ hours in the peak period and for ½ hour in the off-peak period;

(c) the B737 and the SD 330 were parked for ¾ hour in the peak period.

Similar though not necessarily identical assumptions were made by BAA, in the interest of obtaining a realistic indication of typical charges, for the purposes of calculations performed during the Arbitration period.

1.15 On the basis described at paragraphs 1.13 - 1.14 above, the Tribunal has calculated the peak and off-peak charges payable in respect of each of the five aircraft/operations in question for each of the years 1980/81 - 1988/89, the last six of which fall within the Arbitration period. The calculations are set out at Tables 1.15A - E below. Charges in 1983/84 have been taken as the base for indexation purposes so as to produce indices to enable one also to see the relative changes that have occurred over the relevant period.

TABLE 1.15A
B747 USER CHARGES
(International)
MONEY OF THE DAY (I.E. UNADJUSTED FOR INFLATION)

PEAK PERIOD

		1980	1981	1982	1983	1984	1985	1986	1987	1988
Runway	Money(£)	1105	1152	1152	656	362	156	160	200	290
	1983=100	168	176	176	100	55	24	24	31	44
Passenger	Money(£)	2544	2677	2544	3103	3368	3405	3498	2809	2928
	1983=100	82	86	82	100	109	110	113	91	94
Parking	Money(£)	724	958	958	1002	926	944	949	959	703
	1983=100	72	96	96	100	92	94	95	96	70
Total	Money(£)	4373	4787	4654	4761	4656	4505	4607	3968	3921
	1983=100	92	101	98	100	98	95	97	83	82

OFF-PEAK PERIOD

		1980	1981	1982	1983	1984	1985	1986	1987	1988
Runway	Money(£)	553	576	576	328	362	156	160	160	175
	1983=100	168	176	176	100	110	48	49	49	53
Passenger	Money(£)	424	424	292	321	321	331	345	358	384
	1983=100	132	132	91	100	100	103	108	112	120
Parking	Money(£)	241	295	295	308	285	290	292	295	281
	1983=100	79	96	96	100	93	94	95	96	91
Total	Money(£)	1218	1295	1163	957	968	777	797	813	840
	1983=100	127	135	122	100	101	81	83	85	88

TABLE 1.15B
A300 USER CHARGES
(International)
MONEY OF THE DAY (I.E. UNADJUSTED FOR INFLATION)

		PEAK PERIOD									OFF-PEAK PERIOD								
		1980	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**
Runway	Money(£)	387	415	415	280	181	156	160	200	290	193	207	207	140	181	156	160	160	175
	1983=100	138	148	148	100	65	56	57	71	104	138	148	148	100	129	111	114	114	125
Passenger	Money(£)	2160	2273	2160	2635	2860	2891	2970	2385	2486	360	360	248	272	272	272	293	304	326
	1983=100	82	86	82	100	109	110	113	91	94	132	132	91	100	100	100	108	112	120
Parking	Money(£)	167	204	204	214	213	222	225	230	179	52	63	63	66	66	68	69	71	71
	1983=100	78	95	95	100	100	104	105	107	84	78	96	96	100	100	103	105	108	108
Total	Money(£)	2714	2892	2779	3129	3254	3269	3355	2815	2955	605	630	518	478	519	496	522	535	572
	1983=100	87	92	89	100	104	104	107	90	94	127	132	108	100	109	104	109	112	120

TABLE 1.15C
B737 USER CHARGES
(International)
MONEY OF THE DAY (I.E. UNADJUSTED FOR INFLATION)

		PEAK PERIOD									OFF-PEAK PERIOD								
		1980	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**
Runway	Money(£)	77	96	96	104	94	156	160	200	290	38	48	48	52	94	156	160	160	175
	1983=100	74	92	92	100	90	150	154	192	279	74	92	92	100	181	300	308	308	337
Passenger	Money(£)	768	808	768	937	1017	1028	1056	848	960	128	128	80	97	97	97	104	108	116
	1983=100	82	86	82	100	109	110	113	91	102	132	132	91	100	100	103	107	111	120
Parking	Money(£)	29	35	35	37	44	49	50	52	44	10	12	12	12	15	16	17	17	20
	1983=100	78	95	95	100	119	132	135	141	119	78	100	100	100	125	133	142	142	163
Total	Money(£)	874	899	899	1078	1155	1233	1266	1100	1294	176	188	148	161	205	269	281	285	311
	1983=100	81	83	83	100	107	114	117	102	120	109	118	92	100	128	167	175	177	193

TABLE 1.15D
B757 USER CHARGES
(Domestic)
MONEY OF THE DAY (I.E. UNADJUSTED FOR INFLATION)

		PEAK PERIOD									OFF-PEAK PERIOD								
		1980	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**
Runway	Money(£)	215	238	238	190	138	156	160	200	290	107	119	119	95	138	156	160	160	175
	1983=100	114	125	125	100	72	82	64	105	153	114	125	125	100	145	164	168	168	184
Passenger	Money(£)	552	576	516	595	637	648	660	612	660[1]	192	192	132	145	145	145	156	162	174
	1983=100	93	97	87	100	107	109	111	103	111	132	132	91	100	100	100	108	112	120
Parking	Money(£)	113	139	139	145	153	162	165	170	137	35	43	43	45	47	50	51	52	55
	1983=100	78	96	96	100	106	112	114	117	94	78	95	95	100	104	111	113	116	122
Total	Money(£)	880	953	893	800	928	966	985	982	1087	334	354	294	285	330	351	367	374	404
	1983=100	110	119	112	100	116	121	123	123	136	117	124	103	100	116	123	129	131	142

NOTE: (1) The 1988 peak passenger charge has been computed using the *summer* peak rate. The winter peak rate was 9% lower.

TABLE 1.15E
SD330 USER CHARGES
(Domestic)
MONEY OF THE DAY (I.E. UNADJUSTED FOR INFLATION)

		PEAK PERIOD									OFF-PEAK PERIOD								
		1980	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**
Runway	Money(£)	60	72	72	72	64	156	160	200	290	30	36	36	36	64	64	66	50	50
	1983=100	83	100	100	100	89	217	222	278	403	83	100	100	100	178	178	183	139	139
Passenger	Money(£)	32	32	22	Nil	24	108	110	102	110[2]	32	32	22	Nil	24	24	26	27	29
	1983=100[1]	133	133	92	Nil	100	100	108	113	121	133	133	12	Nil	100	100	108	113	121
Parking	Money(£)	6	7	7	8	14	16	17	18	23	2	2	2	3	5	5	6	6	10
	1983=100	75	88	88	100	175	200	213	225	281	67	67	67	100	167	167	200	200	333
Total	Money(£)	98	111	101	80	102	280	287	320	423	64	70	60	39	93	93	98	83	89
	1983=100	123	139	126	100	128	350	359	400	529	164	179	154	100	238	238	251	213	228

Notes:
(1) Since in 1983/84 no passenger charges were imposed in respect of aircraft not exceeding 16 tonnes maximum authorized weight, there were no passenger charges in respect of SD330 passengers in that year.
(2) The 1988 passenger charge has been computed using the *summer* peak rate. The winter peak rate was 9% lower.

Notes: (1) Since in 1983/84 no passenger charges were imposed in respect of aircraft not exceeding 16 tonnes maximum authorized weight, there were no passenger charges in respect of SD330 passengers in that year.

(2) The 1988 passenger charge has been computed using the summer peak rate. The winter peak rate was 9% lower.

1.16 It is evident from Tables 15A-E that by the end of the Arbitration period, large aircraft of the kind typically used for transatlantic flights (the B747) had enjoyed substantial reductions in user charges at Heathrow, whether one compares the figures for 1988/89 with the figures for the first year of the Arbitration period or with 1980/81.

TABLE 1.16

Changes in user charge payments made in respect of typical B747 operations at Heathrow: 1988/89 relative to 1983/84 and 1980/81 (unadjusted for inflation)		
	1988/89 relative to 1983/84	1988/89 relative to 1980/81
Peak	-18%	-10%
Off-peak	-12%	-31%

1.17 By contrast, by 1988/89 small aircraft, especially if engaged in domestic operations, had incurred substantially increased user charges at Heathrow over the same periods.

TABLE 1.17

Changes in user charge payments made in respect of typical smaller aircraft/operations at Heathrow: 1988/89 relative to 1983/84 and 1980/81 (unadjusted for inflation)		
	1988/89 relative to 1983/84	1988/89 relative to 1980/81
International		
B737 Peak	+20%	+39%
Off-peak	+93%	+77%
Domestic		
SD330 Peak	+429%	+332%
Off-peak	+128%	+39%

1.18 The figures that have been given above are unadjusted for inflation. If one adjusts for inflation using the UK Retail Price Index as recorded by BAA for its own purposes in a paper the accuracy of which neither Party contested, the following picture emerges for typical peak and off-peak operations of each of the 5 kinds defined by Table 1.13 above. In constructing the Table, the Retail Price Index figures for the month of June have been used in relation to the peak figures and the Retail Price Index figures for the month of January have been used in relation to the off-peak figures.

TABLE 1.18

Changes in user charge payments made in respect of typical aircraft/operations at Heathrow: 1988/89 relative to 1983/84 and 1980/81 (*adjusted for inflation*)

	1988/89 relative to 1983/84		1988/89 relative to 1980/81	
	Peak	Off-Peak	Peak	Off-Peak
International				
B747	-34%	-31%	-43%	-56%
A300	-25%	- 6%	-31%	-40%
B737	- 5%	+51%	- 6%	+12%
Domestic				
B757	+ 8%	+11%	-22%	-23%
SD330	+321%	+78%	+173%	-12%

(c) Average user charges paid per passenger

1.19Another way of assessing the effect of the changes in the structure of user charges at Heathrow on the airlines is to examine the average charges per passenger that the airlines have incurred in respect of traffic of different descriptions and the relative changes in those average charges. The average charge itself is arrived at by adding together the total of the user charges (landing, parking and passenger) incurred by the airlines on its (or their) relevant operations and dividing that total by the number of passengers (arrivals and departures) carried in the relevant operations. The average charges are thus synonymous with BAA's corresponding average income. In response to a request by the Tribunal, HMG provided to the Tribunal *inter alia* the statistics set out in Table 1.19A below (average income per passenger from *total* user charges, 1983/84-1988/89), together with further statistical material from which it is possible to derive figures showing BAA's average income per passenger, accounted for by each category of user charge, again in

respect of traffic of different descriptions (Tables 1.19B-D). In Table 1.19A, which alone shows figures for inflation, the inflation adjustments made by HMG have been retained, although, being based on annual averages of the Retail Price Index, the adjustments are less precise than those used in calculating Table 1.18 which take account of the different seasonal incidence of peak and off-peak charges. The user charges shown in the tables provided to the Tribunal by HMG and used for the purposes of Tables 1.19A-D below amount in total to 5% less than the totals of user charges used for the purposes of the RPI - X price-cap formula (see paragraph 6.1 - 6.6 of Chapter 7, below) in the two years 1987/88 and 1988/89. The difference may well be attributable, wholly or in part, to the fact that the latter totals evidently include "air jetty charges" whereas the former probably do not. Air jetty charges were not discussed by either Party in the course of the Arbitration and are not considered further in this Award: see paragraph 6.1 of Chapter 5 above.

TABLE 1.19A
AVERAGE INCOME PER PASSENGER FROM *TOTAL* USER CHARGES
1983/84 – 1988/89 (unadjusted for inflation and at 1988/89 prices)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	Arbitration Period 1983/4 – 1988/9	1988/89 v. 1983/84	
Inflation Factors (Using UK RPI Financial Year Averages)	1.2663	1.2046	1.1379	1.1022	1.0604				
	£	£	£	£	£	£	£	£	%
PanAm/TWA to/from US									
Actual	5.32	4.75	4.84	4.84	4.88	4.92	4.92	-0.40	-8
At 1988/89 Prices	6.74	5.72	5.51	5.33	5.17			-1.82	-27
British Airways to/from US									
Actual	7.08	6.30	5.99	5.81	5.16	4.85	5.78	-2.23	-31
At 88/89 Prices	8.97	7.59	6.82	6.40	5.47			-4.12	-46
International to/from Europe									
Actual	3.02	3.04	3.18	3.13	3.23	3.41	3.19	+0.39	+13
At 1988/89 Prices	3.82	3.66	3.62	3.45	3.43			-0.41	-11
Other International									
Actual	4.94	4.20	3.78	3.89	4.07	3.81	4.09	-1.13	-23
At 1988/89 Prices	6.26	5.06	4.30	4.29	4.32			-2.45	-39
Domestic									
Actual	1.82	2.00	2.23	2.24	2.30	2.53	2.22	+0.71	+39
At 1988/89 Prices	2.30	2.41	2.54	2.47	2.44			+0.23	+10
Airport Average									
Actual	3.69	3.45	3.44	3.39	3.46	3.51	3.49	+0.18	+5
At 88/89 Prices	4.67	4.16	3.91	3.74	3.67			-1.16	-25

TABLE 1.19B
AVERAGE INCOME PER PASSENGER FROM *LANDING* CHARGES
1983/84 – 1988/89 (unadjusted for inflation)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1983/84 – 1988/89	1988/89 v 1983/84	
PanAm/TWA to/from US	£1.02	£0.64	£0.32	£0.36	£0.32	£0.39	£0.51	-£0.63	-62%
British Airways to/from US	£1.16	£0.75	£0.35	£0.38	£0.38	£0.42	£0.55	-£0.74	-64%
International to/from Europe	£0.68	£0.64	£0.73	£0.76	£0.77	£0.93	£0.76	+£0.25	+37%
Other International	£1.13	£0.77	£0.41	£0.42	£0.41	£0.46	£0.59	-£0.67	-59%
Domestic	£0.71	£0.75	£0.90	£0.89	£0.89	£1.05	£0.88	+£0.34	+48%
Airport Average	£0.85	£0.69	£0.64	£0.66	£0.66	£0.79	£0.72	-£0.06	-7%

TABLE 1.19C
AVERAGE INCOME PER PASSENGER FROM *TERMINAL* CHARGES
1983/84 – 1988/89 (unadjusted for inflation)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1983/84 – 1988/89	1988/89 v. 1983/84	
PanAm/TWA to/from US	£3.19	£3.02	£3.32	£3.20	£3.45	£3.61	£3.31	+£0.42	+13%
British Airways to/from US	£3.82	£3.82	£3.92	£3.72	£3.25	£3.26	£3.60	-£0.56	-15%
International to/from Europe	£2.00	£2.06	£2.11	£2.01	£2.13	£2.17	£2.09	+£0.17	+9%
Other International	£2.13	£1.93	£1.85	£1.98	£2.19	£2.10	£2.04	-£0.03	-1%
Domestic	£0.87	£0.94	£0.99	£1.04	£1.10	£1.15	£1.03	+£0.28	+32%
Airport Average	£2.05	£2.03	£2.06	£2.01	£2.12	£2.13	£2.07	+£0.08	+4%

TABLE 1.19D
AVERAGE INCOME PER PASSENGER FROM *PARKING* CHARGES
1983/84 – 1988/89 (unadjusted for inflation)

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1983/84 – 1988/89	1988/89 v. 1983/84	
PanAm/TWA to/from US	£1.11	£1.08	£1.21	£1.28	£1.10	£0.91	£1.11	-£0.20	-18%
British Airways to/from US	£2.11	£1.73	£1.72	£1.70	£1.54	£1.17	£1.16	-£0.94	-45%
International to/from Europe	£0.33	£0.34	£0.36	£0.36	£0.33	£0.31	£0.34	-£0.02	-6%
Other International	£1.67	£1.48	£1.48	£1.50	£1.47	£1.24	£1.47	-£0.43	-26%
Domestic	£0.24	£0.30	£0.33	£0.31	£0.31	£0.33	£0.31	+£0.09	+38%
Airport Average	£0.79	£0.73	£0.74	£0.72	£0.68	£0.59	£0.70	-£0.20	-25%

1.20 Tables 1.19A-D indicate that *long-haul carriers* enjoyed reductions in average total user charges per passenger over the period even in terms of money of the day; in real terms the reductions were substantial. *Short-haul international traffic* (to and from other European airports) incurred a 13% increase in average total user charges per passenger expressed in money of the day which translated into a 11% reduction in real terms after adjustment for inflation. *Domestic traffic* incurred an increase of 39% in average total user charges per passenger expressed in money of the day, 10% after adjustment for inflation.

1.21 The different experiences of different airlines in different classes of traffic will have been affected not only by the structure of user charges at any one time and changes in that structure over time; the different experiences will also have been affected by the different airlines' different methods of operation (the type of aircraft used[1], the number of passengers carried per flight, the time occupied by the aircraft in charged-for parking and the mix of peak and off-peak charges incurred) and by changes in those methods of operation over time. There is no specific evidence before the Tribunal to explain in detail the actual differences in the average charges per passenger shown in Tables 1.19A-D.

(d) Proportions of total revenue from user charges accounted for by different categories of user charge

1.22 While it is evident from the statistical material referred to above that the relative weight of user charges borne by different traffic changed substantially during the Arbitration period (and in the 3 preceding years), the proportion of total user charges accounted for by the 3 different elements of user charge (runway charges, parking charges and passenger charges) changed much less. This is conveniently shown in the bar chart below, which is based on a bar chart placed before the Tribunal by USG's expert witness on structure, Dean Michael Levine, and the accuracy of which is not in dispute.

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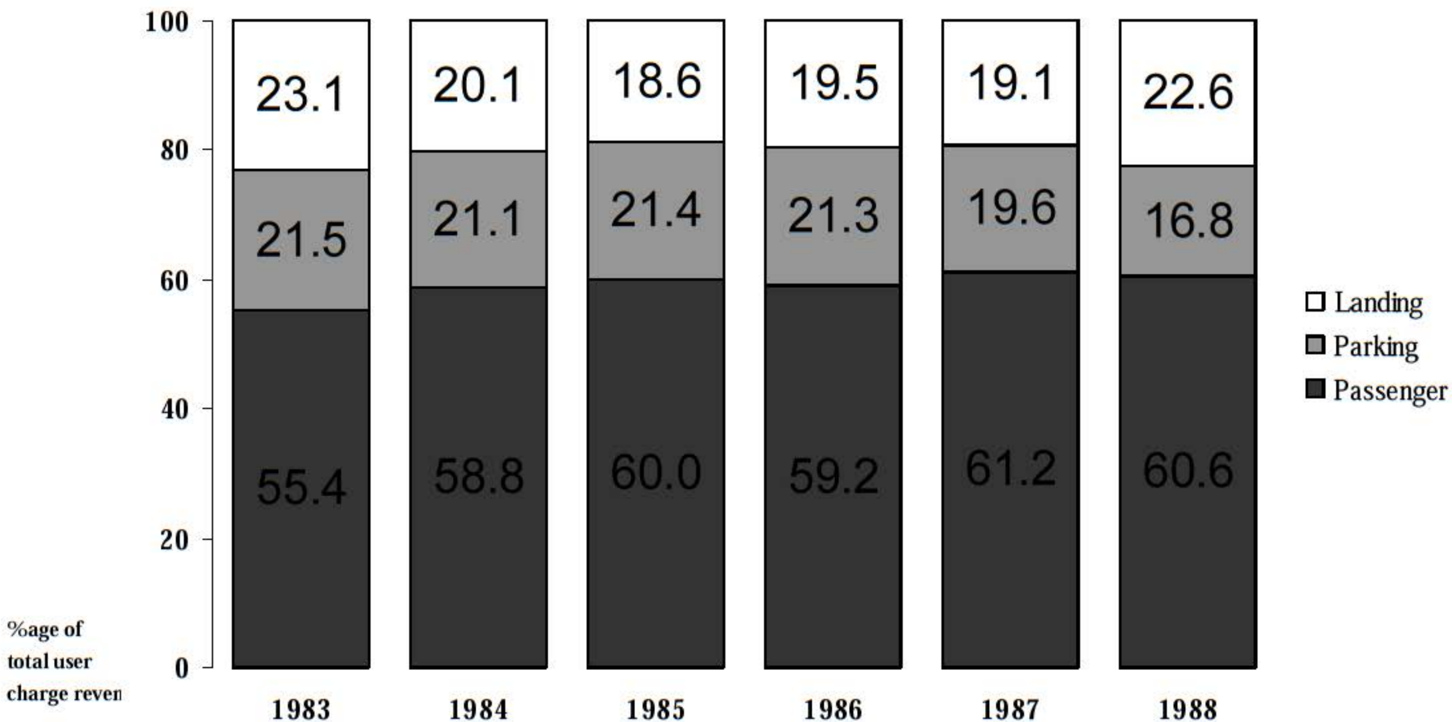
[1] New models of e.g. B747s and B737s, with maximum authorized weights other than those shown in Table 1.13, may have been introduced; but the figures in Tables l.l5A-E and those used later in this Section of the Award assume, throughout the period covered, the weights shown in Table 1.13.

TABLE 1.22
SHARES OF HEATHROW REVENUE BY CATEGORY OF CHARGE



1.23 Further reference will be made to the statistical material contained in the Tables set out above in the Tribunal's discussion of the issues that have been raised in connection with the structure of user charges at Heathrow during the Arbitration period.

II. The Parties' submissions as to the relevant costs to be taken into account

(a) Use of "economic costs" rather than "accounting costs"

2.1 It was common ground between the Parties that user charges at Heathrow were not calculated by BAA by reference to "accounting costs": for example, BAA's Accounts showed that 20% of Heathrow's assets were runways and lighting and that the airfield accounted for 26% of total operating costs at the airport. However, although HMG referred to those facts, it was accepted by all concerned that runway charges had not been set by BAA on the basis of such percentages. It was equally common ground between the Parties that the proportion of total user charges, either by category (runway, parking and terminal) or in the aggregate, borne by a particular airline was not calculated by BAA by reference to the proportion of e.g. total passenger movements through the airport, total air traffic movements (ATMs) or total weight of aircraft using the airport, for which the airline in question accounted. Methods of calculation of user charges using, alone or in combination with other criteria, accounting costs and dividing them pro rata to such totals were, according to the evidence before the Tribunal, the norm in the United States and elsewhere in Europe, though they evidently present their own problems and contentious issues.

2.2 It was ultimately common ground between the Parties that the correct method of setting user charges is to identify the marginal costs (in the Arbitration sometimes called "economic costs") associated with the airline's operation at the airport for which the charge is being made. The Tribunal here uses the expression "ultimately" because USG's First Memorandum was capable of being read as denying the appropriateness of using economic costs; USG's Second Memorandum accepted that there was a case for setting user charges on a marginal cost basis and suggested that use of *either* accounting costs, appropriately allocated by reference to share of relevant usage, *or* of economic costs accorded with sound economic principles so as to satisfy the requirements of Article 10 of Bermuda 2; as appears from HMG's Second Memorandum, USG, after filing its Second Memorandum, described *average accounting cost* pricing to the U.K. Monopolies and Mergers Commission as "the fairest and most economically efficient way to set user charges in the circumstances at Heathrow". However for the purposes of the Arbitration, USG's position was finally defined in unequivocal terms some two months later in USG's List of Issues where USG stated that: "To ensure the most efficient possible use of Heathrow's facilities, ... sound economic principles [required] that user charges at Heathrow be set at short run marginal costs" - that is, a form of economic pricing.

2.3 It was common ground between Dean Michael Levine, who gave evidence for USG, and Professor Alfred Kahn, who gave evidence for HMG, that marginal costs have two principal components. These were conveniently summarized by Professor Kahn as follows:

> "The first [component] is the cost incurred in producing or increasing the supply of each service - - the cost of labor, materials and other variable inputs mobilized for that purpose. The second, somewhat less obvious component, is the external cost that additional consumption of the service by any particular individual or group of individuals imposes on other parties; the most important of these would ordinarily be costs imposed on other users or potential users of the same services, in the form of additional discomfort, delay, or even inability to obtain access to the facility at the preferred time.
>
> "These external costs may be visualized as the (marginal) costs either of crowding or of crowding out, the former involving congestion, delay and discomfort, the latter displacement. In either event, they are real social costs imposed by incremental consumption and must be reflected in the prices of the several airport services if the facilities are to be used with maximum efficiency" (footnotes omitted).

(b) Economic costs: relevance or otherwise of long-run as well as short-run marginal costs

2.4 Much evidence was devoted to the question whether USG was correct in advocating the use of short-run marginal cost ("SRMC") pricing for all relevant purposes at Heathrow (runways, terminals and aircraft parking facilities) or whether HMG was correct in advocating (a) the exclusive use of SRMC pricing only for use of the runways, and (b) long-run marginal cost ("LRMC") pricing, modified, so far as might be appropriate, by reference to SRMC, for use of terminals and aircraft parking facilities.

(i) Short-run marginal cost (SRMC)

2.5 Professor Kahn defined Short-Run Marginal Cost (SRMC) as "the costs - as always, including both supply and congestion costs - imposed by an extra unit of demand under conditions whereat least one input (typically capital, which determines capacity) is fixed"; and the Tribunal adopts that definition, with the qualification, to use Dean Levine's words, that "The degree to which capacity is really 'fixed' in the short run will vary considerably from case to case."

2.6 It follows that at times when, if a user charge is set at merely the extra cost to the airport operator resulting from the use of the facilities in question, all the demand for the use of that facility can be met, then, adopting an SRMC-based approach, the user charge should be set at a level equal to that cost which, in those circumstances, is the SRMC.

2.7 If at such times charges are set at that level, then no user that would have been prepared to pay charges equal to the incremental costs attributable to its use of the airport facilities will have been deterred from using those facilities by reason of the imposition of a higher charge. But when all demand cannot be met if the user charge is set at merely that level (and one may call such a time one of "excess demand"), the user charge should, on an SRMC

approach, be raised to the point at which enough demand is choked off by a rise in price such that all the demand that remains can be met. Thus, at times of excess demand, SRMC-based prices are essentially rationing prices - prices that are high enough to cut off, but only just to cut off, demand in excess of existing capacity. In this way, scarce resources are allocated to those who value them most highly, to whom, presumably, use of the resources is objectively most valuable.

2.8 The matter was put as follows by Dean Levine in his evidence to the Tribunal:-

> "... when demand exceeds capacity for time periods too short to justify increasing capacity, users should be required to choose whether or not to use the facility by paying prices that reflect the value placed on it by other prospective users. Those who do not value it as much will find an acceptable lower-cost alternative (such as access during an off-peak time of day) or will stop using it entirely if enough others value it more highly. But, as before, prices which are set higher than marginal cost (i.e., the costs imposed on other users) result in inefficiency and waste by discouraging uses that could have been accommodated. Therefore, sound economic principles require that short-run prices be set only as high as necessary to bring demand back into line with capacity.
>
> "In short, charging SRMC prices ensures that resources are used by those who value them the most, thus satisfying our first condition for economic efficiency. Such prices also provide part of the information necessary to determine whether more or less investment is required …"

2.9 It will be noted that, *at times of excess demand*, the marginal cost comprises the costs imposed on other users (congestion and crowding out costs) rather than the costs of the airport operator which, *ex hypothesi*, are lower (this follows from the definition of a time of excess demand as a time when all demand cannot be met if the user charge is set at merely the level equal to the airport operator's short-run marginal cost).

2.10 In its First Memorandum USG had referred to the textbook statement of Professor Kahn, that "it is no simple matter to measure marginal cost" and had commented that that was probably the understatement of the year. However, Dean Levine's evidence was that it was unnecessary to seek to measure directly the costs in question of the relevant third parties: the relevant third party was the user that was prepared to pay the market-clearing price but no more. The price that that user was prepared to pay in circumstances of excess demand quantified the cost to it of depriving it of the use of the resources in question. In that sense SRMC-based prices were cost-based, though the costs were not necessarily those of the airport operator. Accordingly, the ascertainment of SRMC at times of excess demand did not require one to try to identify all the costs that would be incurred by the relevant third parties if they were deprived of the use of the resources in question; one needed simply to ascertain, by experimentation, the market-clearing price; the SRMC could then be equated with the cost of the marginal buyer. However, as USG noted, the capacity of an airport is a complex concept and has subjective aspects, e.g. as to the amount of waiting and

degree of discomfort regarded as tolerable and in practice this complicates the ascertainment of SRMC and the establishment of satisfactory rationing prices.

(ii) Long-run marginal cost (LRMC)

2.11 In its Second Memorandum USG accepted that there were circumstances in which it was appropriate to have regard to long-run marginal cost ("LRMC") in setting prices. Before describing those circumstances, it is useful to try to define LRMC and to distinguish it from SRMC.

2.12 Dean Levine defined LRMC as "the cost of adding fixed plant capacity in order to increase output"; when that cost is divided by units of capacity or use, it can, Dean Levine said, be expressed as a cost per unit.

2.13 Professor Kahn's evidence was to the effect that LRMC -- or long-run incremental cost (LRIC) -- could be defined "in terms of the additional costs experienced if all inputs are variable (and, specifically, fixed capacity can be expanded or contracted). The principal distinction between LRMC and LRIC is the recognition in the latter that capacity is typically added in discrete and sometimes large lumps -- in which event what is being measured is a kind of average marginal or incremental cost". Professor Kahn added that, because LRIC was "the more practical variant of long- run marginal cost pricing", that was the term that he preferred to use.

2.14 The third definition of LRMC that was offered to the Tribunal was given by Mr. Wynne Jones, a Partner in the Communications, Energy, Water and Transport Division of the Management Consultancy Services practice in Coopers & Lybrand Deloitte who gave evidence for HMG. Mr. Wynne Jones put the matter as follows:

> "In its simple textbook form LRMC is defined as the cost of an extra unit of supply given adaptation of all factors of production including the capital stock. Effectively the existing capital stock is ignored and it is implicitly assumed that capacity can be recreated in an optimal manner 'from the bottom up'. This definition of LRMC is in essence a timeless notion of cost which gives no weight to the real costs which consumption will impose in the short to medium term and which ought also to bear on efficient (economic) pricing. There are also considerable difficulties in applying such a concept where demand changes over time and investment is lumpy [i.e. where 'the economically-efficient size of capacity additions is large in relation to already installed capacity']."

2.15 In practical terms BAA defined LRMC as "the cost in the long run of meeting a permanent increment in demand" (BAA76/82, November 1982, Annex to Appendix A (Cost and Charging Study Report, October 1982), paragraph 6). "Pursuing a pricing policy based on LRMC therefore means setting charges that in some sense cover both the cost of expanding capacity and any operating costs at the new level of capacity. Since the allocation of traffic between terminals and stands at Heathrow is essentially an operating matter designed to make the most efficient use of the available space, the pricing objective should be to relate the overall tariff for the use of terminal facilities to the LRMC of the latest existing or planned further facilities" (TCG/BAA1, Heathrow Traffic - Cost Related Charges, August 1983,

paragraph 1.9). The terminal and parking facilities used by BAA for the purposes of computing LRMC at Heathrow during the Arbitration were generally those that comprised Heathrow Terminal 4, which came into operation in 1986, i.e. in the middle of the Arbitration period. As BAA noted (*ibid.* paragraph 1.14), LRMC is of no use where, as in the case of runways at Heathrow, new facilities cannot be provided.

2.16 As described by BAA, the "key component" of its approach "has been the recognition that additional terminal and apron capacity is only required to meet growth anticipated in peak periods, since growth of traffic at off-peak times can be accommodated within existing facilities. On this basis the cost of providing additional capacity should be borne by peak passengers, whilst off-peak passengers should only bear the operating costs necessary to accommodate their traffic" (BAA 16/86, Traffic Charges 1986/87, March 1986, paragraph 8). For this reason separate LRMCs were calculated by BAA in detail for peak traffic, on the one hand, and off-peak traffic on the other.

2.17 Therefore BAA broke LRMC down into, on the one hand, "*capacity-related costs*" (costs that arose, or would arise, by reason of the creation of the additional capacity, irrespective of the extent to which it was or would be used) and, on the other hand, "*time-related*" and "*traffic-related" costs* (costs, such as those of lighting the facilities, that varied or would vary, with the time during which the facilities were or would be open; and costs, such as those of baggage-handling, that varied or would vary substantially with the volume of traffic). Capacity-related costs were attributed only to peak traffic, traffic costs to all traffic; other costs were treated as overheads, as a percentage addition to peak and off-peak costs (BAA 82/82 Traffic Charges: Study and Consultation, December 1982, Annex to Appendix A, paragraph 9). Apparently roughly one-third of *operating* costs fell into each of the three categories but all *capital* costs fell into the capacity category; given the fact that about 75% of BAA's costs were capacity-related, it followed that peak LRMCs were much higher than off-peak LRMCs (*ibid.*).

2.18 As BAA recognized, "A key aspect of determining [peak and off-peak LRMC] unit costs is that only peak traffic should bear the capacity-related element of costs. It is therefore necessary to define 'The Peak'" (BAA 76/82, Traffic Charges Study and Consultation, November 1982, Annex to Appendix A, paragraph 17).

2.19 The proper criterion for defining peak traffic was said by BAA to be whether the traffic contributed to the decision to expand capacity; if not, the traffic should be defined as off-peak (TCG/BAA 3, Heathrow Traffic, Analysis of traffic to determine peak periods, August 1983, Overview).

2.20 It follows that, even at times when demand is low relative to capacity, LRMC unit costs (not being determined by the operator's costs of operating the actual facilities in question) may exceed or be less than SRMC (which, at such times, is determined by the operator's actual costs incurred as a result of operating the facilities in question). However, in the absence of a

significant change in technology since the construction of the actual facilities or an expectation that new facilities will be on a significantly different scale, there is no reason to expect LRMC and SRMC to diverge substantially from each other at times when demand is low relative to capacity. By contrast, at times when demand is high relative to capacity, there would seem to be a likelihood of a significant divergence between LRMC unit costs and SRMC since at such times SRMC is determined by the costs of third parties (here, the airlines), whereas the LRMC unit costs are, as always, the costs of the airport operator, or more precisely the costs that the airport operator would incur if it satisfied the demand by expanding its capacity in an economically viable step.[2] Thus, at any rate in the case of airport user charges, in times of excess or relatively high demand, *neither SRMC nor LRMC* is computed by reference to the airport operator's actual costs in the sense of the capital cost of the actual facilities used plus the cost actually incurred by the operator in operating those facilities.

(iii) The first sentence of Article 10(3) of Bermuda 2

2.21 It follows that, once one accepts, as both Parties do, that the structure of charges is to be determined by reference to economic costs (and not necessarily the economic costs *of the airport operator itself*), the first part of the first sentence of Article 10(3) of Bermuda 2 ("User charges ... shall not exceed the full cost *to the competent charging authorities* of providing appropriate airport … facilities and services ...") must be understood as being concerned exclusively with the *level* of charges (the total of all user charges are not to exceed the airport operator's total costs of providing the facilities etc. in question by such an amount as would generate an excessive rate of return) and not at all with the *structure* of charges: otherwise the words in question in Article 10(3) would preclude the use of at least SRMC, which both Parties agreed to be the appropriate basis for establishing runway charges.

(iv) SRMC as the economic cost agreed to be exclusively relevant to the establishment of runway charges

2.22 HMG agreed that SRMC was the appropriate economic cost for use in the establishment of runway charges because there was no prospect of constructing any further relevant runway in the foreseeable future: there was therefore no relevant LRMC on which to base runway charges and the marginal costs to be used for the purpose were therefore necessarily SRMC. For USG, SRMC provided the correct basis for establishing all categories of

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[2] Professor Kahn testified that "*In equilibrium* ... SRMC and LRMC should be equal" (emphasis added); but he immediately noted that, at times of increasing congestion, they could diverge to a substantial degree; and where investment is "lumpy" and the construction of new facilities may take a relatively long time, it seems to stand to reason that there may indeed be substantial divergence.

user charge at Heathrow, so that in this respect runway charges did not differ from terminal or parking charges. Thus, although the Parties agreed that SRMC provided the economically correct basis for establishing runway charges, they did so for somewhat different reasons.

(v) The Parties' views about the use of LRMC

2.23 USG did not absolutely exclude the use of LRMC in price-setting but took the view that the circumstances in which it was appropriate to use LRMC were very restricted and did not exist at Heathrow. Thus, according to USG, use of LRMC-based prices was economically sound only -

- for the purposes of long-term supply contracts requiring major capital investment by both parties or
- where a producer seriously questioned whether users would pay for new capacity, if built, and therefore tested the water with LRMC-based prices.

2.24 According to USG, neither of those conditions prevailed in the present case (with regard to the latter, USG also alleged, *inter alia*, that instead of using prices to signal when to expand capacity, BAA's charges had been imposed subsequent to the investment decision and merely for the purpose of raising revenue).

2.25 HMG contended that, even applying USG's tests, LRMC was relevant to terminal and parking charges since basing them on LRMC did have a value in this case in generating a sufficient degree of certainty to encourage investment; according to HMG, USG's contention that such prices should be used only temporarily to test the water would create uncertainty as to future returns on investment; it would also in practice create volatility of prices and of returns.

2.26 However, HMG did not wholly reject the use of SRMC in setting terminal and aircraft parking charges at Heathrow. Indeed, in its First Memorandum, HMG said that there was no clear-cut choice as to which of SRMC or LRMC was more appropriate as a basis for charging; where, as in the case of terminals and parking stands at Heathrow in the 1980s, capacity could be expanded, SRMC had the disadvantage that prices based on SRMC would fluctuate substantially. By contrast, use of LRMC as a basis for pricing of expandable facilities that were in varying demand in the short term (especially if they were also in growing demand in the long term) had, in the view of HMG, the advantage that those whose demand at the times of greatest demand would be causally responsible for investment in further capacity to meet that demand, should be made aware of the cost of that investment and should be required to bear that cost if they found it economically attractive to persist in the pattern of usage that necessitated investment in the further capacity.

2.27 However, HMG recognized that, although use of LRMC performed the function just described and created greater stability of price, it did not give as much weight to matching demand to capacity over the short term. In such circumstances either LRMC or SRMC could be applied and, in the view of HMG, the basing of charges on LRMC did not exclude reference to SRMC in order that charges might properly reflect short run conditions and changes in them.

III. Irrelevance of international comparisons in choosing between SRMC and LRMC

3.1 In resolving the differences of economic approach advocated by USG, on the one hand, and by HMG, on the other, no help is to be derived from international comparisons since apparently nowhere in the world is there to be found an airport that operates a system of pure SRMC pricing (such as both USG and HMG believed to be economically correct for use as a basis for establishing at least runway charges at Heathrow); nor apparently is there any airport other than BAA airports to which one can look as providing another example of LRMC-based/SRMC-influenced charging such as HMG contended that BAA practiced and properly practiced.

IV. The need to take into account commercial income and its implications

4.1 A further complicating factor requires mention at this juncture. Bermuda 2 clearly recognises the need for charges to be set at levels that do not yield overall excessive returns (though the relationship between that need and the need for charges to be based on sound economic principles has yet to be discussed: see paragraphs 4.13-4.17 of this Chapter, below). The Tribunal has concluded that, in looking at the overall return by reference to which the reasonableness or otherwise of user charges at Heathrow is to be judged, it is necessary to include BAA's commercial activities (shops, including duty-free shops, other concessions, check-in and ticket counters and certain baggage-handling facilities made available to airlines). This means that it is not appropriate to try to identify separately the costs incurred by BAA in earning the commercial revenues and the capital employed by BAA for the purpose and, having done so, to strip out the commercial revenues from the airport's total revenues, on the one hand, and the costs and capital employed attributed to the commercial activities from the airport's total costs and capital employed, on the other hand.

4.2 The "economic" reasons for that conclusion are that:

(i) Commercial activities formed an economically important part of the activities at the airport.

(ii) The air traffic activities and the commercial activities substantially overlapped; for example, many areas of terminals and facilities were used by passengers both when shopping and when on their way to and from aircraft; some of the commercial activities included the

provision of services and facilities to airlines that were ultimately connected with those airlines' traffic activities (for instance, the provision of ticket sales and check-in counters and the provision of those of the baggage-handling facilities that BAA made available to airlines to enable them to engage in air traffic activities from and to the airport).

(iii) The overall attractiveness of, and hence demand on, Heathrow were liable to be affected by the attractiveness of both its air traffic facilities and services and of its commercial facilities and services.

(iv) In such circumstances, sound economic principles provide no basis for allocating many of BAA's operating costs and much of its capital employed as between traffic and commercial activities. The services provided by BAA were produced in common and, as Professor Kahn put it:

> "[The] concept of 'profits' or rates of return on individual products or services that are produced in common with others lacks economic precision. One can speak of and measure the extent to which the prices of various common products exceed their marginal costs, and therefore the net revenues (above marginal costs) that each contributes to the coverage of overheads and joint costs, but the only economically significant measure of profit is for the combined operation - - the difference between total revenue and total cost."

For the purpose of efficient pricing, Professor Kahn went on, allocations of joint or common costs between the air traffic services and the commercial activities, permitting a calculation of their separate "profits", are irrelevant.

(v) Moreover, if such an exercise is attempted *for any purpose*, the definition of the profit/loss attributed to air traffic activities (e.g. "*trading* profit/loss" or "*operating* profit/loss") and the accounting conventions used to compute it are capable of having (and during the Arbitration period in fact had) a significant effect on the apparent split of profit/loss as between the air traffic activities and the commercial activities.

(vi) In an investigation of BAA's commercial activities carried out in 1985, BAA told the UK Monopolies and Mergers Commission "that in practice it had to provide commercial services as well as facilities for the movement of passengers. The distinction in its Accounts between traffic operations and commercial activities was therefore not meaningful and it continued to present them in that form only because the Secretary of State required it to do so."

(vii) The foregoing is not to deny that allocations may in practice be performed that enable management, government and regulatory agencies to see *changes* in the economic importance to an airport of air traffic services and commercial services over time if a known and consistent methodology is adopted; but that should not mislead one

into attributing an independent and objective validity to a figure for profitability for one or other of the activities as such at any one point of time.

4.3 Accordingly, in the absence of any clear indication of a contrary intention on the part of the Parties, the Tribunal would conclude that, in ascertaining whether the total of all user charges exceed full cost etc., including a reasonable profit, commercial profits must be brought into the reckoning either:

- as being analogous to revenue from sales of a by-product which go to reduce costs of the main product or
- as profit that is inextricable from the results of the supply of the main product.

In those circumstances, although commercial charges may fall outside the definition of "user charge" contained in Article 1(o) of Bermuda 2 and although, in accordance with Article 10(3), it is *user charges* that may provide for a reasonable rate of return, those facts do not preclude the bringing of commercial income into the reckoning when the rate of return comes to be computed; and the Tribunal rejects HMG's argument to the contrary.

4.4 In the present case, the Tribunal finds no indication of an intention on the part of the Parties that commercial income should *not* be taken into account. In this connection reference was made to the inter-governmental Memorandum of Understanding of April 6, 1983. The legal significance of the MoU generally is discussed at paragraphs 6.1 *et seq*. of this Chapter, below. Here it is sufficient to refer to paragraph 4(c) of the MoU, which is in the following terms:

> "In formulating financial targets with the BAA, HMG acknowledges the need to secure efficient use of the public resources employed by the BAA, and looks for no more than a reasonable rate of return on investment. In computing revenues that contribute to the rate of return on assets, no distinction will be made as to the sources of revenue, including duty-free sales and other commercial revenues."

4.5 HMG contended that the opening words of the paragraph indicated that the bringing into account of commercial revenues in assessing the profitability of BAA for the purposes of Bermuda 2 was intended by the Parties to be confined to the formulation by HMG of financial targets for BAA.[3]

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[3] By a Freudian slip, HMG pleaded elsewhere, albeit with reference to revenues from investment properties rather than commercial revenues that:

> "Paragraph 4(c) of the inter-governmental MoU provides that, in computing the revenues that contribute to the rate of return on assets, no distinction will be made as to the source of those revenues. This understanding would preclude BAA from omitting such properties from the calculation of rates of return."

4.6 The Tribunal cannot accept that contention. At the time when the inter-governmental MoU was negotiated, BAA was still wholly owned by HMG and it was natural for the Parties to have focused their attention on the financial mechanism that was then in place, namely the formulation by HMG of financial targets for BAA. In so doing, the Parties cannot sensibly be taken to have been recording a common understanding that the bringing into account of commercial revenues was to be confined to discharge by HMG of its responsibilities when setting financial targets; at an airport such as Heathrow, any such confinement would in practice have virtually deprived the rate of return limitation of any real commercial significance.[4] That that was *not* the Parties' intention is evidenced by the following facts:

(a) Not only before privatization but also afterwards - and notably for the purposes of setting the rate-capping formula RPI - X referred to later in this Award - BAA's profitability was assessed without any distinction being drawn between the profitability of traffic activities and the profitability of commercial activities. In October 1986 the U.K. Department of Transport described this, with reference specifically to determination of the value of X, as being "[in] line with our international obligations."

(b) The Public Offer for Sale of BAA shares on its privatization in July 1987 (which may be taken to have been very carefully scrutinized by the lawyers acting for both HMG and BAA) stated that the inter-governmental MoU "acknowledged that, in computing revenues that contribute to the rate of return on assets, no distinction will be made as to the sources of airport revenues, including duty-free sales and other commercial revenues"; yet, on HMG's view of what the MoU signified in this respect, the only understanding of the Parties as to how commercial revenues should be treated in computing profitability would have become spent when BAA ceased to be owned by HMG and, as such, would have been irrelevant to the Public Offer for Sale.

4.7 The Tribunal accordingly concludes that in assessing the profitability of Heathrow Airport for the purposes of Article 10(3) of Bermuda 2,

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Such a line of reasoning would apply *a fortiori* to revenues from commercial activities.

[4] HMG also contended that the only source for the obligation alleged by USG to rest on HMG to adopt a one-till approach was the inter-governmental MoU; if so, that would put obligations on HMG under Bermuda 2 in relation to Heathrow which were not imposed on USG under Bermuda 2 in relation to U.S. airports: the application of the Treaty to airports in the Contracting States would then not be equal. Since, in the judgment of the Tribunal, the MoU is not the source of the obligation to adopt a one-till approach and that obligation rests equally on both Parties, it also rejects this contention made by HMG.

commercial activities as well as traffic activities must be taken into account. This was referred to by the Parties as a “single-till” approach.

4.8 USG submitted that there was no evidence that the combination of adoption of a single-till approach and the setting of user charges equal to economic costs would generate excessive profitability at Heathrow. However, for reasons about to be given, the Tribunal has concluded that on a balance of probabilities that is likely to have been so throughout the Arbitration period.

4.9 The *incremental* capital and operating costs resulting from providing commercial facilities over and above those required anyway for air traffic facilities may be quite small (hence, almost certainly, the fact that, on the basis of essentially marginal cost allocations made by BAA[5], it generally “made a loss” on its air traffic activities at Heathrow and it generally “made a profit” (which very substantially exceeded that loss) on its commercial activities there). Moreover, especially so long as duty-free concessions remain in force at international airports, the high profitability that is to be expected to be earned at “duty-free shops” (where in truth the saving in duty is shared between the passenger/customer, the operator of the shop and the airport, as the owner of the shop) makes it even more likely that, at least during the Arbitration period, an airport like Heathrow, with its very substantial commercial activities, was inherently more profitable than it would have been without those activities; and the documents before the Tribunal frequently refer to the major contribution made by the commercial activities, which BAA had successfully developed at Heathrow, to keeping down user charges.

4.10 It also seems highly improbable that, at a mature and very successful airport such as Heathrow, the establishment of charges at levels *equal to* the relevant economic costs in accordance with sound economic principles would lead to losses or inadequate profits in the absence of the commercial activities comprised of the shops and other similarly valuable trading concessions. There was nothing in the voluminous material before the Tribunal to suggest the existence of such a *prima facie* improbable state of affairs.

4.11 It follows that it is, to say the least, probable that the establishment of user charges at Heathrow in the 1980s at levels *equal to* the relevant economic costs would have resulted in air traffic revenues which, when the commercial revenues were added to them, would have generated excessive profitability. One may add that, if one takes as correct the marginal costs identified by BAA in its 1982-1984 investigations (and, subject to the availability of some additional figures calculated by Coopers & Lybrand

[5] E.g. for its Annual Reports BAA allocated to traffic activities the whole of the cost of terminals, other than the actual areas occupied by shops, banks, etc., and all other expenditure, such as on roads and administration, that was not clearly identifiable with the provision of commercial facilities and services.

Associates in 1987 and referred to below, those are the only marginal costs to have been placed before the Tribunal by either Party), then, on a single-till approach, user charges *equal to* those costs would almost certainly have generated excessive profitability for the airport operation as a whole.

4.12 This has an important consequence, namely that it is most improbable that, at least in the absence of some other change in BAA's *modus operandi*, user charges *could* have been set *at* the corresponding marginal costs, without realizing excessive profitability.

4.13 This potential conflict between the establishment of charges in accordance with sound economic principles (the determination of the *structure* of charges) and the requirement that charges in total (see paragraph 2.21 of this Chapter, above) should not generate excessive profitability (the capping of the *level* of charges) necessarily arises because, as both Parties agreed, charges are to be determined by reference to economic costs and not accounting costs. There is no law of economics that says that the charging of rationing prices for a highly demanded product, the supply of which is more or less limited in the long term, cannot lead to excessive profitability (unless, of course, the profits are themselves capitalized and the profitability is thereby normalized).[6]

4.14 If, in addition to using economic costs to establish the structure of charges, one uses economic profitability (discussed at paragraphs 3.3 - 3.5 of Chapter 7, below) then one introduces a *further* potential source of conflict between the determination of the structure of charges and the requirement that charges in total should not generate excessive profitability, since the appreciation of assets of the undertaking, especially if wholly unrelated to its charges, may be responsible for its excessive profitability.

4.15 In so far as use of SRMC as a basis for user charges contributes to excessive profitability and charges below SRMC are charged in order not to exceed the ceiling on profits, a serious problem will be encountered: as already noted, the only practical way of ascertaining SRMC in periods of excess demand is by experimenting to discover the market-clearing price. But that is precisely what the airport operator will not be able to do without, *ex hypothesi* in the case under consideration, exceeding the ceiling on profit. Moreover, as Dean Levine testified, charges that are set at less than SRMC in periods of excess demand will not result in an optimal allocation of the limited

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[6] By contrast, the use by an undertaking of accountancy costs in the determination of its prices means that the undertaking can always recover its full accounting costs and make no more than a reasonable accounting profit: accounting profit is by definition the excess, if any, of revenue over accounting costs and the undertaking can always limit that excess. Hence, however economically irrational prices based on accounting costs may be, there is no difficulty in preventing their generating excessive accounting profitability.

available resources even if the charges bear the same *relationship* to each other as would SRMC-based charges (set at a different level). In so far as charges are based on LRMC the practical problem is less acute but a potential (and, in the present case, probable) conflict remains between a limitation on the rate of return and the application of sound economic principles.

4.16 In these circumstances it is necessary to decide whether the principle that user charges shall not generate an excessive rate of return or the principle that charges shall be based on sound economic principles takes precedence in any consideration of the quality of user charges as just and reasonable or otherwise for the purposes of Article 10(1) and (3) of Bermuda 2.

4.17 Despite the difficulties inherent in such an interpretation, the Tribunal feels constrained to arrive at the conclusion that the provision contained in the first sentence of Article 10(3) to the effect that user charges "shall not" exceed full cost, including a reasonable rate of return on assets, reflects a view of the Parties that user charges cannot be just and reasonable to the designated airlines of the other Party if they result in an unreasonably high rate of return; the Tribunal is therefore of the view that the maintenance of a ceiling on rate of return is intended to take precedence over the other aspects of charges that are relevant to whether or not they are just and reasonable, including their conformity with "sound economic principles". This, moreover, is consistent with the contrast between the imperative drafting of the first sentence of Article 10(3) ("user charges ... *shall not exceed* the full cost ...") with the discretionary element to be found in the third sentence of the paragraph "User charges shall be *based on* sound economic principles ...".

4.18 On the basis of the material before the Tribunal there appeared to be three potential solutions to the problem of reconciling the use of marginal costs for pricing purposes and the overriding prescribed restriction on the rate of return (i.e. for the purposes of the present Arbitration, in effect the pre-tax rate of return; otherwise the problem could indeed be solved by the imposition on BAA of a tax which would absorb, or largely absorb, "excess profits"; but neither Party argued that use of such a tax would be consistent with Bermuda 2). First, Dean Levine believed that, if there were any excess profit, it could be returned to the airlines by means of a rebate given after the event. Yet, as Professor Kahn pointed out, any such rebate, if given by reference to rational, and therefore predictable, rules would be equivalent to a reduction in price, albeit that the reduction would take the form of a deferred rebate; but in that case, *ex hypothesi* the price would have been reduced to below marginal cost, which is contrary to any pure theory of marginal cost pricing. It may be added that Dean Levine did not suggest on what basis his deferred rebate should be given and it seems inevitable that, whatever basis were adopted, problems of the kind discussed below in connection with the third potential solution would arise.

4.19 Secondly, Professor Kahn suggested that any excess profit could be eliminated by reducing commercial charges, e.g. rents to operators of shops.

But *prima facie* such a reduction would run counter to the principle of economic pricing - i.e. economic pricing of the facilities and services for which BAA makes commercial charges - thereby depriving *those* charges of *their* rationing and other economic functions. Alternatively, *if* the reduction in commercial charges were accompanied by the imposition by BAA of relatively low maximum retail prices/retail charges in the shops and concessions, the benefit would flow largely to passengers who happened to be purchasers of alcoholic and tobacco goods and certain other highly taxed luxury articles. It is not evident to the Tribunal that sound economic principles dictate such a result.

4.20 The third possible solution is openly to depart from equation of user charges and economic costs and to set charges below economic costs, whether by using commercial profits as an offset against traffic costs or otherwise, to the extent necessary to prevent the overall rate of return from becoming unreasonably high. This was apparently the course adopted by BAA.

4.21 Adoption of the third course leaves open the method of its implementation. Initially BAA believed that -

(a) the commercial profits should be deducted exclusively from the terminal charges (the commercial activities being conducted in the terminals) and

(b) the commercial profits should be deducted differentially as between international and domestic terminal charges since international passengers generated more commercial income than domestic passengers.

4.22 The precise treatment of commercial income actually adopted by BAA when it computed user charges remains obscure: see paragraph 9.3 (cited at paragraph 5.2 of this Chapter, below) of the Statement of Principles published by BAA in February 1985 as part of the consultation process; but contrast paragraphs 11.7.21 - 11.7.32 of this Chapter, below.

V. BAA's Statement of Principles in respect of user charges

5.1 As contemplated by the Airlines Settlement Agreement of February 22, 1983 (paragraphs 3.4 - 3.7 of Chapter 2, above), throughout the rest of 1983 and into the fourth quarter of 1984 BAA carried out an extensive review of the structure of its user charges, in particular but not only at Heathrow. The review involved *inter alia* the preparation by BAA of "consultation papers" which were sent to the airlines, including PanAm and TWA, and consideration by BAA of "position papers" prepared by the latter. The review process as a whole was and is generally referred to as "the Medium Term Review" or "the Mid-Term Review". The Statement of Principles referred to at paragraph 4.22 of this Chapter, above formally enunciated the principles which in February 1985, following on the Medium Term Review, BAA claimed that it would apply in setting user charges in future and which it put to users.

5.2 BAA began by referring to "differences of perspective [between it and users] about the proper basis for charging". The differences were said to be in part about the scale and nature of the facilities to be provided by BAA (one of the few issues *not* to be raised in the present Arbitration) and in part about the basis for the establishment of charges, which users believed should "be derived by apportioning the total accounting costs incurred by BAA over any given period between the various operators by some form of averaging". The following paragraphs of the Statement of Principles are of particular relevance to *structure* of charges.

> "*4.* After fully considering the many submissions on this matter including Government policy, principally expressed in the 1978 White Paper "The Nationalised Industries", the Authority has concluded that a pricing structure based on economic costs will best ensure that existing facilities are used efficiently and that resources for investment are allocated efficiently and economically.
>
> "*5.* In assessing traffic charges, the BAA has concluded that the relevant economic costs are those associated with its traffic operations, and are best identified as the marginal costs associated with those operations. However, it is also recognised that commercial income forms an integral part of revenue. The BAA therefore proposes to continue to use commercial income to abate traffic charges, where this is consistent with the achievement of its objectives.
>
> …
>
> "*7.* The BAA believes that the evolution of charges in accordance with marginal cost principles must also reflect the constraints imposed by its statutory obligations and normal financial and commercial criteria. These will include consideration of the need to generate revenue to continue to manage and develop its airports and thereby meet the needs of both present and future customers.
>
> "*8.* In coming to these conclusions, the BAA has been mindful of the Memorandum of Understanding and Settlement Agreement. It has also been cognizant of users' views of the shortcomings of the application of marginal costs as expressed in the consultations. However, the BAA has not accepted that the need to formulate prices broadly consistent with objectives of economic efficiency should be forgone in favour of an accounting-based strategy. The Authority considers that such a strategy does not acknowledge the principle that the BAA has broader responsibilities than meeting the demands of current users.
>
> "*9.* In applying the principles identified above, the BAA believes that the following considerations are important in determining the direction and speed of changes in charging policy: -
>
> …
>
> 9.3 The ability to deploy commercial revenues as the BAA sees fit, to meet its obligations relating to the management and development of airports to meet the needs of the industry. Such revenues may thereby be employed to reduce the level of traffic charges to reflect appropriate financial targets, to the degree that revenues are not required to meet other obligations. Any such action will endeavour to reflect the economic objectives of pricing as they are judged by the BAA. This precludes the adoption of a specific procedure for the disaggregation and allocation of commercial revenues.

> 9.4 The need to avoid dislocation to users by rapid and dramatic changes in traffic structures and levels, except where enforced by external constraints."

5.3 While the Statement of Principles provides what it claims to provide, namely principles, which in the present context allowed to BAA a very wide discretion, by its very nature it provides no indication of (a) how BAA actually used its commercial income during the Arbitration period, a question of considerable importance, to which it will be necessary to revert (see paragraphs 11.1.1 *et seq.* and 11.7.16 *et seq.* of this Chapter, below); or (b) BAA's reasons for making the use of it that it did.

VI. The inter-governmental Memorandum of Understanding and the structure of charges at Heathrow

6.1 Also of relevance to an appraisal of HMG's conduct in relation to the structure of user charges at Heathrow during the Arbitration period is the inter-governmental Memorandum of Understanding of April 6, 1983.

6.2 The Tribunal recalls that the legal status of the MoU was the subject of debate at the time when the Tribunal was called upon to draw up its Terms of Reference. USG then contended that the MoU was intended to be legally binding, that construed in accordance with established principles of international law it should be treated as binding, that both Contracting Parties and the BAA had treated it as binding and that, by virtue of Article 31(3)(a) of the Vienna Convention, account had to be taken of the MoU in interpreting Bermuda 2 and the application of its provisions. According to USG, by virtue of the Vienna Convention the MoU formed a part of the law specifically applicable to interpretation of Bermuda 2 and, as such, merited specific mention in the Terms of Reference in the same way as it had merited specific mention in the BAA Offer for Sale.

6.3 HMG in turn submitted that the MoU was not the source of independent obligations which could be the subject of arbitration under Article 17 of Bermuda 2; the extent to which, the circumstances in which and the purposes for which regard should be had to the MoU might be in issue in the Arbitration; and absence of reference to the MoU would in no way preclude the Tribunal from having regard to the MoU in interpreting Bermuda 2 where it considered it appropriate. According to HMG, the MoU no more deserved specific mention in the Terms of Reference than anything else relevant to the interpretation of Bermuda 2, such as, for example, subsequent practice.

6.4 Decision No. 1 of the Tribunal incorporated the judgment of the Tribunal that inclusion of reference to the MoU in the Terms of Reference would not prejudice any issue in the Arbitration and that by reason of its particular status it was appropriate to mention the MoU in the Terms of Reference. Accordingly the first Question referred to the Tribunal refers to HMG's obligations under Bermuda 2 "interpreted having regard to *inter alia* the [MoU]".

6.5 USG elaborated its submissions on the binding quality of the obligations imposed by the inter-governmental MoU in its Second (or Reply) Memorandum in the main proceedings where it contended that the MoU was a "treaty" within the meaning of Article 2, paragraph 1(a) of the Vienna Convention notwithstanding that it had not been published or registered either with the United Nations, under Article 102 of the UN Charter, or with ICAO, under Article 83 of the Chicago Convention; according to USG, the language of the MoU was in places imperative and under it HMG had secured USG's "agreement" or guarantee that USG would bring no arbitration for the years before 1983. USG did not comment on the Tribunal's *jurisdiction* or *lack of jurisdiction* to give effect to obligations created by the MoU.

6.6 In its Rejoinder HMG said that it was not to be taken as denying any legal effect whatsoever to the provisions of the MoU. Even though the MoU could not be regarded as a source of independent and free-standing legal obligations, both parties to the MoU clearly expected and anticipated that the "understandings" embodied in it would be honored. HMG, for its part, had honored, and would continue to honor, the "undertakings" to which it subscribed in the MoU, even if it did not regard them as amounting to treaty obligations in the strict sense. It was for this reason that HMG believed that it would be right for the Tribunal to concentrate, not on the arid issue of whether or not the MoU embodied binding treaty obligations, but on precisely how Article 10 was to be interpreted and applied in the light of the MoU.

6.7 In the judgment of the Tribunal, the MoU constitutes consensual subsequent practice of the Parties and, certainly as such, is available to the Tribunal as an aid to the interpretation of Bermuda 2 and, in particular, to clarify the meaning to be attributed to expressions used in the Treaty and to resolve any ambiguities.

6.8 The Tribunal notes that, even in respect of the second, third and fourth of the views of USG as recorded in paragraph 5 of the MoU, although HMG said that it saw force in those views, it clearly stopped short of accepting any duty to use its best efforts to ensure that the views were respected. However even if, contrary to the Tribunal's impression, the MoU were intended in the respects here under consideration to create independent legally enforceable obligations as opposed to merely recording the understandings of the Parties, the Tribunal would lack jurisdiction in respect of those obligations, as such, since its jurisdiction is derived from Article 17 of the Treaty which refers only to disputes "arising under this Treaty". The MoU is therefore available to the Tribunal as a potentially important aid to interpretation but is not a source of independent legal rights and duties capable of enforcement in the present Arbitration.

6.9 In addition to paragraph 4(c) of the MoU, which has been discussed at paragraphs 4.4-4.6 of this Chapter, above, the following provisions of the MoU are relevant to HMG's obligations in relation to the structure of charges at Heathrow during the Arbitration period:

Paragraph 4(d)

> "In using its best efforts, HMG expects the charges determined and imposed by the competent charging authorities at UK airports served by U.S. carriers to be just and reasonable, and equitably apportioned among categories of users and in accordance with the principles set forth in Article 10 of Bermuda 2. In particular, the Secretary of State expects the competent charging authorities to ensure that the charges more closely reflect actual differences in the full costs of supplying airport services and facilities, are based on sound economic principles and on the generally accepted accounting practices within the United Kingdom, and are reasonably related to and do not exceed the full costs, including depreciation and a reasonable rate of return, of supplying the services and facilities concerned."

Paragraph 5

> "Both Governments acknowledge in principle that an acceptable system of peak charges reflecting airport costs might be constructed in appropriate circumstances. Further, both Governments welcome the arrangements agreed upon by the BAA and the airlines for a collaborative review of peak charges. The USG has expressed a number of concerns about the BAA's peak pricing practices. In particular, the USG believes that (1) all traffic should bear at least some capital costs; (2) all traffic should bear its share of operating costs; (3) peak periods, where established at any airport, should encompass all periods of comparable activity at that airport; and (4) no peak charge should be assessed with respect to any service or facility unless a charge is also assessed for such service or facility during off-peak periods. HMG sees force in the last three of these views and will commend them to the BAA, as well as drawing all the USG concerns to the attention of the BAA so that they may be taken into account in their collaborative review of peak pricing."

6.10 By letter dated April 18, 1983, the responsible U.K. Secretary of State duly drew to the attention of the Chairman of BAA the concerns expressed by USG over the application of BAA's peak pricing policies and commended to BAA the second, third and fourth of USG's views set out in paragraph 5 of the MoU. The Secretary of State concluded his letter by saying that "I should be grateful ... if you would ensure that [these points] are fully taken into account in the collaborative review of your charging policy which you now intend to undertake with your airline customers."

6.11 The first of the views of USG that are recorded in paragraph 5 of the MoU, *viz.* that all traffic should bear at least some capital costs, need no longer be considered since in the Arbitration both Parties' expert economist witnesses agreed that it would *not* accord with sound economic principles for charges outside peak periods to include capital costs (see further paragraph 2.6 above); and in its final submissions USG conceded that HMG could not validly be reproached if, on the advice of an independent economist, it continued to take the view that there was no principle that all traffic should bear at least some capital costs and therefore continued to refrain from commending the principle to BAA (Tr. 4106-4107).

6.12 The second of the views expressed by USG, *viz.* that all traffic should bear its share of operating costs, even read in conjunction with paragraph 4 of the MoU, casts no light on the SRMC/LRMC controversy which so preoccupied the Parties in the course of the Arbitration and provides

no assistance on the question of the practical implementation of a system of charging based on marginal costs of either kind.

6.13 The third of the views expressed by USG, *viz.* that peak periods, where established at any airport, should encompass all periods of comparable activity at that airport, was invoked by both Parties in the Arbitration. As appears from what is said later in this section of this Award, USG contended that peak periods, as defined by BAA at Heathrow, wrongly included periods of activity that were comparable with other periods not included in the peak and vice versa. In the opinion of the Tribunal, provided that the expression "comparable" is taken to mean "properly comparable in accordance with sound economic principles", the third of the views expressed by USG merely exemplifies the application of sound economic principles.

6.14 HMG invoked the third of the views that had been expressed by USG at the time of the MoU as showing that passenger charges were to be set on an airport-wide basis and not terminal-by-terminal. For other reasons that will in due course appear (see paragraph 11.9.3 of this Chapter, below), and without reference to the MoU, the Tribunal is of the view that HMG did not commit a breach of its obligations under Article 10(1)-(3) of Bermuda 2 on account of its omission to require differentiation of peak charges on a terminal-by-terminal basis.

6.15 However that may be, the Tribunal doubts whether the third of the views expressed by USG, as recorded in paragraph 5 of the MoU, was intended to exclude the possibility of terminal-by-terminal differentiation of peak periods and/or peak charges: thus, for example, in the last year of the Arbitration period different peak periods applied for the purposes of the imposition of passenger charges at the international terminals, on the one hand, and the domestic traffic facilities at Terminal 1 on the other hand; the dispute between the Parties was not whether such differentiation was permissible but whether it should have been introduced earlier. Similarly throughout the Arbitration period, though in different ways in the first and second half, the application or otherwise of peak parking charges to aircraft parking at non-pier-served stands in peak parking hours differed according to the location of the stands within the airport. It was not suggested, and there is no reason to believe, that such intra-airport locational differentiation ran counter to the third of the views of USG, being a view that HMG indicated that it would commend to BAA, as recorded in paragraph 5 of the MoU.

6.16 The last of the four views expressed by USG, as recorded in paragraph 5 of the MoU, *viz.*, that no peak charge should be assessed with respect to any service or facility unless a charge is also assessed for such service or facility during off-peak hours, will require mention in connection with the complaint made by USG that BAA did not in reality assess a charge for use of the passenger terminals during off-peak hours and that the so-called off-peak terminal charge was really a charge to recover airport security costs such as, in the years immediately preceding the Arbitration period (when there

was no off-peak terminal charge), had been recovered through a National Security Levy.

VII. The Tribunal's conclusions on the SRMC and LRMC controversy

7.1 It is now possible and necessary to complete the discussion of the controversy as to whether SRMC, on the one hand, or LRMC (or LRMC flexed towards SRMC), on the other hand, should have provided the basis for setting terminal and parking charges.

7.2 Essentially, that controversy boils down to whether one's primary objective is to establish a system conducive to the bringing into commission in good time of *new* capacity - at Heathrow, terminal and parking capacity - so as to *avoid*, so far as practicable, the occurrence of congestion and crowding out; or whether one's primary objective is to ensure that *already installed* capacity should be used in an economically optimal fashion. If the former, one will not adopt pure SRMC-based pricing: adoption, whether voluntarily or compulsorily, by BAA of pure SRMC-based pricing would have militated against the undertaking by BAA of adequate capital expenditure before large numbers of passengers were subjected to unacceptable congestion and discomfort or had been denied access to the airport since, under pure SRMC-based pricing, user charges will not peak save to the extent that such congestion and crowding out occur. For, if new capacity is brought into use in good time to avoid congestion and crowding out, there will be no reason, under a pure SRMC-based system, for prices to rise above merely the extra costs incurred by the airport operator as a result of the particular use of the relevant facility or services by the airline user for which it is charged: prices will not rise above that level either before or after the investment has been made.

7.3 On the other hand, as HMG accepted, under a pure LRMC-based system, at any one time prices might fail to perform their proper rationing function: capacity available for use might go unused because, in the event, it was unattractive to use it at the LRMC based price; and in times of excess demand, the price would not necessarily be high enough to "clear the market" and ensure that those who valued the facility most highly gained access to it rather than those who valued it less highly. In effect this was why HMG said that the "flexing" of LRMC-based prices "towards" SRMC accorded with sound economic principles. However, HMG and its witnesses never offered any explanation understandable to the Tribunal of the economic principles, if any, that dictated *to what extent* LRMC-based prices were to be modified when SRMC deviated from LRMC - as it was, on HMG's case, *likely* to do after any substantial increment in capacity had been installed. Once one let SRMC into consideration, as HMG accepted that it was sensible to do, there was no evident principle that established the point at which one ceased to modify the LRMC-based price in the direction of SRMC until one reached SRMC itself. But if one modified the LRMC-based price to that extent, then,

as USG observed, one was accepting the validity of SRMC-based, rather than LRMC-pricing.

7.4 In the circumstances described above, it is not surprising that one of the relatively few things on which USG and HMG agreed was that the setting of user charges at airports such as Heathrow, in accordance with sound economic principles, as effectively enjoined by Bermuda 2, was an exceptionally difficult task.

7.5 The Tribunal approaches the issue of HMG's responsibility, in relation to the establishment by BAA of user charges on the basis of sound economic principles, with two considerations in mind. First, in establishing charges in accordance with sound economic principles, BAA had a discretion and, provided that it was not the case that HMG knew or ought to have known that BAA was abusing that discretion or exceeding the allowable limits of its exercise, HMG was not in breach of Article 10 of Bermuda 2 by reason of not having used its best efforts to alter BAA's charging proposals or actual structure of charges. Secondly, and closely related to that consideration, if, on the basis of independent economic advice, HMG believed that LRMC-based pricing was economically appropriate at Heathrow, the Tribunal cannot be expected to hold HMG in breach of the Treaty for conducting itself on the basis of that advice. Here, on the basis of the general economic advice that it had received, HMG had in fact concluded that LRMC-based pricing was the correct pricing system for the public utilities that were in public ownership in the U.K., of which, for about half the Arbitration period, BAA was one. In those circumstances, even if the Tribunal were competent to conclude, and were in fact to conclude, that pure SRMC-based pricing is superior to LRMC-based pricing (or LRMC-based/SRMC-influenced pricing), the fact that, whilst BAA was in public ownership, HMG actively encouraged it to use the latter pricing system and that, after BAA's privatization, HMG knowingly acquiesced in BAA doing so, does not in itself give rise to a breach of the Treaty. This is especially so given that USG itself has evidently had great difficulty in definitively formulating its submissions as to the correct foundation for the structure of user charges at an airport such as Heathrow and was certainly in no position to suggest that a pure SRMC-based system was "obviously" correct: USG had great difficulty in choosing between such a system, on the one hand, and an average accounting cost/share of traffic allocation, type system, on the other hand, and yet it ultimately abandoned its earlier suggestions that the latter type of system accorded with sound economic principles. If use of LRMC were "obviously" incorrect, that would not matter; but the Tribunal is of the view that it would be wrong for it to reach that conclusion.

VIII. The formulation of the relevant questions in respect of the structure of charges

8.1 In these circumstances the Tribunal concludes that its function must be to ask and answer the following questions.

(i) On the facts known to HMG, should it have appreciated that the proposals for, or actual structure of, the user charges at Heathrow at any time during the Arbitration period were such as no reasonable airport authority seeking to comply with the principles contained in Article 10(1) and (3) of Bermuda 2, as interpreted by the Tribunal, could reasonably have adopted?

(ii) If the answer to (i) is Yes, did HMG fail to use its best efforts to ensure that, in so far as resulting charges were or would be unfair to U.S.-designated airlines, such charges or the proposals for them were corrected?

(iii) If the answer to (i) is No, did HMG's best efforts obligation nevertheless make it necessary for HMG to investigate the facts further for the purpose of examining whether the proposals for, or actual structure of, charges was such as no reasonable airport authority seeking to comply with the principles contained in Article 10(1) and (3) of Bermuda 2, as interpreted by the Tribunal, could reasonably have adopted?

(iv) Did any of the user charges at Heathrow at any time during the Arbitration period infringe the principle laid down by Article 10(2) of Bermuda 2?

8.2 The reference in question (iii) to investigation of the facts by HMG includes investigation for HMG by an independent and properly qualified body; and all subsequent references in this Award to such investigation by HMG are to be similarly understood unless the context otherwise requires. If, in the discharge of its best efforts obligation, HMG had caused such an investigation to be undertaken for it, it may be presumed that the investigative body would have enjoyed powers of investigation such as are not possessed by the Tribunal, which has to operate within the constraints of what is essentially an adversary procedure, as HMG reminded the Tribunal in the course of the hearing. An investigative body appointed in the mid-1980s might very well also have enjoyed the benefit of access to the detailed calculations underlying many of the relevant figures, being calculations which, according to HMG, have since been discarded and cannot now be replicated.

8.3 There is a difficult question whether, even if the answer to the questions set out in paragraph 8.1 above disclosed no breach of Article 10(1)-(3) of Bermuda 2, there might nevertheless be a breach because HMG had acted, or had refrained from acting, for *reasons* that were incompatible with the Treaty. On the Tribunal's assessment of the facts of the present case, that question does not arise and accordingly the Tribunal expresses no view about it.

IX. Preliminary observations by the Tribunal

9.1 Before examining in detail USG's criticism of BAA's charging structure and HMG's acts and omissions, certain preliminary comments are necessary.

(a) Some practical problems facing the Tribunal

9.2 Even confining its attention, in relation to the charging structure, to the four questions set out at paragraph 8.1 above, the Tribunal has not found its task an easy one; and despite the very considerable volume of material placed by the Parties before the Tribunal and the great efforts that both of them undoubtedly made to assist the Tribunal, its task is none the easier, given the following facts.

(i) Although Dean Levine had practical experience of airport management and although he had studied a considerable amount of detailed documentation about and relevant to the charging structure at Heathrow and changes to it, he felt unable to offer any concrete views as to the specific levels of the charges that ought in fact to have been set even in one year of the Arbitration period, let alone throughout that period; nor was there any airport anywhere in the world which set user charges as he thought that they ought to be set, so that there was nowhere which, for him, constituted a paradigm, perfect or even imperfect, with which BAA's charging structure at Heathrow could be compared and no experience of the practical operation of such a structure elsewhere to guide one.

(ii) Professor Kahn had not been engaged to study the actual position at Heathrow so that he was unable to comment on the extent to which the structure of charges there in fact conformed to what he would have regarded as economically desirable or acceptable; and there was no non-BAA airport where the operator claimed to set charges as Professor Kahn thought that they ought to be set so that there was again nowhere which, for him, constituted a paradigm elsewhere to which one could refer and no experience of the practical operation of such a structure elsewhere to guide one.

(iii) HMG did call a partner in a British consultancy firm to give evidence about the specific structure of BAA's charges. However, on the important question of the peak/off-peak parking charge differential, his evidence appears to run flat counter to a report prepared for BAA in 1987 by an apparently associated firm of consultants. Since he was not cross-examined on the apparent discrepancy, it is difficult for the Tribunal to know what conclusion it should draw. In other respects the evidence of the consultant in question frequently lacked specificity.

(iv) No figures at all for marginal costs, as calculated by BAA, later than 1984 were available; none had been prepared specifically for the

purposes of the Arbitration. Moreover, the detailed calculations underlying the 1984 figures were no longer available and apparently could not be replicated (which suggests that the proclaimed principles may not lead inexorably to, and only to, the figures that were finally arrived at). Similarly, although the general reasoning underlying changes in charges after 1984 were to be found in BAA documents that were before the Tribunal, HMG said that individual working calculations that had underlain many of the figures in those documents had generally been discarded and, again, the calculations could not be replicated without that information.

(v) Lastly, it seems clear that BAA's own thinking about the structure of charges almost certainly developed, especially during the period of the Medium Term Review in 1982-1984; thinking disclosed in earlier documents may well therefore have been superseded; it is possible that the only person who had a comprehensive overall grasp of the vastly elaborate exercises that were conducted by BAA at that time was its then Chief Economist (subsequently, until at least mid-1987, its Corporate Treasurer). The other senior officer of BAA who appears from the contemporaneous documentation to have been most intimately involved with the extensive restructuring of charges at that time was the Finance Director (who left BAA some time in 1986). Neither of those persons gave evidence to the Tribunal. The person from BAA who did give evidence in respect of the period up to 1985/86 was an ex-officer who had been Planning Director of BAA between 1973 and 1985; in 1985 he had left BAA but in 1985/86 was contracted back for a year as Privatisation Director. The structure of user charges did not fall within his area of primary responsibility as he defined it in his evidence to the Tribunal; and the Tribunal formed the impression that he had not had occasion himself to think deeply, and therefore perfectly understandably had not thought deeply, about the considerable problems associated with devising any economically defensible structure of airport user charges. USG did not comment on these facts and the Tribunal draws from them no inference adverse to HMG. But especially given the difficulties of understanding, and the limits of, the relevant contemporaneous documentation, they remain relevant facts.

(b) The substantive changes in the structure of user charges at Heathrow over time

9.3 The structure of user charges at Heathrow during the Arbitration period was very substantially different from what it had been in the 1970s and the Tribunal has concluded that it is not helpful to go back to the 1970s documentation for the purposes of examining either the structure of charges then in place or the considerations underlying that structure. Secondly, as can be seen from the published tariffs of user charges at Heathrow and the actual charges for certain typical aircraft/operations (see paragraphs 1.2 - 1.21 of this

Chapter, above), the structure of charges in 1985/86 and subsequent years of the Arbitration period was substantially different from the structure that was in place even during the first two years of the period.

9.4 Thus, relative to the charges which the Airlines Settlement Agreement of February 22, 1983, effectively recognized would be introduced, and which were introduced, in 1983/84, typical total user charges for a B747 engaged in international traffic in 1985/86 had been reduced in money terms by 5% in peak periods and 19% in off-peak periods (about 16% and 28% after allowing for inflation); compared with 1982/83, the last charging year before the Settlement Agreement, the proportionate reduction in peak periods was somewhat less but the proportionate reduction in off-peak periods was very much greater.

9.5 Moreover, by 1984/85 the structure of charges was already very different from what it had been in 1982/83. For a typical B747 turnround, the *make-up* of peak and off-peak charges in those two years is shown below.

TABLE 9.5

	Peak		**Off-Peak**	
	1982/83 **%**	**1984/85** **%**	**1982/83** **%**	**1984/85** **%**
Landing charges	24.75	7.77	49.53	37.40
Passenger charges	54.66	72.33	25.11	33.16
Parking charges	20.58	19.89	25.37	29.44
	100.0	100.0	100.0	100.0

(c) The position of HMG in respect of the structure of the charges imposed in the first two years of the Arbitration period

9.6 So far as Article 10(1) and (3) is concerned, the Tribunal is of the view that, given (i) the great difficulty and complexity of reviewing the charging structure at all, (ii) doing so in accordance with the undertakings given by HMG and BAA in the Settlement Agreement and the MoU and (iii) the fact that the structure then advocated by the U.S.-designated airlines did not accord with sound economic principles as now espoused by either USG or HMG, HMG cannot be held to have failed to use its best efforts in respect of the structure of user charges during the first two years of the Arbitration period. In practice HMG would have had to have done something by late 1983 if it was to influence the charges for 1984/85 and USG has not suggested anything that HMG could sensibly have done before then, beyond encouraging BAA, as HMG did, to carry out the required complete review of its charging structure which had in fact been set in motion.

9.7 Moreover in 1983 and 1984 there was nothing to suggest to HMG that the steps taken by BAA to begin to remodel its charging structure, as the inter-governmental MoU envisaged that it would (see paragraph 4(d) of the MoU quoted at paragraph 6.9 of this Chapter, above), were either inadequate or misdirected. On the contrary, the Airlines Settlement Agreement (at paragraph 1(4) of the Memorandum of Understanding contained within it) had expressly provided that changes to the structure (and level) of user charges should be implemented as soon as reasonably practicable but *in a gradual manner;* paragraph 8(b) of the same document recorded that the Airlines had noted that in determining user charges, BAA proposed to move *progressively towards* a structure related to marginal costs (including where appropriate long run marginal costs); and by paragraph 1(3)(iii) of the Airlines Settlement Agreement itself the U.S. airlines had undertaken not to urge or procure USG to make a claim against HMG under Bermuda 2 "in respect of ... any of the user charges for the period 1 April 1983 to 31 March 1984, provided that the charges implemented for that period are substantially *the same as* those proposed to date in consultation and provided that the BAA continues to identify and account for the security charge separately" (emphasis added). Although USG was not a party to the Airlines Settlement Agreement, that Agreement forms part of the factual background against which the adequacy or otherwise of the efforts made by HMG falls to be judged.

9.8 HMG's conduct in 1983 and early 1984 is therefore to be assessed against that background, and in light of the facts (a) that the conditions set out in the proviso contained in paragraph 1(3)(iii) of the Airlines Settlement Agreement were satisfied in respect of the 1983/84 charges, (b) that the promised Medium Term Review had been put in hand and that a great deal of work was being done for it and (c) that in November 1983 BAA proposed and in January 1984 it adopted charges for the charging year 1984/85 which incorporated further changes which, so far as they went, were in a direction favorable to long-haul international carriers (and therefore to, amongst others, the U.S. airlines).

9.9 In the view of the Tribunal, therefore, so far as Article 10(1) and (3) is concerned, whatever may be the position in respect of the structure of charges from 1985/86 onwards (which is considered below), HMG's conduct in respect of the structure of charges in the first two years of the Arbitration period did not put HMG into breach of the Treaty. The position with regard to Article 10(2) is considered at paragraphs 11.2.20 - 11.2.26 of this Chapter and at Chapter 8, below.

(d) The disparity between the U.S.-designated airlines' share of traffic and their share of the burden of user charges at Heathrow

9.10 An important part of the foundation for USG's conviction that the user charges at Heathrow during the Arbitration period were manifestly unfair to the U.S.-designated airlines was to be found in comparisons of the total user charges of each category and in the aggregate that were paid by PanAm

and TWA with the proportions of passengers and of air traffic movements that they accounted for. Thus, USG referred to the fact that, as it believed, the U.S.-designated airlines at Heathrow accounted for the following proportions of passengers, air traffic movements and charges.

TABLE 9.10
U.S.-designated airlines' shares of traffic and of charges (*USG's* figures)

	% of terminal passengers	% of atms	% of passenger charges paid	% of runway charges paid	% of parking charges paid	% of total charges paid
1983/84	9.4	4.4	14.0	12.2	9.8	12.5
1984/85	9.2	4.6	13.4	9.4	13.9	11.7
1985/86	9.1	5.0	12.9	5.9	14.1	10.4
1986/87	7.8	5.1	11.4	5.7	13.0	10.0
1987/88	8.5	5.0	13.2	5.6	12.8	10.8
1988/89	8.4	4.9	13.3	5.4	12.6	10.4

9.11 BAA's corresponding statistics, which were produced for the Tribunal late in the hearing at the Tribunal's request, differed from those put forward by USG, probably, at least in part, because BAA had been able to produce, and had therefore properly produced, figures confined to passenger flights and had excluded cargo traffic. BAA's figures, as supplied to the Tribunal by HMG, are shown in Table 9.11 below.

TABLE 9.11
U.S.-designated airlines' shares of traffic and of charges (*BAA* figures)

	% of terminal passengers	% of atms	% of passenger charges paid	% of runway charges paid	% of parking charges paid	% of total charges paid
1983/84	8.5	3.5	13.2	10.2	12.0	12.3
1984/85	8.5	3.5	12.8	8.0	12.7	11.8
1985/86	7.4	3.4	11.9	3.7	12.2	10.4
1986/87	6.5	3.3	10.4	3.5	11.5	9.3
1987/88	7.1	3.3	11.5	3.5	11.5	10.0

1988/89	6.8	3.2	11.5	3.3	10.5	9.5

9.12 BAA's figures therefore showed an even greater disproportion between share of traffic and share of charges than did USG's so that there was no dispute between the Parties that the U.S. airlines consistently paid a *higher proportion* of total user charges than the proportion of total *passengers* for which they accounted and a *substantially higher proportion* of total user charges than the proportion of *air traffic movements* for which they accounted.

9.13 As appeared from the BAA statistics referred to above, such a disproportion was not confined to the U.S.-designated airlines but existed to a greater or lesser degree with other long-haul international flights. For the Arbitration period as a whole, the picture is given by the Table below.

TABLE 9.13
Long-haul international carriers' average shares of traffic and of charges : 1983/84 - 1988/89 averages

	% of terminal passengers	**% of atms**	**% of passenger charges paid**	**% of runway charges paid**	**% of parking charges paid**	**% of total charges paid**
PanAm/TWA to and from U.S.	7.4	3.3	11.8	5.3	11.7	10.5
British Airways to and from U.S.	6.0	2.9	10.4	4.6	14.0	10.0
Other international to and from outside Europe	20.6	12.6	20.3	16.9	43.2	24.2

NOTE: As to the impossibility for the Tribunal of comparing the average user charge per passenger incurred by British Airways on the totality of its traffic at Heathrow with the average user charge per passenger incurred by PanAm/TWA on the totality of their traffic at Heathrow, see paragraph 11.2.24 of this Chapter, below.

9.14 The easiest way of appreciating the effect of the disproportion on charges is to compare the average total user charge per passenger incurred at

Heathrow by transatlantic and other long-haul traffic with the average total user charge per passenger incurred at Heathrow by all airlines on all traffic. Expressing the latter as 1.00, the BAA statistics show the ratios to have been as follows.

TABLE 9.14

	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9	1983/84 – 1988/89
Traffic to and from U.S.							
British Airways	1.92	1.83	1.74	1.71	1.49	1.38	1.66
PanAm/ TWA	1.44	1.38	1.41	1.43	1.41	1.40	1.41
Other long-haul	1.34	1.22	1.10	1.15	1.18	1.09	1.17

9.15 Thus, taking the 6 years as a whole, PanAm and TWA, on their flights to and from the USA, incurred average total charges per passenger 41% (£1.43) higher than the airport average and British Airways, on its flights to and from the USA, incurred average total charges per passenger 66% (£2.29) higher than the airport average. For other long-haul traffic the excess above the airport average for the 6 years as a whole was 17% (£0.60).

9.16 There were some obvious reasons for this disproportion between share of charges and share of traffic. For example, a B747 engaged on transatlantic (and other long-haul) routes typically occupies a parking stand for 2 to 4 times as long per atm as a smaller aircraft of the kind engaged in short-haul work generally and domestic traffic in particular; and a pier-served stand of the kind that the B747 requires is larger, and has a substantially higher capital value, than a pier-served stand of the kind that one of the smaller aircraft requires.

9.17 However, the most important reasons for the difference in the average total user charge per passenger on the traffic to and from the USA and the average total user charge per passenger for the airport as a whole were to be found in the structure of BAA's charges, with its sharp differentiation of peak and off-peak charges and its lower peak terminal charges for domestic traffic and the fact that an above-average proportion of the traffic to and from the USA attracted peak charges (other than landing charges). Thus, as USG

pointed out, the peak terminal charge was sometimes as much as 10 times higher than the off-peak charge and for much of the period the peak parking charge was 4 times the off-peak charge. This was the reason why, as USG said, the definition of the peaks and the amount of the peak/off-peak differentials were of such concern to the U.S. airlines and to USG.

9.18 In assessing the ultimate relevance of the disproportion between *share of charges* and *share of traffic*, it is necessary to recall the development of USG's case in this regard. As noted at paragraph 2.2 of this Chapter, above, USG ultimately abandoned reliance on share of *average accounting costs* as an appropriate basis for the establishment of charges and accepted that, in order to ensure the most efficient possible use of Heathrow's facilities, sound economic principles required that user charges at Heathrow be set at short-run marginal costs, a form of *economic pricing*.

9.19 As a matter of arithmetic, if average accounting costs are calculated by dividing total accounting costs by units of "traffic" (e.g. passengers, air traffic movements) and user charges are set equal to the average accounting costs, then the share of total accounting costs borne by an airline and the share of "traffic" (as so defined) accounted for by that airline, will necessarily be the same, irrespective of the *pattern* of the airline's traffic, By contrast, the *whole* point of using economic costs (rather than *CCA* accounting costs[7]) as a basis for establishing charges *is* to differentiate charges according to pattern of traffic.

9.20 Thus, Dean Levine, having testified that, as a matter of economics, USG had been wrong in espousing, during the Arbitration period, the use of average costs (or accounting costs) as a basis for charging at Heathrow, further, and very properly, agreed that "an approach to charging which allocated charges according to shares of traffic at an airport regardless of whether the operation was in or out of peak [i.e. according to the pattern of the traffic] would also be economically inefficient" (Tr. 1197).

9.21 It follows that use of economic costs as a basis for charging entails the consequences that one would *expect* the share of traffic for which an airline accounts and the share of charges imposed on it to differ unless their *pattern of usage* of the airport's facilities as well as the share of traffic for which they account happens to be identical.

9.22 In the result, once one has accepted that user charges should be based on economic costs and not on shares of traffic, the mere fact that the share of total airport charges borne by PanAm and TWA exceeded their share

[7] As to CCA, see paragraph 2.1 *et seq.* of Chapter 7, below. (Use of economic costs rather than *HCA* costs (*ibid.*) as a basis for charging has an additional function beyond that mentioned in the text.)

of total passengers and, even more, their share of total atms, tells one nothing about the reasonableness or otherwise of the actual structure of user charges at Heathrow: all it tells one is that the charges resulting from that structure differed more or less substantially from the charges that would have resulted from a different structure.

X. USG's specific objections to BAA's charging structure

10.1 It is now possible to discuss and draw conclusions about the various criticisms of BAA's charging structure that were made by USG at one time or another in the course of the procedure. The following were the principal of those criticisms.

(1) There was no nexus between the economic cost pricing principles that BAA professed to apply and the user charges that it actually imposed.

(2) BAA discriminated in its user charging practices against the U.S.-designated airlines and in favor of British Airways and/or domestic traffic.

(3) Too great a proportion of total user charges was recovered in terminal and parking charges and too small a proportion in landing charges.

(4) The landing charge peak was too narrow.

(5) Common runway charges should have been imposed on aircraft of all sizes: the lower landing charges imposed on small aircraft in peak and off-peak periods in the earlier years and in off-peak periods from 1985/86 onwards were not in accordance with sound economic principles.

(6) There should have been no terminal charge peak at all; alternatively the terminal charge peak was too broad.

(7) The composition of terminal charges was wrong.

(8) The aircraft parking charges were too high: at least after 1986 there should have been no peak charge; alternatively the peak/off-peak parking charge differential should have been smaller.

(9) Passenger charges should have been differentiated by terminal; and use of Terminal 3 (the terminal used by the U.S. airlines at Heathrow) should have been the subject of lower passenger charges than use of Terminals 1 and 2.

(10) "One way charging" for runway and terminal use was wrong: there should have been take-off runway charges as well as landing charges, and terminal charges for arriving passengers as well as for departing passengers.

(11) A rebate applicable when aircraft were parked at remote stands should have been introduced earlier than it was, namely in 1985/86 and the rebate should have been greater than it was.

(12) There had been excessive delays in making such ameliorative changes in the user charges as had in fact been made.

10.2 The Tribunal now addresses each of those specific criticisms in respect of the charging years 1985/86 - 1988/89, having already concluded that, in respect of the first two years of the Arbitration period, namely 1983/84 and 1984/85, HMG was not in breach of Article 10(1) and (3) of the Treaty in respect of the structure of user charges at Heathrow, for the reasons given at paragraphs 9.6 - 9.9 of this Chapter, above.

XI. The Tribunal's conclusions with regard to USG's criticisms

(1) Nexus between the economic cost pricing principles that BAA professed to apply and the user costs that it actually imposed

(a) BAA's calculations of economic costs

11.1.1 Since, for the purposes of Article 10(1) and (3) of the Treaty here under consideration, the Tribunal is taking as its starting point the 1985/86 charges, the economic foundations for those charges are here of great importance, especially as the latest marginal cost calculations that were carried out by BAA were, as HMG from the outset in the Arbitration conceded, carried out in 1984. HMG's case was that it was unnecessary to carry out a full complex marginal cost pricing exercise every year; BAA had carried out such exercises in 1982-1984; thereafter, HMG claimed, it had been sufficient for BAA to monitor developments, as BAA had done, and to make appropriate changes and adjustments in the light of the further developments.

11.1.2 It may be presumed that the 1984 calculations benefited from the experience gained in performing the earlier calculations and were the calculations on which BAA placed the greatest weight in setting the user charges for 1985/86 (although the documentation relevant for the purpose is not dated, it is clear from internal evidence that the 1984 calculations were placed before the Board of BAA in the fourth quarter of 1984, probably in November).

(b) The relationship between **passenger** *charges and economic costs*

11.1.3 The 1984 LRMC calculations relating to passenger charges were computed by reference to forecasts for Terminal 4 which was due to come into commission in 1986. The supporting documentation explains the treatment, in the calculations, of commercial income as follows:

> *23.* The construction of Terminal 4 necessarily involves the provision of commercial activities, such as duty free shops, catering facilities, car parks etc. The foregoing cost analysis has excluded these facilities on the basis that the traffic charges (calculated above) should reflect the cost of providing traffic related facilities.

The cost of the commercial facilities should be recovered through separate charges for the use of each service.

24. In as much as commercial revenues exceed commercial costs, it is BAA policy to use the profits from its commercial activities to offset the cost of providing traffic facilities. An analysis of the cost per passenger of providing the Terminal 4 commercial facilities was undertaken, and this was compared with the expected commercial income per passenger. The resulting net income (profit) from commercial activities is as follows:

Net Commercial Income: Total Income expressed per Departing Passenger

	£
Domestic [Passengers]	1.68
International	5.16

25. These are the amounts which, if the current policy is continued, should be deducted from the LRMC-based passenger charges. In some cases the result may be a negative passenger charge, since the cost of servicing the passenger may be less than the profit resulting from his expenditure. In that case the charge could be set to zero or a nominal amount, and the remainder of the offset loaded onto the landing or parking element.

11.1.4 The resultant "cost-based [passenger] charges", *net of imputed commercial income*, together with the actual passenger charges for 1984/85 (the year during which the calculations were performed) and for 1985/86 were as follows.

TABLE 11.1.4

	"Cost-based charges" £	1984/85 charges £	1985/86 charges £
International peak	13.37	12.71	12.81
International off-peak	-2.85	1.21	1.25
Domestic peak	8.20	5.31*	5.4
Domestic off-peak	-0.10	1.21	1.25

* The original BAA documentation and, following it, HMG's First Memorandum incorrectly show the 1984/85 domestic peak charge as £3.51 and that figure has been corrected to £5.31 in the above Table.

11.1.5 It will be observed first that, in the 1984 calculations, the whole of the commercial income was credited to, and therefore deducted from, the marginal costs computed for use of the terminals (a procedure which would not necessarily have been followed, applying paragraph 9.3 of the

subsequently enunciated "Statement of Principles" quoted at paragraph 5.2 above). Secondly, separate forecasts were made of the commercial income which would be generated by international passengers, on the one hand, and domestic passengers, on the other, the figure for the former being deducted from the estimated marginal costs attributable to terminal use by international passengers and the figure for the latter being deducted from the estimated marginal costs attributable to terminal use by domestic passengers; that procedure was contrary to the procedure which HMG, in the Arbitration, contended to be correct, in part on the ground that domestic passengers who transferred to international flights contributed to duty-free activities (and therefore to the generation of additional commercial income); more generally, HMG contended that differentiation between the imputation of commercial profits to international traffic and to domestic traffic, such as USG contended for, would aggravate the economically distortive effects of imputation of commercial profits at all. Quite apart, therefore, from the doubts expressed by USG about the no longer replicable computations underlying the 1984 figures for marginal costs of terminal usage, the 1984 figures must be treated with considerable reserve even on HMG's own case. However, a comparison of the figures in Table 11.1.4 above for (a) actual peak passenger charges for 1985/86 with (b) the stated 1984 "cost-based [peak passenger] charges" net of imputed commercial income shows that the actual *international* charge was set at 96% of the "cost-based charge" whereas the *domestic* charge was set at 66% of the "cost-based charge".

11.1.6 Another way of expressing this is to say that the computed marginal cost, net of imputed commercial income, exceeded the 1985/86 peak *domestic* passenger charge by £2.80, or 52%, whereas the computed marginal cost, net of imputed commercial income, exceeded the 1985/86 peak *international* passenger charge by only £0.56, or 4%.

11.1.7 In off-peak periods a similar disparity was evident: the 1985/86 off-peak domestic terminal charge of £1.25 exceeded the computed off-peak marginal cost (a negative amount of £0.10) per passenger of domestic terminal usage, net of the average commercial income imputed to domestic passengers, by £1.35. By contrast, the 1985/86 off-peak international charge, again of £1.25, exceeded the computed off-peak marginal cost (a negative amount of £2.85) per passenger of international terminal usage, net of the average commercial income imputed to international passengers, by £4.10, i.e. a differential three times that on the domestic traffic side.

11.1.8 If one strips out the imputed commercial income, a completely different picture emerges but it does not display consistency of relationship between the various 1985/86 passenger charges and the 1984 calculations of the corresponding "cost-based charges" any more than do the figures with commercial income deducted from marginal costs.

11.1.9 The Tribunal has nowhere found any explanation for the disparity between the cost/charge relationships for international and domestic traffic

although it is a disparity that is evident on the face of HMG's First Memorandum which set out the cost-based charges and the 1984/85 actual charges shown in the text above (in fact the apparent disparity was even greater than the actual disparity because BAA's original document and HMG's First Memorandum show the 1984/85 peak domestic passenger charge one-third *below* its true amount: see the footnote to Table 11.1.4 in this Chapter, above).

11.1.10 The fact that the marginal cost-based figures (except for the off-peak "costs" after credit for imputed commercial income) exceeded the actual charges does not provide an adequate justification when what is in issue is the structure of charges, i.e. the relationship between the charges paid by different categories of users and the equitable apportionment of the total burden of charges amongst them. Even if the differential between peak international and domestic passenger charges in 1985/86 had been increased by, say, £1.35 (or 18%), e.g. by raising the peak international passenger charge to £13.35 (which, ignoring inflation, would have been higher than it was in fact at any time in the Arbitration period) and lowering the peak domestic passenger charge to £4.55 (which would have been lower than it was in fact at any time in the Arbitration period), it would still have been true that the "costs" would have exceeded the actual charges; and the total revenues collected from peak passenger charges would probably not have been much affected. Even if the total revenue derived from peak passenger charges was reasonable, the fact that in each case the charge was below "cost" tells one nothing about the reasonableness of the *structure* of the charges.

11.1.11 The Tribunal has considered whether the disparity between the terminal cost/passenger charge relationships for international and domestic traffic that is evidenced by the 1984 marginal cost calculations can be dismissed as a relic of the past that was being phased out as rapidly as "gradualism" permitted. On the evidence no such explanation is possible. In July 1985 a paper presented to the Board of BAA noted that the charges at Heathrow (i.e. those for 1985/86) by then contained "the core elements" of an economic cost structure and the remnants of the previous "taxation" approach had been all but eliminated.

11.1.12 Moreover, *off-peak* passenger charges for international and domestic traffic remained identical with each other in subsequent years.

11.1.13 So far as *peak* passenger charges were concerned, the domestic and international charge went up at about the same rate in 1985/86 and 1986/87. In 1987/88, with the extension of the peak terminal period from 5 to 6 1/2 hours, peak passenger charges were reduced and it is true that one finds that in that year peak international passenger charges were reduced by 19.7% whereas peak domestic passenger charges were reduced by only 7.3%. But in the following year the peak international passenger charge was raised by 13.2% whereas the peak domestic passenger charge was raised by, on average, about 4% (7.8% in the three hour summer peak and minus 2% in the three

hour winter peak). In the result, by 1988/89 the overall movement in peak international passenger charges since 1984/85 had probably been relatively more favourable to international carriers than to domestic carriers but any such change would have been far too small to affect to any significant degree a disparity of the kind identified at paragraphs 11.1.5 - 11.1.6 of this Chapter, above.

11.1.14 One cannot therefore dismiss the anomalies disclosed by a comparison of the 1984 calculations of long run marginal cost of terminal usage and the differentials in the actual international and domestic passenger charges for 1985/86 as an evanescent result of "gradualism".

11.1.15 The foregoing does not establish definitively that sound economic principles dictated that the international/domestic passenger charge differentials should have been smaller in 1985/86 or thereafter. That issue is discussed by the Tribunal at paragraphs 11.7.9 *et seq*. of this Chapter, below.

11.1.16 The relevant conclusion that the Tribunal reaches at this juncture is that use of best efforts by HMG to ensure the establishment of user charges at Heathrow in accordance with Article 10(1) and (3) of Bermuda 2 required that HMG should have examined the relevant BAA documentation on the conclusion of the Medium Term Review. Scrutiny of the papers should have revealed (a) generally, the apparent lack of nexus between the identified economic costs of terminal usage, on the one hand, and actual passenger charges, on the other hand, and (b) in particular, the unexplained and large differences in the relationship between those costs and charges as between international and domestic traffic; the latter *prima facie* differences should have been recognized to be, if real, manifestly adverse to international carriers, including the U.S.-designated airlines. HMG's obligation to use its best efforts would then have necessitated a further investigation: see further paragraph 8.2 of this Section, above.

(c) The relationship between* landing *charges and economic costs

11.1.17 The Tribunal has reached a broadly similar conclusion, though for different reasons, in relation to landing charges.

11.1.18 The 1984 calculations did not attempt to compute a marginal cost attributable to runway use; instead it included under the heading "LRMC" a flat rate charge of £150 which was stated in a footnote to be "the flat rate charge on landing necessary to recover the same real revenue as at present recovered by the landing charge". This may have reflected the difficulty experienced by BAA in quantifying the economic cost of runway usage. A paper presented to the Board of BAA in 1982 stated that "ATM-related costs", i.e. costs related to air traffic movements, comprised "primarily maintenance costs, which tend to be related to weather rather than traffic use or to accidents, which are not connected with aircraft size. Such costs would be most easily recovered as a cost per landing". Those costs, described as "Runway Costs", were quantified at £10 per landing.

11.1.19 A year later a more fully considered paper discussed use of “rationing prices” for runway use and noted the difficulty of assessing the correct level at which to set such prices in the absence of some form of slot auction. It does not appear that any attempt was then made to quantify rationing prices - though it is not clear whether it was believed that, given the air traffic distribution rules in force (abolition of which was strongly opposed by the U.S.-designated airlines at Heathrow), there was no excess demand. Rather, the paper looked at the congestion costs which increased as the “artificial constraint of 275,000 ATMs at Heathrow” was approached. “Only the costs of delay on operators (excluding the costs incurred by passengers) were considered and the results suggested that - at the busiest times - the costs could be as high as £130 per movement”. For the initial analysis contained in the paper a charge of £50 *per ATM* was applied. “This enables comparisons with existing charges during the period shortly prior to the requirement to ration demand”. This led to the suggestion of a flat rate *landing* charge, irrespective of time of usage or type of aircraft, of £100.

11.1.20 As already noted, in the 1984 calculations, prepared about one year later, the figure for landing charges included in the cost-based structure had risen to £150 but that figure was expressly stated not to be cost-based: see paragraph 11.1.18 of this Chapter, above.

11.1.21 When one looks at actual landing charges one finds that BAA made substantial, and in relation to certain types of aircraft very substantial, changes in landing charges between 1982/83 and 1985/86. Landing charges for large aircraft were reduced dramatically (in the case of a B747 the peak landing charge in 1985/86 was only 13.5% of what it had been in 1982/83). By contrast, landing charges for small aircraft, such as would have been engaged mainly if not entirely in domestic work, were substantially higher than in 1982/83. In peak periods, though not in off-peak periods, what BAA regarded as the economic *desideratum* of a common fixed charge per aircraft was achieved. However, the Tribunal has not been able to find anywhere a clear statement of the economic cost or marginal cost on the basis of which BAA established landing charges for 1985/86 or thereafter. Nor has the Tribunal found any evidence that charges for that year or thereafter were set with the object of choking off demand to the point at which every eligible user (or even some proportion of would-be eligible users) could get the slots that it wanted (or even some proportion of those slots). This may have been because BAA and HMG almost certainly believed, contrary to the common position of the Parties in the Arbitration, that the reference in Article 10(3) of Bermuda 2 to the costs of the airpost operator precluded the imposition of charges for runway use equal to, or by reference to, the economists’ short run marginal costs which, in periods of excess demand, exceed, and comprise costs other than, the costs of the airport operator.

11.1.22 Here again therefore the judgment of the Tribunal is that, if the position had been as carefully examined by HMG as it should have been in 1985, following on completion of the Medium Term Review and the

establishment by BAA of charges that were supposedly based on economic costs, the need for investigation should have been apparent and HMG, in conformity with its best efforts obligation, should have caused such an investigation to be held: see again paragraph 8.2 of this Chapter, above. Again here, in fact, so far as appears from the evidence before the Tribunal, no such investigation took place.

(d) The relationship between aircraft **parking** *charges and economic cost*

11.1.23 Lastly in the present connection one may compare BAA's 1984 calculations of the long run marginal cost of aircraft parking with the 1985/86 parking charges. Using the methodology described in paragraphs 1.13 and 1.14 of this Chapter, above, the results for the 5 typical "aircraft/operations" that have been taken as examples earlier in this Chapter of this Award are as follows:

TABLE 11.1.23

	Peak		Off-Peak	
	"Cost-based charges"	1985/86 charges	"Cost-based charges"	1985/86 charges
	£	£	£	£
B747	1074	994	68.00	290.40
A300	359	222	26.32	68.40
B757	306	162	24.48	50.00
B737	129	49	11.36	16.20
SD330	109	16	10.52	5.28

11.1.24 Taking the "cost-based charges" as 100, the corresponding 1985/86 actual charges have the following index numbers.

TABLE 11.1.24

	Peak "Cost-based charge"=100	Off-Peak "Cost-based charge"=100
B747	88	427
A300	63	260

B757	53	204
B737	38	143
SD330	15	50

The greatly differing disparities between the charges actually imposed in 1985/86 and the then most recently available corresponding marginal cost-based calculations (in fact the last such calculations to be carried out by BAA) ought to have been obvious to anyone who had studied the matter in 1985 or 1986, as HMG was obliged to do as a result of its undertaking to use its best efforts to ensure that charges were set in accordance with the requirements of Article 10(1) and (3) of Bermuda 2. In discharge of its best efforts obligation, HMG ought then to have investigated the disparities; so far as appears from the evidence before the Tribunal, it failed to do so.

(e) The relationship between* total *user charges and economic costs

11.1.25 As already stated, for landing charges, the cost-related figure available in 1984 was, so far as the Tribunal can ascertain, the 1983 initial estimate of £100 per landing (£50 per runway movement): see paragraph 11.1.19 of this Chapter, above. If one uses the 1984 cost-based figures for parking and for terminal use (the latter, net of the imputed commercial profit), the cost-based figures for *total* charges available in 1984 may be compared with the *total* actual user charges for 1985/86 as follows.

TABLE 11.1.25

	Peak			**Off-Peak**		
	1985/86 Actual	**Net "cost"**	**Actual as % of net "cost"**	**1985/86 Actual**	**Net "cost"**	**Excess of Actual over net "cost"**
	£	£	%	£	£	£
International						
B747	4505	4717	96	777	-587	1364
A300	3269	3467	94	496	-515	1011
B737	1233	1299	95	269	-117	386
Domestic						
B757	966	1390	69	351	112	139
SD330	280	373	75	93	109	-16

11.1.26 The Table shows that anyone who had made the comparison of the total user charges in 1985/86 with the then latest available BAA figures for relevant economic costs would have seen that, if commercial income were differentially imputed to international and domestic traffic in the way shown in BAA's figures, domestic *peak* charges were typically significantly *lower* than international peak charges relative to economic costs net of commercial income. Equally, international *off-peak* charges typically *exceeded* economic costs, net of commercial income, to a far greater extent than did domestic off-peak charges.

11.1.27 A comparison of this nature was indeed carried out by BAA in 1983 and was included by it in "BAA 1", dated August 1983, which was the most important of the Medium Term Review consultation documents made available to the airlines. The comparison then made by BAA was of the actual 1983/84 charges with "cost-based charges" as then computed by BAA and with a credit for commercial income of £3.98 per international passenger and £1.12 per domestic passenger. The comparison was set out in full, albeit incorrectly copied in a number of material respects, by HMG in its First Memorandum. Basing oneself on the figures used in the comparison contained in "BAA 1" the following picture emerges.

TABLE 11.1.27

	1983 peak charges as % of peak "cost-based" charges	**Excess of 1983 off-peak charges over peak "cost-based" charges**
International		
B747	81.4%	£1,301
A300	74.9%	£ 836
B737	68.4%	£ 216
Domestic		
B757	58.8%	£ 461
SD330	22.7%	£ 178

11.1.28 As can be seen, the apparently differential treatment of international and domestic traffic is here more pronounced in peak periods and less pronounced in off-peak periods than when one uses the 1984 costs and 1985/86 charges. Having satisfied itself of that fact, the Tribunal reverts

to the use of the 1984 costs and the 1985/86 actual charges as the more significant for present purposes.[8]

11.1.29 If one adjusts Table 11.1.25 above (1984 "costs", 1985/86 charges) by adding back the credit for commercial income so as to make the comparison as between actual charges and gross "costs" before commercial income, the figures are as follows.

TABLE 11.1.29

	Peak			**Off-Peak**		
	1985/86 Actual	**Gross "Cost"**	**Actual as % of gross "Cost"**	**1985/86 Actual**	**Gross "Cost"**	**Excess of gross "Cost" over Actual**
	£	£	%	£	£	£
International						
B747	4505	6084	74	777	780	3
A300	3269	4628	71	496	646	150
B737	1233	1711	72	269	309	40
Domestic						
B757	966	1592	61	351	301	-50
SD330	280	407	69	93	142	49

11.1.30 If the figures in Table 11.1.29 were the only figures with which one needed to be concerned, one might conclude that, given the necessary approximations in the whole exercise and the fact that one is only looking at typical aircraft/operations anyway, the structure of user charges in 1985/86 bore an acceptable relationship to the latest computed economic costs; and if the figures in the Table had been the only calculable figures available when the 1985/86 charges were set, HMG, had it then examined the matter, might reasonably have concluded that no further investigation was required. But the

[8] HMG's pleadings also included a comparison made by BAA of the 1984 cost-based charges with 1984/85 actuals, but only for the B747 and B737 aircraft engaged in international traffic: the deductions from the cost-based charges for commercial income were made at the differential rate of £5.16 applicable to international passengers (as to which, see paragraph 11.1.3 of this Chapter, above).

figures in Table 11.1.29 were not the only calculable figures available; other readily calculable figures included figures of the kinds set out in the immediately preceding passages of this Award.

11.1.31 Moreover, Table 11.1.29 illustrates the extent to which comparisons are affected by the calculation of commercial income and its allocation as between categories of charge (and categories of user) and it highlights the significance of the fact that the Tribunal does not know the details of how BAA took commercial income into account in the establishment of user charges at Heathrow during the Arbitration period or the considerations taken into account by BAA in modifying the relationship between gross costs and actual charges by reference to commercial income. Indeed the Tribunal has seen no evidence that shows that such an exercise was ever, at least explicitly or consciously, carried out as part of the actual charge-setting process.

11.1.32 The extremely unsatisfactory nature of the record and of the evidence in this regard are discussed more fully at paragraphs 11.7.21 *et seq*. of this Chapter, below, which again demonstrate HMG's failure to investigate the position as its best efforts obligation under Article 10(1) and (3) of the Treaty required it to do.

(f) Nexus: Conclusion

11.1.33 The 1984 calculations of marginal costs may have been wrong; alternatively there may be valid reasons that displace the *prima facie* conclusion that the actual charges in both 1984/85 and 1985/86 lacked any rational and consistent relationship to the computed "cost-based charges". However that may be, given that the whole foundation claimed by BAA as the basis for its charging structure was the alleged relationship between economic costs and charges, the making of such comparisons was, in the judgment of the Tribunal, a self-evident requirement for a government that had undertaken to use its best efforts to ensure that charges should be set in accordance with the principles enshrined in Article 10(1) and (3) of Bermuda 2. There is nothing to suggest that *HMG* made any such comparisons. Especially against the background of the continuing complaints by the U.S.-designated airlines, it ought to have done so.

11.1.34 If in 1985 HMG had used its best endeavours as required by Article 10(1) and (3), it would have identified the apparent anomalies in the relationship between the identified economic costs and BAA's charges and, at a time when very probably more detailed information was available than is now, would have investigated them. Accordingly, in respect of the last four years of the Arbitration period, the Tribunal accepts USG's submission, and finds that, by reason of HMG's failure to take such action, HMG failed to fulfil its obligations under Article 10(1) and (3) of Bermuda 2.

(g) Introduction to the Tribunal's consideration of USG's other specific complaints

11.1.35 The problem of the apparent lack of any consistent or satisfying rationale for the differing relationships between actual user charges and the economic costs, as identified by BAA, on which those user charges were purportedly based necessarily affects any definitive conclusion about many of USG's specific objections to the structure of BAA's charges. It would be open to the Tribunal simply to pass by those objections on the ground that they could more appropriately have been considered as part of the more general investigation that should have been carried out by HMG by reason of the apparent lack of nexus between charges and economic costs. However the Tribunal has concluded that in some cases it can and should go further than that and identify certain elements in the structure of charges which, on the basis of the material placed before the Tribunal:

(a) can be seen to have fallen *outside* the margin of appreciation enjoyed by BAA and HMG; or

(b) were expressly based on a principle or an approach which USG attacked but which, in the judgment of the Tribunal, BAA and/or HMG were *entitled to adopt*; or, in a position between (a) and (b),

(c) required *specific investigation* of a kind that the Tribunal can identify, in order to ascertain whether the particular charging method adopted was objectionable.

11.1.36 It must be emphasized that where, in what follows, the Tribunal does not condemn an element in the structure of charges as contravening the principles set out in Article 10(1)-(3) of the Treaty, that fact does not exclude the possibility that a general investigation of the relationship between charges and economic costs such as ought to have been conducted by HMG would have disclosed such a contravention.

(2) Alleged discrimination in favor of British Airways/UK domestic traffic and against the U.S.-designated airlines/long-haul international traffic

11.2.1 The possibility of discrimination contrary to the principles contained in Article 10(1)-(3) of Bermuda 2 can conveniently be considered under five heads:

(i) Particular aspects of the general structure of BAA's user charges which were said by USG to infringe the principles contained in Bermuda 2, to the disadvantage of long-haul international carriers and therefore to the disadvantage of the U.S.-designated airlines.

(ii) An allegation made by USG that certain specific practices by BAA discriminated specifically in favor of British Airways relative to, in particular, the U.S.-designated airlines.

(iii) An allegation made by USG that BAA's profession of adherence to marginal cost pricing was a cloak under which to hide a policy of deliberate discrimination against the U.S.-designated airlines in favor of domestic traffic or U.K. airlines generally or British Airways in particular.

(iv) An unparticularized allegation made by USG that HMG had infringed Article 10(2) of Bermuda 2.

(v) A potential cause for concern that emerged from BAA statistical material produced in the course of the hearing.

(i) Particular aspects of the general structure of BAA's user charges alleged to disadvantage long-haul international carriers

11.2.2 With regard to the first of these five heads of complaint, the gravamen of the charges was that an undue share of the burden of user charges at Heathrow fell on long-haul operators using large aircraft, including the U.S.-designated airlines, and that for that reason, and because certain aspects of the charging system favored domestic operators to an allegedly undue extent, domestic operators were especial beneficiaries of the charging structure. All the features of BAA's general charging structure that allegedly gave rise to that result are considered in connection with USG's other specific complaints about the charging structure and will be discussed by the Tribunal when it comes to those complaints.

(ii) Specific practices of BAA that were alleged to favor British Airways

11.2.3 USG alleged that in certain respects BAA discriminated against the U.S.-designated airlines in favor of British Airways which until 1987 was, like BAA itself, in public ownership. USG referred to a January 1980 BAA document which, according to USG, showed that BAA had a policy of "being nice" to British Airways as its largest customer.

11.2.4 By its First Memorandum USG alleged three types of specific discrimination by BAA in favor of British Airways. The allegations and HMG's answers may be summarised as follows:

(1) The waiver by BAA of overnight parking charges. HMG stated that this had never been the subject of complaint; the concession was available to all airlines. Overnight parking caused no additional costs to BAA and the imposition of a charge would probably not have raised additional revenue since British Airways could simply have towed their aircraft to their own maintenance base overnight, thereby incidentally increasing congestion of the airfield.

(2) BAA's alleged policy of not charging British Airways for its use of cargo area parking stands. HMG stated that, in fact, those stands were charged for at off-peak rates to any operator using them.

(3) The definition by BAA of "passengers" for the purposes of terminal charges. HMG stated that the definition adopted was the only practicable one and was entirely rational; it had not been the subject of complaint till shortly before the Arbitration.

11.2.5 In its Second Memorandum USG did not refer to any of those specific complaints (nor did any of them feature in USG's List of Issues) and at the hearing (subject to one vague reference which was of insufficient evidentiary value to be relied upon) neither USG nor its witnesses referred to them. The Tribunal finds that it has not been established that Article 10(1) - (3) has been infringed in any of these respects.

(iii) The allegation of deliberate discrimination by BAA in favor of U.K. carriers under the cloak of the professed use of marginal cost pricing

11.2.6 It was USG's contention that BAA's profession of adherence to marginal cost pricing was a cloak under which to hide a policy of deliberate discrimination against the U.S. airlines in favor of domestic traffic or U.K. airlines generally or British Airways in particular, which, until 1987, was, like BAA itself, in public ownership and which was BAA's largest customer.

11.2.7 In this connection USG referred to a number of documents antedating the Arbitration period, including the January 1980 BAA documents which, according to USG, showed that BAA operated a policy of "being nice" to British Airways. The Tribunal does not believe that it is useful to refer to the pre-Arbitration period documentation in question: the structure of BAA's charges at Heathrow during the Arbitration period was very different from that in operation during the preceding decade; and the 1980-83 litigation between the airlines, on the one hand, and BAA and HMG, on the other hand, culminating in the Airlines Settlement Agreement of February 22, 1983, and the intergovernmental MoU of April 6, 1983, constitutes a clear dividing line between the position before the Arbitration period and the Arbitration period itself.

11.2.8 So far as the Arbitration period was concerned, USG relied on:

(a) the lack of observable nexus between the identified economic costs and actual user charges;

(b) the fact that the U.S.-designated airlines bore a proportion of the total burden of user charges substantially greater than the share of total traffic for which they accounted;

(c) the allegedly greater rate of growth of domestic traffic than of international traffic at Heathrow, which allegedly reflected a policy of deliberate discrimination in favor of domestic traffic;

(d) the circumstances in which in 1985/86 BAA withdrew its proposal to introduce a common landing charge not only in peak but also in non-peak periods for aircraft of all sizes;

(e) the three specific matters referred to at paragraph 11.2.4 of this Chapter, above.

11.2.9 In the judgment of the Tribunal, the state of mind of members of the Board of BAA or of employees of BAA is, as such, irrelevant to the questions whether (a) HMG failed to use its best efforts as required by Article 10(1) and (3) of the Treaty or (b) the requirements of Article 10(2) were infringed. Therefore, the Tribunal examines the matters set out at sub-paragraphs (a) - (e) of the last preceding paragraph solely in so far as the matters there referred to cast light on the questions that the Tribunal is called on to decide.

11.2.10 The Tribunal also has in mind the fact that:

(i) BAA was not a party to the Arbitration and was not represented before the Tribunal; and

(ii) USG did not itself put to any of the witnesses called by HMG the allegation that BAA had deliberately pursued a discriminatory policy.

(a) Lack of observable nexus between the identified economic costs and the actual user charges

11.2.11 The Tribunal has already recorded its finding that, having regard to the lack of observable nexus between the identified economic costs and the actual user charges at Heathrow, it was incumbent on HMG to investigate the structure of charges at Heathrow that applied in the charging years 1985/86 - 1988/89 and that by reason of HMG's failure to do so properly or, in certain respects at all, HMG failed to fulfil its obligations under Article 10(1) and (3) of the Treaty. In the judgment of the Tribunal, that is the only respect in which lack of observable nexus is, in itself, relevant to any issue that the Tribunal is called upon here to decide.

(b) The disproportion between the share of traffic for which the U.S.-designated carriers accounted and the share of charges that they bore

11.2.12 The Tribunal has already recorded, at paragraph 9.22 of this Chapter, above, its conclusion, based on the record before it, that the fact that the share of total airport charges borne by PanArn and TWA exceeded their share of traffic in itself tells one nothing about the reasonableness or otherwise of the actual structure of user charges at Heathrow.

(c) The allegedly greater rate of growth of domestic traffic than of international traffic at Heathrow

11.2.13 The Tribunal also does not accept USG's allegation that BAA's charging structure ensured that domestic use of Heathrow claimed ever greater proportions of Heathrow's resources over the years (and was thereby instrumental in implementing an alleged policy of HMG). So far as the Arbitration period is concerned, USG's own calculations indicated that from

1984/85 onwards the proportion of total air traffic movements at Heathrow accounted for by domestic traffic declined every year. So far as passenger flights were concerned, that was confirmed by the BAA statistics provided to the Tribunal by HMG in the course of the hearing. And in this connection it is use of the runways (which are shared by domestic and international traffic) rather than use of terminals (which are separate for the one and the other) that is relevant.

11.2.14 In fact, the major growth of passenger flights to and from Heathrow during the Arbitration period was accounted for by international flights to and from other European airports. Between 1983/84 and 1988/89 such flights increased in number by 37% (with a growth in passenger numbers of 49%). By contrast, the number of domestic passenger flights increased during the Arbitration period by only about the same proportion (15.55%) as long-haul international passenger flights (15.33%) and PanAm/TWA passenger flights to and from the U.S. (15.25%). In the result domestic passenger flights, which had accounted for 29.0% of all passenger flights to and from the airport in 1983/84, accounted for 26.4% of the total in 1988/89.

11.2.15 USG alleged that the discrimination was most marked and most unjustified in the case of "small" aircraft. It is impossible to tell what proportion of the domestic flights was accounted for by small aircraft. However, in so far as small aircraft continued to use Heathrow at peak periods, they incurred an increasingly heavy price in the form of landing charges for so doing: see Table 1.2 in this Chapter, above. For example, by 1988/89 the operator of an 11 tonne aircraft engaged in scheduled traffic and carrying a typical load of 20 passengers which landed in the Heathrow landing peak, was paying *landing charges* alone equivalent to £14.50 per arriving passenger compared with £1.10 for a transatlantic carrier, with a typical load of 265 passengers.

11.2.16 If one looks at total user charges, by 1988/89 the operator of the 11 tonne aircraft engaged in domestic traffic, landing and taking off with 20 passengers, with a three-quarter hour turnround, was paying 43% more *per passenger* in peak hours and 41% more *per passenger* in non-peak hours than the operator of a 335 tonne aircraft engaged in international traffic, landing and taking off with 265 passengers, with a turnround time of 3 peak parking hours and 1 off-peak parking hour: the relevant figures may be derived from Tables 1.15A and 1.15E.

11.2.17 Accordingly, the Tribunal concludes (a) that, in so far as usage of Heathrow for domestic passenger flights was affected by BAA's charging policy, the policy had the effect of reducing and not increasing the proportion of total passenger flights accounted for by domestic traffic during the Arbitration period; and (b) that if one confines one's attention to small aircraft engaged in domestic traffic, the relative decline is probably more pronounced than in the case of large aircraft engaged in domestic traffic. These

conclusions militate against, rather than corroborate, USG's allegations of deliberate discrimination by BAA in favor of domestic traffic.

(d) Differentials in off-peak landing charges related to size of aircraft from 1985/86 onwards

11.2.18 The Tribunal's discussion of the circumstances in which in 1985/86 BAA withdrew its proposal to introduce a common off-peak landing charge is to be found at paragraphs 11.5.3 - 11.5.15 of this Chapter, below, where the Tribunal concludes that HMG's acts and omissions in relation to the weight-related differentials in off-peak landing charges from 1985/86 onwards constituted a breach of Article 10(1) and (3) of the Treaty. However, the existence of a single incident in relation to a distinct issue that generated a distinct political controversy does not provide evidence of pursuit by HMG of a *general policy* that was incompatible with its Treaty obligations.

(e) The specific matters of complaint referred to at paragraph 11.2.4 of this Section, above

11.2.19 The Tribunal has already recorded, at paragraph 11.2.5 of this Chapter, above, its conclusion that USG had not substantiated any of the specific complaints referred to at paragraph 11.2.4.

(iv) Article 10(2) of Bermuda 2

11.2.20 USG did not specifically plead in either its First or its Second Memorandum that the discrimination against the U.S.-designated airlines which it alleged gave rise to infringement of Article 10(2) of the Treaty. However, in its List of Issues USG alleged, without elaboration, that Article 10(2) had been infringed.

11.2.21 Article 10(2) and its interpretation are discussed by the Tribunal Chapter 8 of this Award. In that Chapter the Tribunal records its conclusion that the record before it does not contain sufficient evidence for it to make a finding of overt or covert discrimination in violation of Article 10(2) and to sustain such a charge. However, it is convenient here to note a number of matters that are relevant, directly or indirectly, not only to Article 10(2) but also to the conformity or otherwise of the user charges at Heathrow with the principles contained in Article 10(1) and (3).

11.2.22 First, Article 10(2) is capable of raising special questions in view of the fact that it imposes on the Parties an "obligation of result" and not merely an "obligation of conduct". In consequence and irrespective of the efforts used by HMG, if, at any time during the Arbitration period including the first two years, discrimination of the kind prohibited by Article 10(2) occurred, there was a breach of the Treaty.

11.2.23 The second point to note is that precisely the same *rates* of user charges at Heathrow were applicable to the aircraft/operations of U.S.-designated airlines as to British airlines in respect of their flights to and from

the U.S. (see paragraphs 1.1 - 1.21 of this Chapter, above, for a description of those rates; and see paragraphs 11.2.4 and 11.2.5 of this Chapter, above, for the rejection by the Tribunal of USG's allegations that there were departures from the generally applicable rates that BAA made in favor of British airlines generally or British Airways in particular). There was therefore no overt discrimination in respect of the rates applicable to similar international air service operations.

11.2.24 Similarly, a comparison of the average of total user charges per passenger incurred at Heathrow by the U.S.-designated airlines, on the one hand, and British Airways, on the other hand, in respect of Heathrow/U.S. traffic shows that in five of the six years of the Arbitration period British Airways incurred a higher average user charge per passenger; in the sixth year the average charge incurred by British Airways was lower, but by only 1.4%, than the average charge incurred by the U.S.-designated airlines; for the six-year period as a whole British Airways incurred an average charge per passenger 17.5% higher than the average charge incurred by the U.S.-designated airlines: see Table 1.19A in this Chapter, above. These figures relate exclusively to traffic between the U.S. and Heathrow, which for this purpose may be taken to constitute "similar international air services" within the meaning of Article 10(2) of Bermuda 2.

11.2.25 There are no statistics available to the Tribunal that show the average user charges per passenger incurred by the U.S.-designated airlines on their total operations at Heathrow (though the figures will probably approximate to the figures in respect of their Heathrow/U.S. traffic, which appear to have constituted the great majority of their operations at Heathrow). Equally there are no statistics available to the Tribunal that show the average user charges per passenger incurred by British airlines in general or British Airways in particular on their total operations, domestic and international of all kinds, at Heathrow, though they will be substantially lower than the figures for British Airways in respect of its Heathrow/U.S. traffic viewed in isolation (see generally Table 1.19A of this Chapter, above). But whilst such statistics could be relevant to the issue of equitable apportionment within the meaning of Article 10(3) of the Treaty, they could not be relevant for the more limited purposes of Article 10(2), which is concerned exclusively with "similar international air services".

11.2.26 Although, as already noted, the Tribunal makes no finding of violation of Article 10(2), its interpretation of Article 10(2), as recorded in Chapter 8 below, entails the consequence that under the Treaty there is a need to consider whether the charging system, as a whole, at a Treaty airport is operating more favorably to a Party's own airlines than to the other Party's designated airlines. Given that need and given the fact that this Chapter of this Award deals generally with the structure of charges at Heathrow, this is a convenient place to record one matter that seems to the Tribunal to give rise to a potential cause for concern and the Tribunal now turns to that matter.

(v) A potential cause for concern that emerged from BAA statistical material produced in the course of the hearing

11.2.27 Using BAA statistical material that became available to the Tribunal through HMG as a result of a request by the Tribunal to HMG in the course of the hearing, it became possible for the Tribunal to analyze the different experiences of PanAm/TWA, on the one hand, and British Airways, on the other hand, in relation to average user charges, by category and in total, per passenger so far as U.S./Heathrow traffic was concerned. The results are included in Tables 1.19A-D above: for convenience, the relevant figures are replicated in Table 11.2.27 below.

TABLE 11.2.27

Average user charges, by category and in total, per passenger incurred by PanAm/TWA and British Airways in respect of US/Heathrow traffic

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1988/89 v. 1983/84
Terminal charges							
Pan/Am/TWA	£3.19	£3.02	£3.32	£3.20	£3.45	£3.61	+£0.42
British Airways	£3.82	£3.82	£3.92	£3.72	£3.25	£3.26	-£0.56
Runway charges							
Pan/Am/TWA	£1.02	£0.64	£0.32	£0.36	£0.32	£0.39	-£0.63
British Airways	£1.16	£0.75	£0.35	£0.38	£0.38	£0.42	-£0.74
Parking charges							
Pan/Am/TWA	£1.11	£1.08	£1.21	£1.28	£1.10	£0.91	-£0.20
British Airways	£2.11	£1.73	£1.72	£1.70	£1.54	£1.17	-£0.94
Total user charges							
Pan/Am/TWA	£5.32	£4.75	£4.84	£4.84	£4.88	£4.92	-£0.40
British Airways	£7.08	£6.30	£5.99	£5.81	£5.16	£4.85	-£2.23

11.2.28 In 5 of the 6 years of the Arbitration period British Airways incurred higher per passenger charges on those routes than PanAm/TWA (33% higher in 1983/84) and over the Arbitration period as a whole the average per passenger charge incurred on U.S.-Heathrow routes by British Airways was 17.5% higher than the average per passenger charge incurred on those routes by PanAm/TWA. In 1988/89, the last year of the Arbitration period, the average per passenger charge incurred on those routes by PanAm/TWA was 1.4% higher than the corresponding average for British Airways. PanAm/TWA generally paid an average charge per passenger on their U.S.-Heathrow routes about 1.4 times the Heathrow airport average. At the beginning of the Arbitration period British Airways was paying an average per passenger on their U.S.-Heathrow routes of about 1.9 times the airport average; the ratio declined to about 1.4 times by the end of the Arbitration period.

11.2.29 Thus, the average total charge per passenger incurred by British Airways on U.S.-Heathrow routes can be seen to have fallen significantly more than the average charge per passenger incurred on such routes by PanAm/TWA.

11.2.30 When one comes to examine the make-up of the total charges incurred by PanAm/TWA and British Airways on their U.S./Heathrow routes one finds that the primary reasons for the elimination of the difference in the total charges incurred by the former and the latter was that the average per passenger terminal charge incurred by British Airways fell by 15% whereas the average per passenger terminal charge incurred by PanAm/TWA rose by 13%; secondly British Airways very greatly reduced the substantial amount by which the average per passenger parking charge that it incurred exceeded that incurred by PanAm/TWA. There was no explanation as to how those developments came about.

11.2.31 Even in what should be analytically the simpler case of terminal charges, although the Tribunal has been supplied with figures showing the total number of passengers, arriving as well as departing, on PanAm/TWA flights and on British Airways flights to and from the U.S., the Tribunal does not know the ratio of departing to arriving passengers. If the proportions had been equal, then one could infer from a comparison of Tables 1.10A and 1.19C of this Chapter, above, that the percentages of PanAm/TWA and British Airways departing passengers on flights to the U.S. who attracted peak charges differed and varied as follows during the Arbitration period.

11.2.32 It seems very likely that the proportions of departing and arriving passengers were not always equal and that the percentages were therefore not precisely those shown in Table 11.2.30. Thus, a BAA document (which forms part of Appendix 5 to BAA16/86 at JR Z-59, which was prepared in the first quarter of 1986), states that BAA then estimated that “the proportion of PanAm/TWA passengers within the Heathrow passenger peak has fallen from 47.5% to 39.1% over the last financial year”. Assuming that “the last financial

year" referred to was 1984/85, this would seem to show that the actual percentage of PanAm/TWA passengers departing for the U.S. in peak terminal hours in 1983/84 was 47.5% and not the 49.2% that would have prevailed if the proportions of arriving and departing passengers had been equal; similarly the actual percentage for 1984/85 seems to have been 39.1% and not the 42.1% that equal proportions of arriving and departing passengers would have implied.

11.2.33 On the other hand, there is no reason to doubt that Table 11.2.31 probably gives a reasonable indication of orders of magnitude and trends. If so, then, at the time of the extension of the terminal peak from 5 to 6½ hours in 1987/88, both PanAm/TWA and British Airways were incurring peak terminal charges in respect of significantly lower percentages of their passengers departing for the U.S. than in 1983/84; not surprisingly, the extension of the duration of the peak terminal period by 30% seems to have resulted in an immediate increase in the proportion of departing passengers in respect of whom peak terminal charges were payable; but, in the case of PanAm/TWA, the rise was much greater than in the case of British Airways; and in the case of British Airways, but not PanAm/TWA, the change did no more than temporarily interrupt the previous downward trend line. In the result, it seems probable that, whereas at the beginning of the Arbitration period a significantly higher percentage of British Airways' passengers than of PanAm/TWA's passengers departing for the U.S. attracted peak terminal charges, by the end of the Arbitration period that position had been reversed. The Tribunal refers further to the re-definition of the terminal peak period in 1987/88 at paragraph 11.6.19 of this Chapter, below.

TABLE 11.2.31

	1983/84 %	1984/85 %	1985/86 %	1986/87 %	1987/88 %	1988/89 %
Percentage of passengers departing to U.S. in peak terminal hours	**5 hour peak**				**6½ peak**	
PanAm/TWA	49.2	42.1	46.5	42.9	60.0	54.7
British Airways	61.2	55.9	56.8	51.6	55.7	48.1

11.2.34 The apparent effect of the extension of the terminal peak in 1987/88 by bringing into the peak period 0900-0959 and 1500-1529 (as always in April - October) has caused the Tribunal particular anxiety in view of a letter sent from PanAm to BAA on November 30, 1984. That letter related to the (unimplemented) *proposal* that had by then been made by BAA for 1985/86 to extend the terminal peak by bringing into the peak 0830-0959 and 1500-1529, i.e. what was actually done in 1987/88 save that 0830-0859 then remained outside the peak. With regard to the proposal for 1985/86, PanAm said:

> "By expanding the peak passenger charging period 1½ hours earlier and ½ hour later, BAA has captured over twice as many PanAm trips in its new peak definition as were in the old peak definition.
>
> "By expanding the peak charge period by the selected 1½ hours in the morning and ½ hour in the afternoon, BAA has redefined our passenger peak from 45% of the PAA forecast to 78% of the forecast departing PanAm passengers. …
>
> "If the expansion of the defined period had been two hours in the afternoon, i.e., 1500-1659 GMT, the percentage of PAA passengers charged the peak fees would have increased by 14%, not 33%. This would have captured more total passengers from all carriers and not just PanAm, so that the peak fees would have been less for everyone.
>
> "Even if the period had been expanded by two hours in the morning, only 24% more of PAA's forecast passengers from all carriers would have been captured, not 33%.
>
> "In short, the 120 minutes selected for expansion of the peak would appear to us, if we were paranoid, as if they had been based on the PanAm forecast. They are not based upon the activity charts of Terminals 1 or 2 as shown in the Patterns of Traffic.
>
> "They are not based upon the airport as a whole, higher activity leads [*sic*] are evident from 1500 to 1759 than during some of the proposed period. (Patterns of Traffic, Chart 42)."

11.2.35 The proposal for *1985/86* was not implemented and no witness from PanAm gave evidence to the Tribunal about the effect on PanAm of the 1½ hours extension of the terminal peak in *1987/88* (which continued in operation in *1988/89*): it is, in any event, impossible for the Tribunal to make a definitive finding that the terminal peak periods should have been differently defined (see paragraph 11.6.21 of this Chapter, below).

11.2.36 However that may be, even without the background of PanAm's response to BAA's proposal for 1985/86, an obvious candidate for investigation as a cause of the more rapid fall in the average terminal and parking charges per passenger for British Airways than for PanAm/TWA would have been a change of mix in peak/off-peak traffic. If an investigation had established that that was so, then it would have been necessary to consider how the change had been achieved and in particular whether for some reason British Airways had been able to re-schedule out of peak to a greater extent than PanAm/TWA. So far as appears from the record before the Tribunal, PanAm/TWA had in fact re-scheduled departures out of the critically important terminal peak hours on only rare occasions during the Arbitration period and, between them, had only three transatlantic departures in off-peak terminal hours in 1988/89. Certainly, in February 1986 PanAm and TWA

complained to BAA that they had been unable to schedule out of peak hours for both the 1985 and 1986 seasons, adding "By definition, an off-peak hour cannot be one that is so busy that a carrier is unable to transfer to it". Having said that, it must be noted that, although Mr. Shane, the U.S. Assistant Secretary for Transportation, gave some general evidence about this, no witness from either PanAm or TWA gave any evidence to the Tribunal about the possibility or otherwise of their rescheduling out of terminal peak hours at any time during the Arbitration period.

11.2.37 HMG's specific duty under Article 10(2) of Bermuda 2 and its duty to use its best efforts to ensure that user charges conformed to the principles contained in Article 10(1) and (3) of the Treaty required that, especially against such a background of complaint, HMG ought to have taken steps to monitor whether the operation of the sharply differentiated peak/off-peak charging system was in practice working inequitably, to the detriment of the U.S. airlines, by reason of British Airways having some advantage, that was denied to PanAm/TWA, in relation to re-scheduling flights out of terminal peak hours. HMG's failure to undertake the required monitoring constituted a breach of its obligations; that is so, even though, on the record before it, the Tribunal cannot be satisfied (on the issue with which it is here concerned) that the system was in fact working inequitably as between PanAm/TWA and British Airways. For example, as already noted, for most of the Arbitration period and on average for the period as a whole, British Airways incurred *higher* user charges per passenger than did PanAm/TWA in respect of flights to and from the U.S.

(3) The proportions of total user charges accounted for by runway, terminal and parking charges.

11.3.1 It follows from what has been said (at paragraphs 11.1.1 *et seq.* of this Chapter, above) about the lack of evidence of nexus between actual charges and economic costs, especially so far as runway usage is concerned, that it is impossible to be satisfied that the balance between runway and other charges was correct. But it does not follow from that fact that USG has established that the balance was incorrect and that HMG was in breach of its best efforts obligation in failing to intervene directly in order to correct the balance. It is therefore necessary to examine USG's arguments that that was so.

(a) USG's case

11.3.2 At its highest, USG's case was that, with runway charges at their actual levels, demand exceeded supply for most of the time; therefore, on an SRMC-based approach, such as both Parties finally accepted for this purpose, runway charges should have been increased, so as to choke off the excess demand; by contrast, at all times there was, according to USG, an excess of terminal and parking capacity over demand so that, on USG's SRMC-based approach, terminal and (at any rate after the opening of Terminal 4 in 1986) parking charges should not at any time have exceeded the extra costs incurred

by BAA as a result of the terminal or parking stand usage for which the charge was made.

(b) HMG's case

11.3.3 HMG summarised this part of the case as follows. There was, HMG said, little difference of substance between USG and HMG on the issue of runway demand at Heathrow. Both parties agreed that demand had been high throughout the period. The difference was that HMG did not accept that the runways had been saturated; sufficient spare capacity had existed for the growth in demand to be accommodated by Heathrow's incumbent airlines to and beyond the end of the period covered by the Arbitration (although there had been insufficient spare capacity for new airlines to open up competitive operations at Heathrow). Heathrow's landing charges had therefore risen to reflect the growth in demand, and the increasing pressure which it had placed on existing capacity.

11.3.4 HMG and USG differed widely on the issue of terminal demand and capacity. HMG said that it accepted the views developed by BAA over its long period of expertise in assessing terminal capacity. It noted that BAA's views had been set out repeatedly for reasons other than those of the present investigation, and that they reflected the views of successive Public Inquiries and the industry generally. HMG further observed that BAA considered terminal capacity to be under very considerable pressure at Heathrow and had backed that judgment with the investment of many millions of pounds in new terminal capacity. According to HMG, the costs of that capacity had been legitimately reflected in the structure of charges.

11.3.5 USG had neither accepted nor disputed that existing parking capacity had been under pressure before 1986, but HMG claimed that it had demonstrated that that had been the case. HMG contended that USG had overstated the amount of spare capacity since 1986, and had disregarded continuing shortages of the most convenient stand positions in busy periods.

11.3.6 According to HMG, the simple truth was that all aspects of Heathrow's capacity had been subject to excess demand in busy periods, and the kind of full capacity rationing system advocated by USG would have raised all the charges.

11.3.7 USG's final argument that higher runway charges would have resulted in lower passenger and parking charges was, in the submission of HMG, erroneous: if such higher runway charges had caused small aircraft to be replaced by large aircraft, the increase in passenger numbers would have raised terminal congestion and brought forward higher passenger and parking charges.

(c) The Tribunal's conclusion

11.3.8 It is clear from BAA's contemporaneous documentation that, at the time of the Medium Term Review, BAA regarded the limitation of terminal

capacity rather than the limitation of runway capacity at Heathrow as the bottleneck. The reason for that belief was that there was scope to increase the number of runway movements substantially without incurring any significant capital expense and certainly without constructing a new runway, which would have been impracticable within the confines of the existing airport. By contrast, BAA concluded that terminal capacity would have been inadequate to handle the expected increase in numbers of passengers without the construction of a further terminal.

11.3.9 The scope for increasing the number of runway movements within the limits of existing runway capacity is evident from the fact that the total number of flights did increase as follows.

TABLE 11.3.9

	Number of movements	
	'000	**1983 = 100**
1983	260	100
1984	273	105
1985	283	109
1986	289	111
1987	304	117
1988	327	126
1989	345	133
1990	367	141

NOTE: The figures in the Table are those provided by HMG; they are broadly similar, though not identical, to the figures for "Scheduled air transport movements", per charging year, given in BAA's annual Reports and Accounts and the two sets of figures show a closely parallel increase over the Arbitration period. Over the same period "Total aircraft movements" at Heathrow, the number of which generally exceeded the number of "Scheduled air transport movements" by about 9%, grew slightly less rapidly than the number of the latter.

11.3.10 As appears from the Table, the increase in the number of movements was actually greater, both absolutely and proportionately, after 1986 than earlier in the period: thus, whereas between 1983 and 1987 it was possible to increase the number of movements by an average of 11,000 a year, in the following three years an average increase of over twice that number was achieved. One must therefore conclude that runway capacity was not

"saturated" in the sense of imposing an absolute and fixed constraint on landings and take-offs.

11.3.11 The Tribunal is also bound to accept that the increase in the number of passengers, which was in line with estimates made by BAA in 1983, necessitated the construction of Terminal 4. The increase was very substantial.

TABLE 11.3.11

	Number of passengers	
	Millions	**1983 = 100**
1983	26.7	100
1984	29.1	109
1985	31.3	117
1986	31.3	117
1987	34.7	130
1988	37.5	140
1989	39.6	148
1990	42.6	160

NOTE: Again the figures are those provided by HMG which do not precisely tally with those contained on a charging year basis in BAA's annual Reports and Accounts; the latter show a slightly larger percentage increase in numbers of passengers in 1988/89 relative to 1983/84 than the increase shown in the Table.

11.3.12 Interestingly, using HMG's figures, it appears that the increase in the numbers of passengers over the period 1983-1988 resulted more from the 26% increase in passenger flight air traffic movements that were accommodated by the existing runways than from an 11% increase in average numbers of passengers per flight over the same period.

11.3.13 It seems inconceivable that BAA would have incurred the capital expenditure of over £300 million involved in constructing Terminal 4 if the existing terminals could have satisfactorily handled the additional traffic. A public inquiry into the need for Terminal 4 had resulted in a finding that it was necessary; HMG had accepted that finding. In the circumstances, HMG was entitled to act on the basis that the expected increase in traffic necessitated large capital expenditure on terminals and little if any expenditure on increasing runway capacity.

11.3.14 The Tribunal recognizes that some airlines refrained from applying to the Heathrow Users Committee, which allocated slots, with requests for slots that they would have liked, because they knew that, as a result of the application of the principle of "grandfather rights", it would be useless to make such an application. Equally, airlines that were free, under the Traffic Distribution Rules, to use Heathrow and that did apply to the Committee for slots at Heathrow were not able to obtain all the slots that they needed on an uninterrupted daily basis in order to operate all the scheduled services that they wished to operate. Indeed, there is no reason to doubt that BAA's perception of the situation was accurately reflected in a Report prepared by Coopers & Lybrand Associates for BAA in July 1987 where it says "We understand from [Heathrow Airport Limited] that the capacity of the runways is becoming an increasingly pressing constraint on the use of the airport and for this reason the 1987/88 Conditions of Use introduced a shift in the balance of charges from parking to runways".

11.3.15 HMG concluded in its Second Memorandum that all user charges, and therefore *inter alia* runway charges, would have been higher if the kind of full capacity rationing system advocated by USG had been practiced. So far as *landing charges* are concerned, the Tribunal thinks that that must be so when one considers how, during the Arbitration period, peak landing charges were in fact increased by 86% after 1985/86 without running into any shortfall of demand relative to capacity. On the other hand, though there is evidence of airlines being unable to re-schedule out of peak into off-peak runway time, there is no evidence about the incidence of this phenomenon and there is no evidence as to the extent, if at all, to which off-peak landing charges (which were increased only slightly after 1985/86) could have been increased more than they were without running into a shortfall of demand relative to capacity. The precise definition of the peak landing hours is considered at paragraphs 11.4.1 *et seq.* of this Chapter, below.

11.3.16 The Tribunal has already held that it cannot hold HMG guilty of breach of Article 10(1) and (3) of Bermuda 2 because of HMG's espousal of LRMC-influenced pricing for terminal usage. LRMC-influenced pricing clearly implies establishment of *terminal charges* at Heathrow throughout the Arbitration period on the basis of marginal costs which could properly be calculated by reference to *inter alia* the cost of, and of operation of, Terminal 4. USG has therefore failed to satisfy the Tribunal that HMG should have intervened to ensure that, for the whole or at least the great majority of operating hours, terminal charges were held down to an amount equal to merely the extra costs incurred by BAA as a result of the terminals' operations in question.

11.3.17 With regard to *parking charges*, an expectation of additional demand similarly necessitated an expansion of capacity; and parking capacity was expanded when Terminal 4 was constructed: a requirement to expand parking capacity was indeed an almost inevitable corollary of the expected increases in the numbers of runway movements and passengers. Accordingly,

under an LRMC-based pricing system it would be appropriate at times to charge for parking more than the mere costs of operating parking stands during the period of their occupancy. On the other hand, it seems clear that the investment in further parking stands when Terminal 4 was constructed turned out in the event to have been excessive, with the result that in the latter part of the Arbitration period there was persistent excess parking capacity. This was indeed reflected in significant reductions in parking charges and in the proportion of total user charges for which they accounted, in 1987/88 and 1988/89.

11.3.18 USG did not seek to quantify what user charges of different categories, whether peak, off-peak or in the aggregate, should have been, at any point or points of time during the six year Arbitration period. However, it seems to the Tribunal probable that, applying the principles that HMG was entitled to apply without incurring liability under Article 10(1) and (3) of Bermuda 2, any disproportion between landing charges, on the one hand, and terminal and parking charges, on the other hand, was smaller than the disproportion implicit in USG's submissions. An investigation into the relationship between economic costs and user charges such as the Tribunal has held that HMG ought to have carried out should have been able to establish the extent of the disproportion, if any (i.e. beyond the margin of appreciation allowable to BAA).

(4) The width of the landing charge peak

USG's initial criticism

11.4.1 USG's criticism of BAA's definition of the landing charge peak was formulated as follows by Dean Levine in his Principal Evidence:

> "For most of the period in question, BAA included in its 'peak' periods only those few hours when U.S. carrier activity was greatest, while excluding other hours with comparable levels of operations. But despite the similarity in the reported levels of activity over a 12-hour period at Heathrow, BAA defined much narrower five-hour, peaks for charging purposes and centrered them on the arrival hours most heavily used by U.S. airlines. Time periods with levels of activity comparable to or greater than those in BAA-defined peaks were nonetheless classified as non-peak periods and were subject to lower charges. Some of these non-peak periods were characterized by high levels of British domestic operations. Since runway capacity was constrained for most of the day over the entire period in dispute, many more users should have been required to take the competing demands of others in account. Peak charges should have been imposed for a substantially longer period each day." (Footnote references omitted.)

HMG's initial answer

11.4.2 In their Counter-Evidence the BAA witnesses provided statistics, amplifying HMG's pleadings on this point, which showed that the percentage of PanAm/TWA's total landings at Heathrow that were accounted for by landings in the runway peak period was lower than the percentage of British Airways/British Midland's total landings at Heathrow that were so accounted for and lower than the airport average. The BAA witnesses concluded that

there was therefore no substance to Dean Levine's suggestion that the runway peak was designed to include U.S. airlines and to exclude U.K. airlines.

11.4.3 The BAA witnesses also drew attention to the fact that, at least so far as the Arbitration period is concerned, the runway peak/off-peak differential was not introduced until the third year of the Arbitration period, 1985/86. In the first year, 1983/84, the old summer/winter differential was still in operation; and in the second year, 1984/85, there was neither a seasonal nor a peak/off-peak differential in landing charges. When peak/off-peak differentials were introduced in 1985/86, they applied only to aircraft of up to 50 tonnes maximum authorized weight and the same was true in the following year; in the last two years of the Arbitration period there were peak/off-peak landing charge differentials applicable to all aircraft. Because of this history, the Medium Term Review that was conducted by BAA in 1982-1984 did not cover the definition of the peak period for runway charges.

11.4.4. Chart 11.4.4 is a legibly redrawn version of the contemporaneous BAA chart included amongst the papers placed before the Tribunal which shows the pattern of landings at Heathrow in March 1986 (a month outside those when peak landing charges operated). BAA and PanAm/TWA both referred to the original of the Chart in connection with BAA's 1987/88 charging proposals. The maximum hourly landing capacity at the airport of 34 has been marked by the Tribunal on the redrawn version of the Chart.

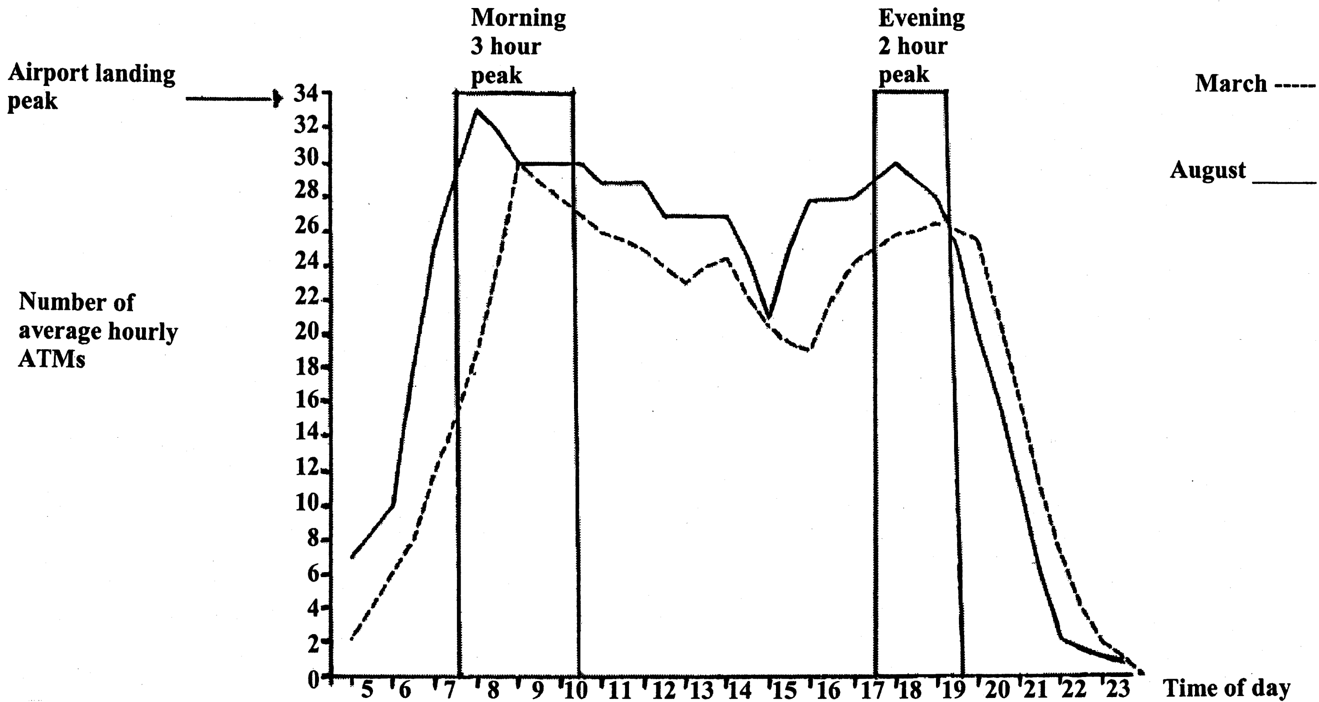
11.4.5 The proposals for landing charges, made by BAA for that year as part of the consultation process with the airlines, included the following statement:

> "The current structure of a flat fee in the five hour split peak, with lower charges for small aircraft in off-peak period was implemented in 1985. Over the last two summers it has been possible to assess the definition of the peak period in action.
>
> "The five defined peak hours (0700 - 0959 and 1700 - 1859) remain at the peak of demand, but other hours are now approaching the 30 arrivals threshold [reference to Chart 11.4.4]. A wider peak has therefore been considered. However, a wider band could reduce the ability of operators to respond to prices in their scheduling decision. Since stability in peak definitions is desirable, given the time lags in operational responses to those definitions, no change is proposed for 1987/8, although the pattern of traffic and charges will be kept under review with a view to introducing structural changes for 1988/9 if appropriate." (JR Z-9, Heathrow Attachment, paragraphs 8 and 9.)

11.4.6 In their contemporaneous comments on BAA's proposals for 1987/88 in this respect, PanAm/TWA suggested that the peak charges as a whole and for all activities should be for the entire period 0700-1900 so that all three peak charges would make operations more expensive when runways were congested and less expensive when they were not (JR Z-64, Section El, page 19). BAA replied in the following terms to that suggestion:

CHART 11.4.4

Heathrow hourly flow of arriving Air Transport Movements: Daily averages in March and August 1986



> "The argument that runway, terminal and apron peak periods should all be based on a wide runway based peak is a shift of position by PanAm/TWA, from their previous views that, for instance, the passenger peak should be based on the sum of all the terminal peaks (or alternatively, that there should be separate peaks for each terminal). We are not sure what it is intended to achieve by such a wide peak period. PanAm/TWA have previously stressed to us the importance of providing access for large aircraft at the most congested periods on the runway. A very wide peak would eliminate the incentive for operators of smaller aircraft to operate outside peak hours. It would also separate passenger charges from the long run costs of meeting demand for passenger facilities." (*Ibid.*, facing page.)

Dean Levine's rebuttal evidence

11.4.7 In his Rebuttal Evidence, Dean Levine commented that the BAA witnesses' evidence did not respond to his assertion in his Principal Evidence that British airlines used Heathrow at times outside the landing peaks that were equally congested; he regarded it as incontrovertible (a) that any hour in which Heathrow operated at its defined capacity was a peak hour and (b) that a period in which the Scheduling Committee would not allocate an additional landing slot to an airline requesting it was also a peak period. Dean Levine's evidence was then to the effect that, although there were some interpretative difficulties, the final output of the Scheduling Committee (which was operated, in accordance with what appears to be industry practice, by and on behalf of the *airlines*, to allocate landing and departure slots at Heathrow) showed that several hours per day outside peak landing hours were unavailable for daily scheduled arrivals. Dean Levine based his conclusions on an analysis of "constrained demand" or "adjusted demand", i.e. what airlines were told by the Scheduling Committee with respect to the availability of slots, rather than "unconstrained demand", i.e. the initial requests made to the Scheduling Committee, although even "adjusted demand" was, he said, an imperfect measure. Basing himself on his analysis of adjusted demand, Dean Levine concluded that in 1986, 1987 and 1988 the hours shown in the Table below were unavailable for scheduled arrivals.

TABLE 11.4.7

Hour commencing	1986	1987	1988
0600	X		X
1000	X	X	X
1100	X	X	X
1400			X
1600	X	X	X

11.4.8 Dean Levine then reviewed the material relating to the work of the Scheduling Committee and the interpretative difficulties connected with the use of that material. Just how great those difficulties are is evidenced by the fact that the 0600-0659 hour which Dean Levine would have treated as peak

in 1986 and 1988 was *not* included by PanAm/TWA in the 12 hour landing charge peak that they suggested in the very full commentary on the 1987/88 proposed charges that they put forward to BAA on February 10, 1987 (Appendix to JR Z-64). Conversely Dean Levine did *not* include in his hours that were unavailable for scheduled arrivals three of the seven hours between BAA's morning and late afternoon landing charge peaks that *were* included in the peak suggested by PanAm/TWA.

Mr. Turner's oral evidence

11.4.9 The only other evidence to which the Tribunal can usefully refer in this connection was that given by Mr. Turner, the former BAA Director of Planning in his oral testimony. Mr. Turner testified that, in defining peak periods, BAA had looked at the pre-existing pattern of usage at the airport and had also looked at unconstrained demand. In Mr. Turner's view one should always go to unconstrained demand in the first instance because, he said, it represented the preferred bids or the preferred way in which traffic would flow in the future. Mr. Turner then referred to the pattern of unconstrained demand in the week of August 13 - 19, 1983 (which might reasonably be expected to be a week of peak demand in the course of the year). The chart to which he referred showed the arrival movements *demanded* from the Scheduling Committee in that week. Mr. Turner concluded that the peak that was defined for the year 1985/86 was a very close match to the pattern of traffic that had been experienced in the summer of 1983. When peak periods were defined, he said, they were not solely based on what had actually happened in the previous year or so, but the process was to look ahead and see how the peak pattern would grow.

The Tribunal's conclusion

11.4.10 In the judgment of the Tribunal, HMG, in discharge of the obligations that it had accepted under Article 10(1) and (3) of Bermuda 2 ought to have reviewed the definition of BAA's charging peaks generally, including the landing charge peak, in the course of the Arbitration period. The Tribunal can find no evidence in the record before it that HMG did that. However, if HMG had done so, the Tribunal concludes that HMG could properly have found that BAA's definition of the landing charge peak fell within the margin of appreciation allowable to BAA.

(5) Differentiation of runway charges by reference to size of aircraft.

Charges prior to 1985/86

11.5.1 It will be recalled that in the five charging years 1980/81 - 1984/85, i.e. including the first two years of the Arbitration period, all landing charges were more or less substantially weight-differentiated (see Table 1.2 above). The weight-related differentials narrowed during the period, as the following Table shows.

TABLE 11.5.1
Landing charges : 1980/81 and 1984/85

	1980/81[1]			1984/85 The whole time[3]	
	Summer	Winter[2]	Weight differential B747 = 100		Weight differential B747 = 100
B747	£1105	£553	100	£362	100
A300	£ 387	£193	35	£181	50
B757	£ 215	£107	19	£138	38
B737	£ 77	£ 38	7	£ 94	26
SD330	£ 60	£ 30	5	£ 64	18

Source: Tables 1.15A-E above.

NOTES: (1) The short-haul rebate of 50% that was operative in 1980/81 has been ignored in the Table but could have operated so as effectively to widen the differentials shown.

(2) Since in 1980/81 (as in 1981/82 - 1983/84) winter landing charges were half summer landing charges, the weight-related differential was the same throughout the year.

(3) There was no seasonal or peak/off-peak landing charge differential in 1984/85.

11.5.2 It is unnecessary for the Tribunal to consider the weight-related landing charge differentials prior to 1985/86 since:

(a) 1980/81 - 1982/83 fall outside the Arbitration period;

(b) HMG did not fail to use its best efforts in respect of the structure of user charges at Heathrow for the charging years 1983/84 and 1984/85 (see paragraphs 9.6 - 9.99 of this Section, above);

(c) the differentials were not alleged to raise separate problems under Article 10(2) of the Treaty.

Charges for 1985/86 and thereafter

11.5.3 In late 1984 BAA proposed, for 1985/86, a common landing charge (of £195 before rebate for quiet aircraft/£156 after such rebate) for application to all fixed wing aircraft at all times throughout the year. There can be no doubt that when BAA made that proposal it believed, as it had done for several years previously, that sound economic principles required that

landing charges should be applied at a single flat rate for all aircraft and that they should be so applied throughout the year. The proposed charge represented an increase of 144% for aircraft up to 16 tonnes maximum authorized weight and an increase of 67% for aircraft in excess of 16 tonnes but not exceeding 50 tonnes in maximum authorized weight.

11.5.4 The proposal provoked vehement opposition by, and in the interests of, operators of small aircraft at Heathrow, i.e. mainly domestic airlines. There was a considerable political outcry about the proposed increases; and at a meeting at the Department of Transport on December 5, 1984, according to a BAA minute, the Minister for Aviation told the Chairman of BAA that:

> "He could understand that the BAA wished to optimise the use of Heathrow by concentrating on the larger operators, both for commercial reasons and because this helped them demonstrate they were meeting their international obligations. The Government, however, also had to consider the effect of this on small domestic operators whom the Government wished to encourage."

Later in the meeting, and more directly, the Minister stated that:

> "At this stage he just wished to register the Government's strong concern about the effects on small airlines. He hoped that an amicable solution could be achieved. The Government would want to avoid having to resort to the reserve powers available to it in the Air Navigation Order, which could give rise to many problems." (BAA Minute at Appendix A to JR Z-55.)

11.5.5 BAA, which was at the time still in public ownership, then reconsidered its proposal and amended it so as to introduce for the first time during the Arbitration period a landing charge peak (the differential that had operated in the years 1980/81 - 1983/84 had been a summer/winter, rather than a peak/off-peak, differential and had been abolished in 1984/85) and to apply, to small aircraft, outside the peak, the lower landing charges that had applied to them, throughout the year, in 1984/85, namely:

aircraft ≤ 16 tonnes : £80 (£64 after quiet aircraft rebate)

aircraft > 16 tonnes ≤ 50 tonnes : £117 (£93.60 after quiet aircraft rebate).

11.5.6 As appears from contemporary records, BAA took the following matters into consideration in reaching that decision:

(i) It had become very uncertain whether the annual limit on ATMs at Heathrow of 275,000 that had been proposed would be implemented; if it were not, although there would remain a capacity problem at peak hours, there would not, as BAA believed, be one outside those periods.

(ii) Given the uncertainty referred to in (i), BAA believed that what was required was an interim charging structure which would reflect the flat "opportunity cost" of runway use at peak hours and which could lead to pricing policies fully reflecting an ATM limit or equally (and this represented an entirely new line of thinking for BAA) towards

differential charging for runway use in peak hours, to encourage maximum total use of the physical capacity of the airport (including Terminal 4) in the absence of an ATM limit.

(iii) The newly devised structure would encourage operators of small aircraft to reschedule out of peak hours and thus to make room for large aircraft.

(iv) Adoption of such a charging structure at least as an interim measure would mitigate the severity of the effect of the move to a flat rate charge by more gradual change.

11.5.7 The "merits of this approach" to use the words of a contemporary BAA document, were seen by BAA to be, in summary, as follows: (1) it provided relief to the aggrieved domestic carriers; (2) it did not prejudice the position of long-haul carriers or the principle of the flat rate charge; and (3) it avoided any excessive loss of revenue by BAA.

11.5.8 There is no doubt that BAA believed that its abandonment, as regards off-peak periods, of its proposal to apply no differential in landing charge according to size of aircraft provided a solution to the politico-commercial problem that its proposal had caused that would not prejudice long-haul carriers such as the U.S.-designated airlines.

11.5.9 Nevertheless the Tribunal concludes that the introduction in 1985/86 of the off-peak landing charge discount for small aircraft was inconsistent with the principles enshrined in Article 10(1) and (3) of Bermuda 2 and should have been recognized as such by HMG.

11.5.10 The economic costs attaching to runway usage by small aircraft are as great as those attaching to runway usage by larger aircraft; indeed there was controversy between the Parties about whether they were not even greater and, if one takes as given that an airport such as Heathrow *must* accommodate large aircraft, then it is true that, for technical reasons, use of the runway also by small aircraft results in a reduction in maximum overall runway usage compared with use of the runway only by larger aircraft, though apparently, as size of aircraft continues to increase, a point is reached where maximum overall runway usage again declines.

11.5.11 There was no reason why, in the exercise of its discretion, BAA should not have introduced an off-peak differential in the 1985/86 landing charges for aircraft of all sizes if, by so doing, it could reduce the pressure of demand in peak periods and cause re-scheduling into off-peak periods when there was no capacity problem. However there was no reason, that was acceptable within the terms of Article 10(1) and (3) of Bermuda 2, to introduce an off-peak reduction for small but not for large aircraft.

11.5.12 Similarly the maintenance of *larger* off-peak differentials for small aircraft than for larger ones in *1987/88* (when an off-peak differential was first introduced, during the Arbitration period, for aircraft in excess of 50

tonnes maximum authorized weight) and in *1988/89* (when there were again different off-peak landing charge differentials according to size of aircraft) suffered from the same vice. Article 10(1) and (3) of Bermuda 2 obliged HMG to use its best efforts to correct the situation through the equalisation of the off-peak landing charge differential, if any, for fixed wing aircraft of all sizes. So far as appears from the record, HMG made no such effort.

11.5.13 After the introduction in 1985/86 of a common peak landing charge for large and small aircraft with an off-peak reduction for aircraft of up to 50 tonnes maximum authorized total weight, BAA noted that the purpose of the arrangement was not

> "explicitly to price small aircraft out of the peak, but only to allocate capacity to those users who value it most. (A small commuter aircraft with a high yield per seat might be more prepared to pay the fee than a larger aircraft operating low-cost charters). However, it appears inevitable that the effect overall will be to discourage high frequencies by small aircraft at peak hours. To the extent that this produces higher average loads it will increase the effective utilisation of terminal facilities. This would be consistent with the BAA's duty to manage its airports efficiently and economically."

11.5.14 This is entirely consistent with the understanding expressed by the Minister of Civil Aviation to the Chairman of BAA quoted at paragraph 11.5.2 of this Section, above, as to BAA's preference for use of the runways by large aircraft and demonstrates the unreliability of an argument advanced by HMG that, if higher runway charges for small aircraft in off-peak landing charge hours had caused small aircraft to be replaced by large aircraft, the increase in passenger numbers would have raised terminal congestion and brought forward higher passenger and parking charges.

11.5.15 HMG's attitude towards the maintenance of weight-differentiated off-peak landing charges in 1985/86 and its apparent acquiescence in the continuance of such differentiation during the remainder of the Arbitration period reflected HMG's general attitude to use of Heathrow by domestic traffic. Thus, in 1986 the CAA made proposals for changes in the air traffic distribution rules applicable to Heathrow, which would have displaced from Heathrow "thin" domestic services on relatively low-density domestic routes, so as to make for better utilization of scarce runway capacity there. However, by letter dated July 21, 1986, the U.K. Secretary of State for Transport wrote to the Chairman of the CAA stating, *inter alia*:

> "I have concluded that the capacity utilization advantages which might accrue at Heathrow would be outweighed by the wider, social and economic implications of displacement for the regions affected. I do not therefore intend to follow the CAA's advice in this respect."

11.5.16 The Tribunal is not concerned with the U.K.'s air traffic distribution rules; however, any wider, social and economic considerations that may justify those rules are, in the judgment of the Tribunal, irrelevant to the application of Article 10(1)-(3) of Bermuda 2 with regard to use of differential off-peak runway charges at Heathrow or at all.

Conclusion

11.5.17 Accordingly the Tribunal concludes that HMG failed to fulfil its obligations under Article 10(1) and (3) of Bermuda 2 when, in 1985/86, it effectively encouraged the introduction of off-peak landing charge differentials for, and for only, small aircraft, and when in 1987/88 and 1988/89 it acquiesced in the maintenance of larger off-peak landing charge differentials for small aircraft than for large.

(6) Peak Terminal charges

The importance of peak terminal charges

11.6.1 The structure of terminal charges presents as great difficulties as any of the specific issues relating to the structure of user charges. At least from 1985/86 onwards, terminal charges were far the most significant element in the user charges typically paid by a transatlantic operator. If Table 1.15A in this Section, above, is used for the purpose, one can calculate the make-up in percentage terms of the different elements of charge for the operator of a B747 with 265 passengers and a turnround time of 4 hours as follows.

TABLE 11.6.1

	Peak Period				**Off-peak period**			
	1985/ 86 %	**1986/ 87 %**	**1987/ 88 %**	**1988/ 89 %**	**1985/ 86 %**	**1986/ 87 %**	**1987/ 88 %**	**1988/ 89 %**
Runway	3.5	3.5	5.0	7.4	20.1	20.1	19.7	20.8
Passenger	75.6	75.9	70.8	74.7	42.6	43.3	44.0	45.7
Parking	21.0	20.6	24.2	17.9	37.3	36.6	36.3	33.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

11.6.2 The peak terminal charge was between about 8 and about 10.5 times the off-peak terminal charge during the Arbitration period and other calculations made by the Tribunal support the conclusion that over half the total user charges paid by the U.S.-designated airlines on U.S.-Heathrow traffic was accounted for by peak terminal charges. It seems almost certain that it was the establishment of the terminal charge at the level at which it was set and the definition of the international terminal peak period that were, between them, primarily responsible for the U.S.-designated airlines paying total user charges at a rate per passenger some 40% higher than the Heathrow airport average taking the Arbitration period as a whole.

USG's arguments

11.6.3 By its Second Memorandum USG contended that at no time during the Arbitration period had terminal congestion justified *any peak charges at all*. In its opening submission at the hearing USG had stated that it was its best guess that peak terminal charges were justified in *less than 70 to 80 hours a year* in the international terminals. Dean Levine, in his evidence on behalf of USG, implicitly criticized BAA for imposing peak terminal charges in *more than 100 hours a year*. Yet as late as February 25, 1988, USG had itself proposed *extension* of the international passenger peak from 1529 hours to 1959 hours (making 10½ hours in total) in 1988/89 and by a further 2 hours in the morning to a total of 12½ hours in 1989/90. USG had then said that it believed that such a charge would be "fully consistent with sound economic principles and the obligations assumed by HMG in Article 10 and the 1983 MoU" - though it was said by USG that this had to be seen as a mere bargaining move which, if accompanied by the reduction in the peak passenger charge it was seeking, would have accomplished USG's aim of reducing the sums paid to BAA by the U.S. airlines at Heathrow.

11.6.4 USG's case that no or no significant peak was justified for the purposes of charging for the use of terminals at Heathrow during the Arbitration period was essentially based on its claim that terminal capacity at Heathrow was at all times fully adequate to meet demand. If that was right, then, applying USG's SRMC-based approach, passenger charges should at no time have exceeded the extra cost incurred by BAA as a result of usage of the terminals.

HMG's arguments

11.6.5 HMG contested USG's case on this point on two grounds. First, it claimed that in relation to usage of terminals, LRMC (or Long Run Incremental Cost) rather than SRMC was the appropriate primary measure of economic cost. Secondly, HMG contended that USG had greatly understated demand by the airlines for terminal facilities at the period defined by BAA as peak hours. HMG particularly criticized USG's use of airport-wide terminal capacity which, according to HMG, was based on assumptions that were defective in theory and invalid in practice. The conclusion drawn by HMG was that the demand for use of terminals at the times classified by BAA as peak passenger hours fully justified the imposition of the LRMC-based passenger charge in fact imposed.

Definition of peak terminal hours for LRMC-based pricing

11.6.6 As USG rightly pointed out, under an LRMC-based approach, the definition of peaks would need to be made using a careful analysis of future demand designed to identify the times during which demand could be expected to necessitate investment in additional capacity. In the course of the Medium Term Review, BAA had recognized that such an approach was necessary and had carried out an elaborate probabilistic exercise. According to

those responsible within BAA at the time, the exercise showed that only the hours 0600-1159 for arrivals and 0900-1459 for departures had significant probabilities of experiencing passenger throughputs in excess of the declared pre-Terminal 4 capacity; the conclusion was that a practical definition of peak periods would not be straightforward to achieve; various permutations of hours and months of the year were then considered, in each case for arrivals and departures separately (JR Z-34, August 1983). According to HMG, if the results of the probabilistic analysis as such had been applied there would have been an impracticable fragmentation of the peak periods.

11.6.7 Mr. Wynne Jones, for HMG, in his evidence similarly sought to dismiss the results of the exercise carried out as part of the Medium Term Review on the ground that it would have produced an unduly complex definition of peak hours and that "peak/off-peak price differentials based on complex multiple peak periods (many of which would have been very narrow) would have been likely to cause peak-shifting (i.e. the peak would reappear in the time periods designated as off-peak)". However, examination of the original Review document discloses that, apart from the fact that separate landing and departure peaks were envisaged (a possibility discussed at paragraphs 11.10.1 *et seq.* of this Chapter, below), the various schema generally did not involve complex multiple or very narrow peaks, and certainly did not do so to a greater extent than the domestic terminal peaks that were in fact introduced by BAA for 1988/89, following on Cooper & Lybrand Associates' July 1987 Report (two 1½ hour peaks in the summer months and two 1½ hour peaks in the winter months). Thus, one of the three possibilities considered in the Medium Term Review document involved one arrivals peak and one departures peak, each of 5 hours, April - October; the second was similar save that in March - May and October the arrivals peak and the departures peak would each have been of 3 hours instead of 5. The third possibility also involved, at any one time, a single arrivals peak (2 hours in June - August; 1 hour in April, May and September) and a single departures peak (3 hours in July and August; 1 hour in May, June and September). The additional use, discussed in the Medium Term Review document, of "shoulder" charges would generally have added little (and in any event the possibility of shoulder charges has been raised on more than one occasion and always rejected).

11.6.8 In fact, so far as the Tribunal can judge from the record before it, although LRMC supposedly influenced the *level* of peak terminal *charges*, the *definition of the peak* was influenced entirely by rationing considerations of a kind used in SRMC-pricing. There is in this regard an apparent conflict between (a) the theoretical conclusion at which BAA's economists had arrived, that peak/off-peak differentials did very little to influence the pattern of traffic (and therefore had the primary purpose of allocating costs to those who were responsible for them rather than altering their behaviour) (JR Z-36) and (b) BAA's belief that airlines did respond to the peak/off-peak terminal charge

differential by re-scheduling out of the peak, thereby promoting the more efficient use of the airport's facilities (JR Z-6).

11.6.9 Thus, in February 1985 BAA told airlines that it had "decided to retain the current definition of the passenger peaks. This responds to the identifiable trend to re-schedule out of this peak, which promotes the more efficient use of the airport's facilities. The [earlier possible change proposed by BAA] for a seven hour peak appeared to threaten re-scheduling back into the narrower peak contrary to the objective of efficiency. However the BAA acknowledges that the basis for determining the peak period will change when Terminal 4 is commissioned. We will seek to notify users at an early date of any widening of the peak consequent upon the increased availability of capacity in the short term, in order that this can be taken into account in scheduling. The narrower peak implies a higher charge per passenger; this has been set to recoup the same revenue as under the seven hour peak proposals" (JR Z-6). Accordingly the existing 5 hour terminal peak was retained for 1985/86.

11.6.10 1986/87 was explicitly a year of minimum structural change and the definition was left unaltered.

11.6.11 In early 1987 BAA resolved to alter the definition of the terminal peak period for 1987/88 and notified the airlines of its decision in the following terms:

> "When users were notified of the absence of structural change in the 1986 charges, BAA undertook to review the situation at Heathrow when the effects of Terminal Four had been assessed.
>
> Two points stand out:
>
> (1) The additional capacity provided by T4 has reduced the pressure in peak periods at the airport overall. This suggests that a reduction in the level of peak passenger charges may be justified in the short term, although differentials may need to widen again as the airport reaches the four terminal capacity. Any reductions in peak charges should however be limited by the fact that there is still unsatisfied peak hour demand. In any event, the principle needs to be maintained, in order to give a clear signal as to the long-term costs of adding further tranches of capacity to meet peak demand.
>
> (2) The current five hour peak of 1000 to 1459 hrs GMT no longer matches the pattern of traffic. Graph 1 shows the August 1986 departing passenger flows by scheduled time. This suggests a peak of 6½ hours from 0900 to 1529 hrs.
>
> A wider peak would allow a lower peak charge, and a 4% overall increase in passenger charges could be combined with a reduction in the international peak charge from £13.50 to £10.60, if the off-peak charge rises with inflation from £1.30 to £1.35.
>
> Peak period definitions will be kept under review during 1987 and it is intended to give consideration to the possibility of introducing shoulder charges in future years."

"Graph 1" is reproduced in the form of two redrawn Charts below.

CHART 11.6.11A

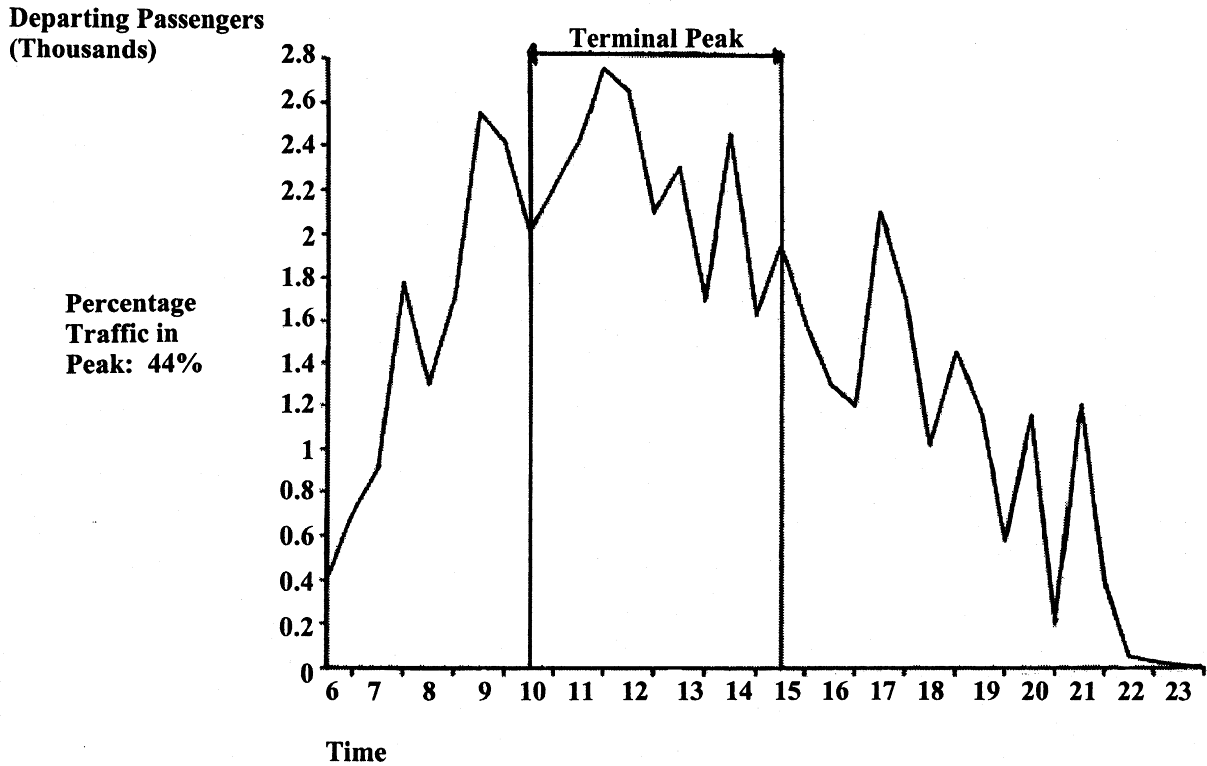
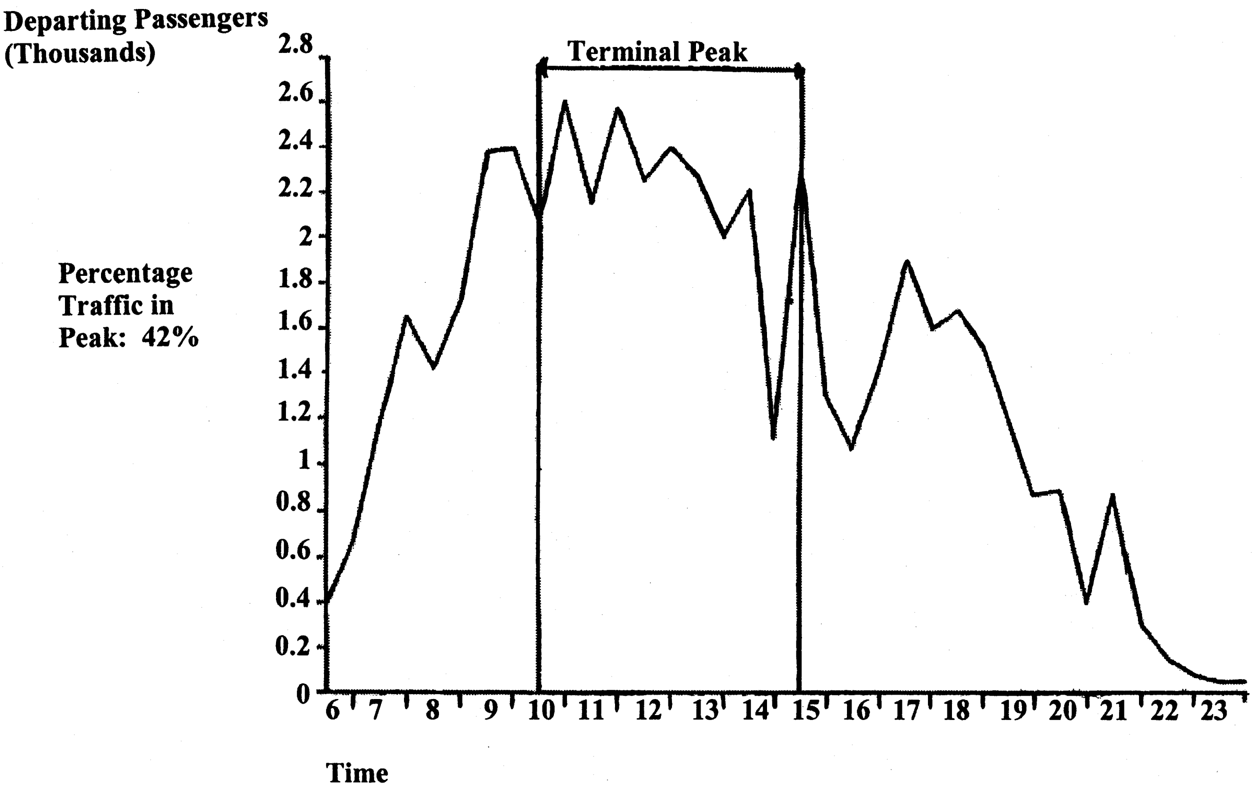


CHART 11.6.11B

Heathrow Half Hourly Flow Departing Passengers
Airport Average for August 1986 (Scheduled)



11.6.12 Finally for 1988/89 separate domestic terminal peaks were introduced. They are discussed at paragraphs 11.7.43 *et seq*. of this Section, below. The definition of the international terminal peak was left unaltered.

The Tribunal's conclusions

11.6.13 In the judgment of the Tribunal, BAA's decision to *adopt* a system of economic pricing of a conceptually sophisticated character carried with it the inevitable corollary that the system should have been *implemented* with equal sophistication. That was understood by those who did the work underlying the Medium Term Review but does not appear to have been properly appreciated by those who have subsequently been concerned, who, when they have looked at the definition of the peak, have done so impressionistically and largely, if not entirely, on the basis of recent patterns of traffic.

11.6.14 When Coopers & Lybrand Associates were commissioned by BAA in 1987 to study *inter alia* passenger peak periods, their remit was to consider whether there should be separate international and domestic terminal peaks and if so what the effects of differentiation would be; i.e. they were not engaged to examine the definition of the international terminal peak. Hence in their Report of July 1987 C&LA commented, with reference to the "precise definitions of the peak periods", that they were "a matter for Heathrow Airport Limited", i.e. BAA, and "would require a more detailed review of traffic patterns". However, when Mr. Wynne Jones of Coopers & Lybrand Deloitte formulated his evidence to the Tribunal on this issue, it was confined to producing charts showing the pattern of international and domestic terminal traffic in 1988.

11.6.15 Mr. Wynne Jones's charts raised as many questions as they answered. They showed *inter alia* the average number of international passengers per half hour, month by month, in the calendar year 1988 (which had a 6½ hour terminal peak in April - October). Of the 91 entries within the charging peak, 26% had an average passenger flow per half hour of less than 1600, and 56% had an average passenger flow per half hour of less than 2000. Of the remainder, 32% had an average flow of 2000-2400, 10% had an average flow of 2400-2800 and 2% had an average flow of 2800+.

11.6.16 If, using LRMC-based pricing methodology, the peak period had been defined by reference to the previous passenger flows that had necessitated the construction of Terminal 4 or the predicted future passenger flows which were expected to necessitate investment in additional terminal capacity, such figures would not necessary cast doubt on the definition of the peak period, especially since Terminal 4 had come into use only 2 years earlier and could be expected to have provided some growing-room within the terminals. However, there is nothing in the record to indicate that the peak terminal period was defined by reference to previous or predicted future passenger flows. Moreover any predictions would surely have had to take into account the fact that the increase in passenger numbers differed greatly by

class of traffic: the U.S.-designated airlines (flights to and from the U.S.) and other international traffic, excluding traffic to and from other European airports, must have accounted for much of the passenger flow through Terminal 3 in 1988; in 1988/89 the number of such passengers had increased by 21.3% since 1983/84; by contrast, over the same period the number of international passengers travelling to and from other European airports (i.e. on short-haul flights) had increased by 48.9% and the number of domestic passengers had increased by 54.6%.

11.6.17 In these circumstances it seems to the Tribunal that deeper analysis was and is required to establish the reasonableness of the definition of the terminal peak for use with LRMC-pricing than is possible merely by looking at Mr. Wynne Jones's chart or at charts such as those to be found at Charts 11.6.11A and B above; in particular, in the judgment of the Tribunal, one cannot conclude, as Mr. Wynne Jones did, from the impression that one forms from the general appearance of the Chart that he produced, that "The peak periods *appear reasonable overall*, given the distribution of traffic, although a case might be made for altering the international peak to cover both summer and winter peak periods" (emphasis added).

11.6.18 Moreover, even taking Mr. Wynne Jones's chart on its own terms and assuming that it establishes a sufficient degree of congestion in the international terminals to justify a significant international terminal peak, anomalies are apparent. For example, international passenger traffic between 1230 and 1529 in April and May and, to a lesser extent, June (all peak terminal hours) was much lighter that international passenger traffic between 1000 and 1259 in November and December and, to a lesser extent, March (all off-peak terminal hours); and the half hour before the commencement of the peak was invariably as congested as, or more congested than, the last hour of the peak.

11.6.19 The economic consequences of the delineation of the boundary between peak and off-peak terminal hours were potentially great. For example, the extension of the peak terminal period from 5 to 6½ hours in 1987/88 may have substantially affected the relative proportions of passengers departing from Heathrow for the U.S. in peak hours on PanAm/TWA flights, on the one hand, and on British Airways flights, on the other hand: see paragraphs 11.2.33 - 11.2.35 of this Chapter, above. The precise delineation of the peak terminal period therefore required profound consideration. It does not seem to have received it from BAA since the Medium Term Review, the conclusions from which were not in this respect implemented by BAA in practice.

11.6.20 The Tribunal has already recorded its conclusion, at paragraphs 11.1.33 and 11.1.34 of this Section, above, that the failure by HMG properly to investigate the relationship of actual charges and economic costs constituted a breach of Article 10(1) and (3) of Bermuda 2.

11.6.21 In the judgment of the Tribunal, the same is true of the definition of the peak terminal periods. Given the nature of the present arbitral

proceedings, the limited powers of the Tribunal and its constitution, the Tribunal is not in a position to conclude definitely that the terminal peak periods should have been differently defined. Nevertheless:

- the importance of the correct delineation of the boundaries between the peak and off-peak terminal periods,
- the complexity of defining them in a way that permitted their valid use in conjunction with LRMC-pricing and
- the difficulty of interpreting the data

lead the Tribunal to conclude that HMG's best efforts obligations required a much more vigorous questioning of BAA's general assertions and specific conclusions in respect of terminal charges than actually took place, and HMG's failure to undertake such questioning constituted a breach of Article 10(1) and (3) of Bermuda 2.

(7) The composition of terminal charges

11.7.1 Three specific controversies that attach to the composition of the terminal charges at Heathrow now need to be considered:

(a) whether the off-peak terminal charge was inadequate in the sense of failing to cover the net cost attributable to keeping terminals open in off-peak hours;

(b) whether the relationship between international and domestic terminal charges was unduly favorable to domestic traffic; and

(c) whether the use, until 1988/89, of common peak terminal periods for the international and domestic terminals fell with the margin of appreciation enjoyed by BAA.

The size of the off-peak terminal charge

11.7.2 The position with regard to the size of the off-peak terminal charge is complicated by the history of the evolution of the charge. In 1980/81, 1981/82 and 1982/83 there was no off-peak terminal charge at all. But during those years there was in operation, distinct from terminal charges, a National Security Levy which was payable in respect of passengers arriving on aircraft in excess of 10 tonnes maximum authorized weight (whereas in the same years, terminal charges, payable in peak hours, were payable in respect of passengers departing on aircraft in excess of 16 tonnes weight). In 1983/84 the National Security Levy was abolished and BAA introduced an off-peak terminal charge, payable in the ordinary way in respect of departing passengers; like the peak terminal charge in that year, the off-peak charge was payable in respect of passengers departing on aircraft in excess of 16 tonnes in weight. There can be no doubt that the off-peak charge was a replacement for the National Security Levy; and, subject to the fact that in 1983/84 it was not payable on passengers on aircraft of 10-16 tonnes maximum authorized

weight, the off-peak charge was intended to cover security costs that would previously have been paid out of the National Security Fund. In 1984/85, as part of a move, of the kind that the U.S.-designated airlines were urging, to make small aircraft bear a greater share of the burden of charges at Heathrow, the application of the *off-peak* passenger charge was extended to cover passengers departing on aircraft in excess of 5 tonnes; however, in order to smooth the increase for small aircraft, the peak charge remained payable for a further year only in respect of passengers departing on aircraft in excess of 16 tonnes. Finally in 1985/86 both peak and off-peak terminal charges alike became payable in respect of passengers departing on aircraft in excess of 5 tonnes.

11.7.3 It is clear that, at least in the early years after the introduction of the off-peak terminal charge, it was calculated, and justified, by reference to security costs, although up to 40% of the security costs appear to have arisen outside the terminals.

11.7.4 In the last set of marginal cost calculations performed by BAA in the Arbitration period, namely those performed in 1984, BAA calculated that, on an economic cost-based charging approach, in which commercial income was used to off-set traffic costs and to do so differentially as between international passengers and domestic passengers, a *negative* off-peak terminal charge of £2.85 would have been payable in respect of international passengers and a *negative* off-peak terminal charge of £0.10 would have been payable in respect of domestic passengers. If implemented, such "charges" would have implied that there would have been deducted from the total bill presented to an operator engaged in international traffic, embarking passengers in terminal off-peak hours, £2.85 per passenger - typically for a B747 with 265 passengers, a total deduction of £752; similarly there would have been deducted from the total bill presented to an operator engaged in domestic traffic, embarking passengers in terminal off-peak hours, £0.10 per passenger - typically for a B757 with 120 passengers, a total deduction of £12. An international airline that operated at Heathrow at off-peak times could actually have been paid by BAA to do so if this approach had been adopted.

11.7.5 However BAA never introduced any such system of credits for off- peak terminal users. Instead, as already noted, when the National Security Levy was abolished with effect from 1983/84, the security cost was recovered (as the National Security Levy had been) on a per passenger basis and at the same level for international and domestic traffic. BAA incorporated the resulting charge in the peak terminal charge in peak terminal hours and introduced it as an off-peak terminal charge outside those hours. Thereafter, the off-peak charge was broadly increased in line with, but more slowly than, inflation: the charge of £1.21 per passenger in 1983/84 had risen to £1.45 in 1988/89, an increase of 20% compared with inflation of about 27% over the same period.

11.7.6 In the result USG claimed that the off-peak terminal charge was just the old security charge by another name and that, since security costs were not the only costs incurred by BAA as a result of keeping a terminal open during an off-peak hour, the off-peak charge *could* not cover the relevant marginal cost (and for this purpose, it makes no difference whether one uses LRMC or SRMC). Indeed, USG submitted that there was *no* true off-peak charge for the use of the terminal facilities (as distinct from a charge for the provision of airport security services); in consequence, according to USG, there was an infringement of the fourth of the principles which it had put forward in 1983 when the intergovernmental MoU was negotiated (no peak charge should be assessed with respect to any service or facility unless a charge was also assessed for such service or facility during off-peak hours) and which, under Article 5 of the MoU, HMG had undertaken to commend to BAA.

11.7.7 In the judgment of the Tribunal, leaving aside the changes in the size of aircraft, passengers on which were subjected to the charge, the replacement of the National Security Levy by a BAA terminal charge (or an element in the BAA terminal charge) in itself did nothing to change the position in economic terms from what it had been when no off-peak terminal charge had been imposed. Both Parties accepted that passenger throughput-related direct costs incurred within the terminal ought to be recovered in terminal charges. That being so, the only ways in which the off-peak passenger charges in fact imposed by BAA during the Arbitration period could be justified would be by showing that, after taking properly into account commercial income:

(a) there was no need to levy any off-peak terminal charge as such (or to pay any off-peak terminal rebate) for domestic or international passengers, so that what was recovered by way of off-peak terminal charge, and the equivalent element in the peak terminal charge, continued to be available to pay airport security costs; or alternatively

(b) the off-peak charge that was in fact levied bore a reasonable relationship to the corresponding economic costs (within-terminal security costs of a direct nature and other within-terminal passenger throughput-related direct costs), leaving the balance of airport security costs to be recovered through other charges.

11.7.8 Because of the absence of *any* satisfactorily demonstrated, consistent relationships between peak and off-peak terminal charges, on the one hand, and the corresponding economic costs on the other hand (see paragraphs 11.1.1 *et seq*. of this Section, above), one cannot be satisfied that either (a) or (b) was so. Indeed it would be a surprising coincidence if either were. This should have been apparent to HMG if it had properly investigated the relationship of BAA's user charges to the corresponding economic costs and is therefore a further instance of HMG's general failure to investigate the

relationship between the two and of its resultant breach of Article 10(1) and (3) of the Treaty.

The relationship between domestic and international terminal charges

11.7.9 It will be recalled that at all times during the Arbitration period the off-peak terminal charge was the same for international and domestic passengers. The peak terminal charge for international passengers was at all times over twice the peak terminal charge for domestic passengers, the difference varying between £5.50 (108% of the domestic peak terminal charge) at its lowest (in 1987/88) to £7.70 (140% of the domestic peak terminal charge) at its highest (in 1986/87). The *average* terminal charges per passenger paid in respect of domestic passengers and in respect of international passengers are set out in Table 11.7.14 in this Chapter, below. As appears from that Table the average difference for the Arbitration period as a whole was £2.28 per passenger (arriving as well as departing), implying that, taking the Arbitration period as a whole, the average terminal charge paid per *departing* international passenger was on average *about* £4.56 higher than the average terminal charge paid per *departing* domestic passenger.

11.7.10 By a Diplomatic Note of February 25, 1988, USG stated "We recognize that international passengers may impose a greater cost burden on the airport. However, we believe that the Heathrow charging structure overstates this disparity and fails to take into account adequately the greater commercial revenues generated by international passengers that offset those costs."

11.7.11 The evidence confirmed the correctness of USG's recognition that domestic passengers imposed lower costs on Heathrow than did international passengers. HMG drew attention to the fact that, for example, because no doubt of the absence of need for passport control and Customs facilities for domestic traffic, Terminal l's domestic traffic facilities occupied approximately 10% of the Central Terminal Area building space at Heathrow, yet catered for roughly the same number of passengers annually as Terminal 3, which occupied approximately 50% of the CTA building space.

11.7.12 HMG also submitted that throughout the period covered by the Arbitration, charges to domestic airlines had risen while those to international airlines, and particularly long-haul airlines including the U.S.-designated airlines, had fallen. This was undoubtedly true of *total* user charges per passenger (arriving as well as departing), as the following Table shows.

TABLE 11.7.12

Average total user charges per passenger:
U.S. airlines, domestic flights and airport average (unadjusted for inflation)

	1983/ 84	**1984/ 85**	**1985/ 86**	**1986/ 87**	**1987/ 88**	**1988/ 89**	**Average**
PanAm/TWA to/from U.S.	£5.32	£4.75	£4.84	£4.84	£4.88	£4.92	£4.92
Domestic flights	£1.82	£2.00	£2.23	£2.24	£2.30	£2.53	£2.22
Airport average	£3.69	£3.45	£3.44	£3.39	£3.46	£3.51	£3.49

11.7.13 Thus, at the beginning of the period PanAm/TWA were paying £3.50 or 192% more in *total* user charges per passenger than were domestic operators, whereas by the end of the period the differential had fallen to £2.39, so that the total user charge per international passenger was down to 94% above the total user charge per domestic passenger: putting the matter another way, total user charges per international passenger *fell* by 7.5% over the period whereas total user charges per domestic passenger *rose* by 39%.

11.7.14 If one confines one's attention to average *terminal* charges per passenger (and HMG made the point in relation to terminal charges) a similar, but much less marked, trend is to be found.

TABLE 11.7.12

Average total user charges per passenger:
U.S. airlines, domestic flights and airport average (unadjusted for inflation)

	1983/ 84	**1984/ 85**	**1985/ 86**	**1986/ 87**	**1987/ 88**	**1988/ 89**	**Average**
PanAm/TWA to/from U.S.	£3.19	£3.02	£3.32	£3.20	£3.45	£3.61	£3.31
Domestic flights	£0.87	£0.95	£0.99	£1.04	£1.10	£1.15	£1.03
Airport average	£2.05	£2.03	£2.06	£2.01	£2.12	£2.13	£2.07

11.7.15 Thus, at the beginning of the period PanAm/TWA were paying £2.32 or 267% more in terminal charges per passenger than were domestic operators, whereas by the end of the period the differential, although it had enlarged to £2.46 in money terms, had reduced to 214%: the average terminal charge per domestic passenger had risen by 32% over the period whereas the average terminal charge per passenger payable by PanAm/TWA had risen by only 13% (all figures unadjusted for inflation).

11.7.16 The calculations of marginal costs made by BAA in 1984 indicated the following terminal LRMCs per (departing) passenger, *disregarding commercial income*:

	Peak	Off-peak
	£	£
International	18.53	2.31
Domestic	9.88	1.58
Difference	8.65	0.73

11.7.17 Given the probably different mix of peak/off-peak terminal usage by international and domestic traffic (with the then common peak period for both), the Tribunal has no reason to believe that those figures are not at least broadly consistent with the statement contained in a November 1983 BAA Board paper that there was a cost justification for differential terminal charges for domestic and international traffic of the order of £5 per passenger (i.e. departing passenger).

11.7.18 In fact the differences in average terminal charges realized per passenger (arriving and departing) in 1983/84 and 1984/85 were as follows:

	1983/84	1984/85
	£	£
International	2.29	2.26
Domestic	0.87	0.95
Difference	1.42	1.31

11.7.19 The above figures are derived by dividing total revenue from terminal charges by the total number of terminal passengers, i.e. *arriving as well as departing*, whereas terminal charges were payable only in respect of *departing* passengers. *If* the numbers of arriving and departing passengers were about the same, both at the international and the domestic terminals, then the figures given in paragraph 11.7.18 above imply that the average terminal charge per departing international passenger exceeded the average terminal charge per departing domestic passenger by about twice the figures for "Difference" shown in that paragraph, i.e. by £2.84 in 1983/84 and £2.62 in 1984/85. Therefore, if HMG had relied on BAA's cost calculations and if

inquiries had verified that the numbers of arriving and departing passengers were about the same, HMG would have concluded that, leaving commercial income out of account, the average differential in domestic/international terminal charges was more than justified (to the extent of some £2.00-£2.50) by the differences in the economic costs, information about which was available to HMG.

11.7.20 However, BAA's 1984 calculations also indicated that departing international passengers generated on average some £3.48 more commercial income than departing domestic passengers. The whole question is whether on that account HMG was obliged, by reason of its best efforts obligation, directly to intervene to reduce the peak international/domestic terminal charge differential and presumably, as a natural corollary, to introduce an off-peak international/domestic terminal charge differential in favor of international traffic.

11.7.21 However, before answering that question, there is an antecedent question, namely how *did* BAA in fact use the commercial income earned at Heathrow during the Arbitration period. Here there is an apparent conflict between what BAA has said, in general terms, about how it used commercial income and HMG's apparent understanding about its use.

11.7.22 Thus, in March 1988 BAA prepared a Response to a document entitled "Comments of TWA and PanAm on airport charges proposed for 1988/89" dated January 26, 1988 (see JR Y-36). One of the complaints made by TWA and PanAm was that:

> "[The] domestic peak passenger charge is the base charge of £1.45 plus a surcharge of £4.05, whereas the international surcharge is over two times greater or £9.60.
>
> "There is no cost justification for this difference. (The only data which has been provided offsets domestic costs per passenger with average net commercial revenues. The latter are largely generated by international passengers.)"

11.7.23 BAA's comment on the second of those paragraphs was as follows:-

> "This is incorrect. Users have been referred repeatedly to Appendix 6 of BAA 1 which distinguishes explicitly between the commercial revenues attributable to domestic and international passengers."

11.7.24 As there stated by BAA, Appendix 6 to "BAA 1" (JR Y-32), which was dated August 1983, did distinguish explicitly between the commercial revenues attributable to domestic and international passengers (see also paragraph 11.1.27 of this Chapter, above) as also did Appendix 6 to BAA's "Traffic Charges Policy for the South East Airports : The Medium Term Strategy" of about November 1984, to which fuller reference is made at paragraph 5.1 of this Chapter, above.

11.7.25 The only meaning that the Tribunal can give to BAA's comment quoted at paragraph 11.7.23 of this Chapter, above, is that, in some way and at least to some extent, BAA took into account the difference in "the commercial

revenues attributable to domestic and international passengers" when it established user charges at Heathrow. Otherwise it would have been wholly irrelevant, not to say disingenuous, for BAA to have referred users to the explicit distinction which BAA had drawn between the commercial revenues attributable to domestic and international passengers and to have relied on that fact in the context here under consideration.

11.7.26 Under cover of a letter dated March 21, 1988, Mr. David Moss, then the Under-Secretary who headed the International Aviation Directorate of the U.K. Department of Transport, sent to Mr. Shane, then Deputy Assistant Secretary for Transportation Affairs at the U.S. Department of State, a number of documents, including the January 26, 1988, Comments of TWA and PanAm and BAA's paragraph-by-paragraph Response to those comments. Mr. Moss stated in his letter, *inter alia*:

> "I assure you that we have reviewed the charges very carefully indeed in the light of the inter-governmental consultations during January and the subsequent exchanges. As a result of that review I can confirm that we are satisfied that the charges are based on sound economic principles in terms of charging on the basis of economic costs and are fully consistent with the principles set out in Article 10 of Bermuda 2."

11.7.27 In its first Memorandum to the Tribunal in reply to USG's first Memorandum, HMG stated that commercial income was *not* allocated between individual categories of users. It did so in the following terms:

> "8.127 Before signing of [the Airlines] Settlement Agreement, it had been BAA's policy to retain its commercial income to meet the financial needs of the business. As already indicated, commercial income had been used to finance investment in addition to capacity (such as the construction of additional parking areas and piers at Heathrow and the development of Gatwick). By so doing, BAA avoided incurring debt and building up interest payments to be recovered from later charges. To the extent that commercial income exceeded investment needs, it was used to offset losses made on the provision of services to airlines. *It was not, however, allocated between individual categories of user, but instead was used to reduce the level of charges generally.* The MoU noted BAA's intention to continue to treat commercial income on the same basis as hitherto, and did not record any airlines' objection to this" (emphasis added).

At the same time, however, HMG's pleadings relied on comparisons of user charges and costs in which the costs were differentially reduced by commercial income for international passengers, on the one hand, and domestic passengers, on the other: see paragraph 11.1.27 and the footnote to paragraph 11.1.28 of this Chapter, above.

11.7.28 The BAA witness responsible for giving evidence in respect of BAA's position up to August 1985 stated that to the best of his knowledge, information and belief Parts 4, 8 and 9 of HMG's Memoranda (and therefore *inter alia* paragraph 8.127 cited at paragraph 11.7.27 of this Chapter, above) were true. Similarly the other BAA witness, who was responsible for giving evidence in respect of BAA's position thereafter, stated that to the best of his knowledge the information in HMG's Memoranda was true.

11.7.29 The evidence given to the Tribunal by the BAA witnesses did not advance the matter. Mr. Turner confined his evidence about commercial income to saying that BAA's Statement of Principles (paragraph 5.2 above) indicated:

> "That commercial income would continue to be used to abate traffic charges."

11.7.30 The only reference to commercial income contained in the evidence of the other BAA witness, Mr. Everitt, was that:

> "15. BAA's charging policies over the last three years of the period under consideration were therefore intended to provide sufficient revenue to cover the costs of operating airport facilities, taking account of commercial income, and to provide for a reasonable rate of return on assets, at a level to remunerate the capital employed in new investments. In 1986/7 the required rate of return on investment was reflected in the financial target set by HMG."

11.7.31 Neither of the BAA witnesses was cross-examined about the use made by BAA of commercial revenues or about the apparent inconsistency between the statement made by BAA in March 1988, cited at paragraph 11.7.23 of this Chapter, above, which had been communicated by HMG to USG, and HMG's written pleadings, cited at paragraph 11.7.27 of this Chapter, above, which the BAA witnesses verified.

11.7.32 The Tribunal has been unable to find in the voluminous documentary material placed before it any request by HMG to BAA to explain to HMG the use which, after the conclusion of the Medium Term Review and the presentation to the Board of BAA of the "Medium Term Strategy" document referred to at paragraph 11.7.24 of this Chapter, above, BAA was making of commercial revenues; similarly the Tribunal has been unable to find any explanation, whether provided to HMG or at all, of what that use was.

11.7.33 As the Tribunal has already found (see paragraph 4.2(ii)-(iv) of this Chapter, above), it is impracticable to allocate, in an economically meaningful way, terminal *costs* as between traffic and commercial activities and it is therefore impossible to identify the *difference* in *traffic costs*, viewed in isolation, as between domestic and international passengers.

11.7.34 Thus, any economically rational decision by an airport operator about the level of user charges required to justify expansion of terminal facilities would need to take into account not only the resulting incremental annual cost but also the resulting incremental annual revenue; and for this purpose the airport operator should not, could not, and in the case of BAA would not (see paragraph 4.2(v) of this Chapter, above), distinguish between incremental costs attributable to traffic activities and incremental costs attributed to commercial activities. The higher the incremental commercial revenue, then, *other things being equal*, to the same extent the lower the terminal user charges required to justify the investment in the expanded facilities and *vice versa*.

11.7.35 This does not mean that BAA was obliged to adopt a crude assumption of other things being equal. It in fact properly recognized the need

to take into account direct differences in relevant terminal costs. It was also entitled to take into account the extent to which domestic traffic was believed to contribute more to the airport than merely the user charges and commercial income directly attributed to it. This would not have been confined to consideration of the fact that some incoming domestic passengers transferred to international flights and as such generated additional *commercial* income (which was the case to which HMG referred: see paragraph 11.1.5 of this Chapter, above).

11.7.36 Given that a proportion of domestic passengers transferred to or from international flights, then *to the extent that raising domestic terminal charges would have had the indirect result that such passengers would have been lost to the airport*, BAA would have lost not only the additional commercial income that the lost arriving domestic passengers would have generated as departing international passengers; BAA would also have lost the international terminal user charges that all the lost domestic passengers, arriving or departing, would have generated. In accordance with sound economic principles BAA would be entitled to take into account whether such loss would not have been compensated for, fully or at all, by any increase in international traffic resulting from any release of runway capacity that would otherwise have been required for domestic traffic.

11.7.37 Such considerations could properly be taken into account in setting the differential between international and domestic terminal charges; and no doubt, even with the benefit of market research, BAA would have been left with a significant margin of appreciation.

11.7.38 However, in the judgment of the Tribunal, it would not have been in conformity with the principles enunciated in Article 10(1) and (3) of Bermuda 2 for BAA to have differentiated (as it did) international and domestic terminal charges by reference to differences in costs attributable to the international or domestic nature of the traffic, without also having taken into account in an economically defensible way differences in revenue that were equally directly attributable to the international or domestic nature of the traffic.

11.7.39 The Tribunal has recorded at paragraphs 4.22 and 5.3 of this Chapter, above, its state of ignorance about the use in practice by BAA of commercial revenues. It has also there recorded the fact that, so far as the Tribunal can ascertain, HMG never sought to discover how BAA had used those revenues; nor has the Tribunal been able to ascertain what, if any, explanation BAA gave to HMG as to how it had done so or its reasons for having made the allocations that it had. In the judgment of the Tribunal, this is another of the matters the failure by HMG to investigate which gave rise to a breach of Article 10(1) and (3) of the Treaty.

11.7.40 The Tribunal has had the greatest difficulty with the question whether it should have been evident to HMG that the international/domestic terminal charge differential was in fact too large, in the sense of falling

outside the area of discretion allowable to BAA, to the detriment of international carriers. The Tribunal has concluded that, on the state of the evidence and the argument before the Tribunal, it is impossible to say with any confidence whether that was so or not. Accordingly, the Tribunal here confines its finding of breach to the failure by HMG properly to investigate a matter which, in the judgment of the Tribunal, required to be investigated.

11.7.41 Before leaving this issue, the Tribunal notes that HMG also adduced a substantial volume of evidence, which USG did not seek to controvert, to the effect that operators of other major airports worldwide charged airlines much less in respect of domestic passengers. However the Tribunal did not find that evidence in itself to be useful since the foundations for the structure of charges at other airports were evidently wholly different from the foundations relied on by BAA and the resulting structures were themselves evidently very different. In the judgment of the Tribunal, HMG cannot pick and choose as between the elements of the charging structure at other airports that it rejects as unsound and the elements of the charging structure at other airports that are reflected in BAA's charging structure and that HMG therefore approbates.

The use of a common peak period for terminal charges until 1988/89

11.7.42 Using the methodology used by BAA internally for its own purposes and charts based on that methodology that were placed by the BAA witnesses before the Tribunal, it appears that the pattern of domestic terminal usage at Terminal 1 was *at least* as "peaky" as the pattern of international terminal usage at Terminal 3 and "peakier" than at the other international terminals. That fact ought to have been readily discoverable by HMG.

11.7.43 The documentation before the Tribunal clearly establishes, and it should have been evident to HMG, that, up to and including 1987/88, a different pattern of international and domestic terminal usage resulted in a *much* lower proportion of domestic traffic than of international traffic incurring peak terminal charges during the common peak period and that the difference was even greater if one compared domestic terminal traffic with the particularly "peaky" North American terminal traffic.

11.7.44 During the Arbitration period the numbers of domestic passengers passing through the domestic terminal at Heathrow grew even faster than the number of passengers passing through the airport as a whole (as to which, see Table 11.3.11 in this Chapter, above). The figures for domestic passengers are as follows:

TABLE 11.7.34

	Number of passengers	
	‘000s	**1983 = 100**
1983/84	4,503.7	100
1984/85	5,195.7	115
1985/86	5,490.9	122
1986/87	5,675.5	126
1987/88	6,400.1	142
1988/89	6,961.5	155

Source: BAA statistics provided by HMG in the course of the hearing.

11.7.45 In those circumstances the Tribunal must assume that BAA envisaged the eventual expansion of terminal capacity for use by domestic passengers at Heathrow, albeit not within the Arbitration period. Indeed, the use by BAA of LRMC, and not purely of SRMC, as a basis for charging for the use of the domestic terminal facilities presupposes that BAA envisaged such an expansion. Since the international and domestic terminal facilities were substantially different and were not satisfactorily substitutable for each other, this would have implied expansion of specifically domestic terminal capacity.

11.7.46 In light for the foregoing, and of the espousal by BAA and HMG of LRMC as an important element in the basis for pricing, the need for separate international and domestic terminal peak periods, each with its own appropriately computed economic costs, should have been obvious; HMG ought to have identified that need and used its best efforts to ensure that separate international and domestic terminal peaks were introduced well before their actual introduction in 1988/89. HMG’s failure in this respect in itself constituted a breach of Article 10(1) and (3) of Bermuda 2 if it had the result of prejudicing the U.S.-designated airlines; whether or not it in fact did so would have been ascertained if the required investigation of nexus between charges and economic costs had been carried out.

11.7.47 When separate domestic peaks were introduced in 1988/89, although they were for only 3 hours a day, they operated throughout the year, whereas the 6½ hour international peak operated only in April-October. Following on the redefinition of the domestic peak the average terminal charge per domestic passenger was 4½% higher in 1988/89 than in 1987/88; by contrast, the average terminal charge per international passenger was only 0.25% higher in 1988/89 than in 1987/88. There is therefore certainly nothing to suggest that the redefinition was a subterfuge to reduce domestic terminal charges as USG appears at one point to have suspected. Nor, in the judgment

of the Tribunal, was there anything in the redefinition as such to have directly required HMG to intervene, as opposed to undertaking the required investigation.

(8) Parking charges, generally and after 1986 in particular

11.8.1 Parking charges have for long been a bone of contention between, amongst others, the U.S.-designated airlines and BAA. Paragraph (3) of the Arrangements as to the Future contained in the Airlines Settlement Agreement of February 22, 1983, records that the airlines were happy to accept that subject to the performance by BAA of its statutory duties, it was its intention *inter alia*:

> "to develop its parking charges so as more closely to reflect the relative costs by aircraft type and/or category of type of supplying parking facilities and parking services. The BAA intends to consider introducing a differential between pier and remote stands designed to reflect the costs to airlines of coaching operations."

11.8.2 However, according to USG's First Memorandum, the peak parking charge during 1983-1989 remained unsound and unjustified because there was no actual or foreseeable shortage of stands. Indeed, according to USG's Second Memorandum, the peak parking charge at Heathrow (until 1988/89, 4 times the off-peak charge for 5 hours in the day; in 1988/89 3 times the off-peak charge for 5½ hours in the day; in both cases in the seven months April-October) was "perhaps the most blatant example of the complete economic irrationality of BAA's charging structure".

11.8.3 The Tribunal has already commented on the lack of any consistent or satisfying relationship between the last (1984) marginal cost calculations by BAA in respect of use of parking stands and the 1985/86 charges in respect of their use.

11.8.4 There is no doubt that as a result of changes in the structure of parking charges during the Arbitration period, large aircraft, such as those operated by the U.S. carriers, ended up paying relatively less. The effect is quantified in the Table below which relates to aircraft and turnround times of kinds evidently regarded as typical: see Tables 1.15A-1.15E of this Chapter, above. The fact that in 1988/89 the peak period was for half an hour (10%) longer than in 1983/84 slightly affects the comparison, but not enough to justify trying to adjust the figures, for present purposes, to allow for it.

TABLE 11.8.4

	1983/84		1988/89		Difference			
	Peak	Off-peak	Peak	Off-peak	Peak		Off-peak	
					£	%	£	%
B747 (4 hours)	£1002	£308	£703	£281	-£299	- 30%	-£27	- 9%
A300 (2 hours)	£ 214	£ 66	£179	£ 71	-£ 35	- 16%	+£ 5	+ 8%
B757 (2 hours)	£ 145	£ 45	£137	£ 55	-£ 8	- 6%	+£10	+ 22%
B737 (1 hour)	£ 37	£ 12	£ 44	£ 20	+£ 7	+ 19%	+£ 8	+ 67%
SD330 (1 hour)	£ 8	£ 3	£ 23	£ 10	+£ 15	+188%	+£ 7	+233%

11.8.5 Despite the changes in the structure of parking charges, the relationship of 1988/89 charges to 1984 "costs" continues to raise substantial questions. In the peak period in 1988/89, "costs" *as calculated in 1984* continued substantially to exceed charges: using the methodology described at paragraphs 1.13 and 1.14 of this Chapter, above, the excess was 53% for the B747, rising to 374% for the SD330; by contrast, in off-peak periods charges continued to exceed 1984 "costs": by 313% for the B747 falling to 76% for the B737 (for the SD330 the off-peak charge in 1988/89 was about equal to the 1984 "cost"). This again reinforces the Tribunal's conclusion that the relationship of charges to computed economic costs manifestly required independent investigation and shows that it continued to do so through the Arbitration period.

11.8.6 However, so far as the Tribunal can ascertain, it does not have available to it the material needed to perform calculations about the relationship between *average* parking charges (peak and off-peak in a typical mix by aircraft and type of operation) and average economic cost associated with use of parking stands. It is therefore not obvious whether, adopting an LRMC approach and using BAA's 1984 calculations of costs, HMG ought to have seen that, even on BAA's own theoretical and factual premises, parking charges *overall* were too high or, as BAA's internal documentation indicates that BAA believed, "about right" (though this may have meant only in the aggregate rather than for particular types of user or aircraft/operation).

11.8.7 The relationship between usage and capacity of aircraft parking stands is extremely complex, since aircraft of different sizes require different

piers and there needs to be the correct mix of stands in the locations where they are needed. There is a distinction between (a) pier-served stands and remote stands and (b) remote stands within the Central Terminal Area/Terminal 4 Apron and remote stands outside those areas. There is a substantial capital investment in pier-served stands, the amount of which differs according to the size of the aircraft. There is no evidence before the Tribunal that the establishment of remote stands involves any substantial investment. BAA regarded it as preferable, from the point of view of good operation of the airport and the convenience of passengers, that pier-served stands should be available and that if pier-served stands were available for use they should be used rather than remote stands.

11.8.8 One of the clearest conflicts between use of LRMC and use of SRMC arose in relation to charging for aircraft parking stands. It appears that demand for stands had been close to capacity in 1984 and 1985 and that, without Terminal 4, pier-served stand capacity would have been insufficient in 1987. An insufficiency of parking stand capacity is potentially very serious since aircraft must be moved off runways so as not to interfere with runway movements and, in the absence of stands, passengers cannot be disembarked or cannot be embarked as the case may be. 23 additional stands had therefore been constructed in conjunction with Terminal 4 and became available for use in 1986 when Terminal 4 came into operation. HMG accepted that thereafter there was excess parking stand capacity, although it said that the excess would be a temporary phenomenon. USG did not seek to argue that the expansion of aircraft stand capacity in 1986 had resulted in BAA bringing into existence facilities that were not "appropriate" within the meaning of the first sentence of Article 10(3) of Bermuda 2.

11.8.9 In circumstances such as those just described, LRMC is bound to exceed SRMC - indeed that is a virtue that the proponents of use of LRMC claim for it. The ambivalence sometimes displayed by HMG and its witnesses towards use of LRMC is evidenced by their reliance on the fact that towards the end of the Arbitration period - perhaps somewhat tardily, it was said - average parking charges and to a substantial degree parking charges for large aircraft were reduced.

11.8.10 In April 1987 Coopers & Lybrand Associates ("C&LA") were asked by BAA to review and analyze *inter alia* the following issues in relation to parking charges at Heathrow:

- the most appropriate measure of economic cost for parking charges;
- the balance of charges as between fixed and weight-related elements, and the appropriateness of any break-points in weight bands, given the evidence currently available of a significant fixed element in parking costs; and

- the definition of the parking peak period, following on the broader passenger peak period and lower passenger peak charge introduced in 1987.

11.8.11 C&LA were requested to address *inter alia* those issues within the context of the overall policy of relating the structure of charges to the structure of economic costs and within the constraints of price control contained in the airport operator's permit to levy charges. They were asked to adopt those considerations as a framework for their study and not to review either the overall policy or the price controls themselves.

11.8.12 C&LA were not asked to make specific recommendations.

11.8.13 Subject to the foregoing, in their Report dated July 1987 C&LA endorsed the allocation by BAA (for costing purposes) to parking of the following facilities: aprons, ramps and rotunda; piers; and gaterooms (including, in the latter two, the airside concourse at Terminal 4).

11.8.14 C&LA updated the estimates of the costs of parking facilities contained in BAA's Position Paper (BAA1) of August 1983.

11.8.15 C&LA then produced two alternative "Parking Charge Options" which differed from BAA's current parking charges, the differences being exemplified by the following Table prepared by C&LA in relation to a B737 and a B747.

TABLE 11.8.15 (from C&LA Report)
Parking Charge Options (March 1987 prices)

<table>
<tr><td rowspan="2">Pricing Option</td><td colspan="2">Boeing 737*</td><td colspan="2">Boeing 747*</td></tr>
<tr><td>Peak rate (£/hr)</td><td>Off-peak rate (£/hr)</td><td>Peak rate (£/hr)</td><td>Off-peak rate (£/hr)</td></tr>
<tr><td>(a) Current</td><td>90</td><td>23</td><td>330</td><td>82</td></tr>
<tr><td>(b) LRMC Peak Pricing Option</td><td>430</td><td>18</td><td>920</td><td>29</td></tr>
<tr><td colspan="5">(c) Pier Service Option</td></tr>
<tr><td>Pier-Served Stands</td><td>360</td><td>18</td><td>770</td><td>29</td></tr>
<tr><td>Remote Stands</td><td colspan="2">18</td><td colspan="2">29</td></tr>
</table>

*NOTE: C&LA's calculations appear to presuppose maximum authorized weights of:

(a) 83 tonnes for the B737 model used in the calculations (versus the 53 tonnes for the B737 model generally used in BAA calculations and used by the Tribunal in all its calculations) and

(b) 380 tonnes for the B747 model used in the calculations (versus the 335 tonnes for the B747 model generally used in BAA calculations and used by the Tribunal in all its calculations).

Table D3 at Appendix D to C&LA's Report lists the weight of the "B737" as 58.73 tonnes and that of the "B747" as 356.01 tonnes (which may well have been the maximum authorized weights of models of the B737 and B747 that had by then entered service): using those weights and BAA's published tariff of parking charges current in March 1987 (or, for that matter, in March 1988, being the month of March that fell in the 1987/88 charging year) there is no way apparent to the Tribunal by which one can arrive at the "current" peak and off-peak rates (£/hour) shown by C&LA in their Report.

11.8.16 As C&LA observed, full implementation of the *LRMC Peaking Pricing Option* would have implied:

(a) a large increase in peak rate charges over 1987/88 levels; and

(b) some reduction in off-peak charges,

with a consequent widening of the peak/off-peak differential.

11.8.17 The full implementation of the *Pier Service Option* would have implied:

(a) a single flat rate charge for all parking except for those aircraft on pier-served stands during the defined peak period;

(b) a large increase in the peak charge (for pier-served stands only) above the current peak rate;

(c) some reduction in the off-peak rate below the current level with a consequent widening of the peak/off-peak differential; and

(d) a large differential between the charge for pier-served and remote stands in the peak.

11.8.18 With regard to the *structure* of parking charges, C&LA concluded that a fixed plus variable charge provided a closer approximation to the costs of parking than a simple variable charge or a simple fixed charge;

they also discussed the possibility of banding aircraft by size or weight, though such banding would greatly have increased the complexity of the charging structure. The fixed plus variable charges that they then produced as "consistent with the results of our regression analyses" are set out below.

TABLE 11.8.18 (from C&LA Report)
Weight Related Parking Charges (March 1987 prices)

Parking Option	Peak Charge		Off-Peak Charge	
	Fixed (£/hr)	Variable (£/tonne/hr)	Fixed (£/hr)	Variable (£/tonne/hr)
LRMC Peak Pricing Option	390	1.70	17	0.04
Pier Service Option				
Pier Served Stands	330	1.40	17	0.04
Remote Stands	–	–	17	0.04

11.8.19 Finally, after referring to the pattern of parking stand usage during the peak week of 1986 (without differentiation by location or by size of stand), C&LA concluded that there was a case for some extension of the peak, in which case the peak charges calculated in the Tables set out above would be lower.

11.8.20 Following on the C&LA Report, parking charges for 1988/89 were modified as follows:

(i) the peak period for peaking stand use was extended by half an hour (10%) so as to start at 0700 instead of 0730;

(ii) a fixed charge of £10 (off-peak) was introduced (effectively in substitution for a variable charge of £0.54 (off-peak) per tonne per hour for the first 20 tonnes, i.e. £10.80 for the first 20 tonnes for each hour); and a variable charge of £0.18 (off-peak) per tonne per hour was applied over and above the fixed charge (effectively in substitution for a variable charge of £0.20 per tonne per hour for every tonne in excess of 20).

11.8.21 Even allowing for the fact that in 1988/89 the peak parking period was extended in duration by 10%, the resulting pattern of parking charges for 1988/89 bore no resemblance to either of the sets of charges calculated by C&LA. Using the methodology described at paragraphs 1.13 and 1.14 above, the figures are as follows.

TABLE 11.8.21

	Peak					Off-Peak			
	1988/89 Actual		C&LA			1988/89 Actual		C&LA	
			LRMC Peak Pricing Option	Pier Service Option				LRMC Peak Pricing	Pier Service Option
	Pier Stands	Remote Stands[1]		Pier Stands	Remote Stands	Pier Stands	Remote Stands		
B747	703	597	2909	2427	Nil	281	175	122	
A300	179	89	961	807	Nil	71	(19)	45	
B757	137	89	843	704	Nil	55	7	42	
B737	44	12	360	303	Nil	20	(12)	19	
SD330	23	15	307	259	Nil	10	2	17	

[1]This column applies to remote stands in the Central Area/Terminal 4 Apron; outside those locations, the actual parking charges at remote stands in peak hours were the same as the actual parking charges at remote stands at off-peak periods. It would seem that the U.S.-designated airlines made no significant use of remote stands in any event.

11.8.22 Indexing the figures for Pier Stand charges in the Table to Actual Charges = 100, the Table looks as follows:

	Peak			Off-Peak		
	1988/89 Actual	C&LA		1988/89 Actual	C&LA	
		LRMC Peak Pricing Option	Pier Service Option Pier Stands	Pier Stands	LRMC Peak Pricing Option	Pier Service Option
B747	100	414	345	100	43	
A300	100	537	451	100	63	
B757	100	615	514	100	76	
B737	100	818	689	100	95	
SD330	100	1135	1126	100	170	

11.8.23 It may be that C&LA's calculations did not correctly give effect to BAA's LRMC-based charging principles, on which they were intended to be based, or were otherwise erroneous or, unknown to the Tribunal, were subsequently revised. Alternatively the reasons that led BAA to depart so widely from the figures as computed by C&LA may have been economically sound. However that may be, any body that had undertaken to use its best efforts to ensure that user charges were just and reasonable should have felt the need to investigate the position further.

11.8.24 It is perfectly true that with the actual parking charges in 1988/89, the U.S.-designated airlines (and, to an even greater extent, operators of short-haul flights and domestic operators) were almost certainly substantially better off than they would have been overall with either of C&LA's calculated charging options. But the Tribunal has to ask itself the question, which in a slightly different form was posed to it by USG: if BAA felt it necessary and proper to depart from "economic costs" so far in its pricing structure, in what sense was the structure based on the economic costs at all? To say that the departures merely reflected the "flexing" of LRMC-based charges to SRMC-charges, without identifying the relevant short-run marginal costs and explaining why the flexing was in one direction in peak hours and in the opposite direction at off-peak periods and why the flexing was substantially greater in respect of small aircraft than in respect of large, is to raise more questions than it answers.

11.8.25 Mr. Wynne Jones, a Partner in the Communications, Energy, Water and Transport Division of the Management Consultancy Services practice of Coopers & Lybrand Deloitte, who gave evidence on behalf of HMG, did not proffer answers to any such questions. Nor did the two witnesses from BAA who gave evidence for HMG. However, Mr. Wynne Jones did make the following observations which are of relevance in the present context:

> "Parking
>
> "769 The peak to off-peak differential in parking charges was a multiple of 4 until 1988/89 when it was reduced to 3 (USG Exhibit 1), reflecting the significant increase in parking capacity after the opening of T4. A reduction in peak/off-peak differentials was certainly warranted on economic grounds, although there is a case that the fall in the differential should have occurred sooner after the additional capacity became available. BAA, however, justified the delay in carrying out changes in the structure of parking charges ... in the interest of gradualism (JR Z-10), as in 1987/8 they were already proposing significant structural changes overall and other charges would have had to increase to meet financial targets."

11.8.26 Mr. Wynne Jones's statement that "a *reduction* [emphasis added] in peak/off-peak differentials was certainly warranted on economic grounds, although there is a case that the fall in the differential [which occurred in 1988/89] should have occurred sooner after the additional capacity became available" may be compared with the July 1987 Report of C&LA. As appears from what has been said above, in that Report, C&LA, taking as given the

economic principles of charging which they understood to underlie BAA's structure of charges, had put forward two options, both of which implied a *widening* of the peak/off-peak differential. There was no cross-examination about the apparent inconsistency and the Tribunal can only note it.

11.8.27 At the same time, the Tribunal does not overlook the substantial reductions in parking charges typically enjoyed by the U.S. airlines over the Arbitration period.

TABLE 11.8.27

	Peak[1]	Off-Peak[1]	Average per passenger[2]
1988/89 compared with 1983/84			
Unadjusted for inflation	-30%	- 9%	-18%
Adjusted for inflation[3]	-45%	-28%	-35%

NOTES: (1) Typical B747 operations as per Table 1.15A in this Chapter, above.

(2) See Table 1.19D in this Chapter, above.

(3) Using inflation adjustment as per Table 1.19A in this Chapter, above.

11.8.28 It is impossible for the Tribunal to tell whether the parking charges payable by the U.S. airlines were too high or, if only thanks to the reductions that were made, were, or at some point of time in the Arbitration period became, on the view of the applicable economic principles that HMG was entitled to take, about right or too low. However, it is crystal clear that HMG's obligation to use its best efforts to ensure that user charges at Heathrow were just and reasonable required that it should at least have procured comparisons of e.g. parking charges for typical aircraft/turnround times at peak and off-peak times and compared them with the economic costs by reference to which the charges were said to have been established.

(9) Terminal-by-terminal passenger charges

11.9.1 The question whether passenger charges should have been set as they were, on a Heathrow airport-wide basis or, differentially, terminal-by-terminal, provides an excellent illustration of the scope for indisputedly honest disagreement about the application of sound economic principles to airport user charge-setting, the dangers of holding the Parties to Bermuda 2 to an excessively onerous obligation to intervene in the charge-setting process and

the clear limits to the efforts that the Tribunal should itself make to establish mandatory parameters for that process.

11.9.2 Dean Levine argued persuasively that sound economic principles required the establishment of passenger charges on a terminal-by-terminal basis: in particular, inter-terminal differentials would have provided airlines with incentives to re-organise their operations in ways that could have left both the airlines and BAA better off, in other words a classic example of use of the pricing mechanism to optimize use of resources with all interested parties gaining in the result.

11.9.3 Although HMG's LRMC approach presupposed that BAA should have regard initially to economic cost of terminal usage unrelated to the particular terminal used by the airline, the "flexing of LRMC to SRMC" in which BAA engaged would have been well able to have accommodated inter-terminal differentiation of passenger charges. However, after the opening of Terminal 4 in 1986 any inter-terminal differentiation that had not resulted in the establishment of *higher* charges at Terminal 3 (the terminals used by the U.S. airlines) would evidently have been exposed to the kind of criticism that the U.S. airlines and USG had made during the Arbitration period of other differentials. Whether for that or other reasons, USG stated quite definitely in its Second Memorandum that the establishment of passenger charges on a terminal-by-terminal basis would have been unwise. In those circumstances it seems to the Tribunal that, whether or not terminal-by-terminal setting of international passenger charges would have had advantages compared with airport-wide setting of international passenger charges, HMG cannot be held to have failed to fulfil its obligations under Article 10(1)-(3) of Bermuda 2 by reason of its not having intervened to bring about the one result rather than the other.

(10) One-way charging

The arguments of the Parties

11.10.1 It will be recalled that throughout the Arbitration period runway charges were payable in respect of landing and not in respect of take-off and that terminal charges were payable in respect of departing and not in respect of arriving passengers.

11.10.2 USG contended and HMG conceded that, at least as a matter of principle, such "one-way charging" did not accord with sound economic principles. However, HMG submitted that:

(i) one-way charging was standard practice at European and U.S. airports;

(ii) it had the major benefit of greater administrative simplicity;

(iii) BAA had levied each charge in the direction where the greatest costs arose;

(iv) two-way charging would not necessarily have benefited U.S. airlines, since the new charges would have required the identification of new peak periods (one for passenger arrivals and one for runway take-offs) and these would have been likely to capture equally high proportions of U.S. traffic;

(v) USG's particular allegations about the unfairness of the landings-only peak period were contradicted by the evidence, since U.S. airlines had experienced a lower than average proportion of arrivals in the peak period - in its First Memorandum HMG had put forward figures to show that only 14% of the wide-bodied aircraft used by PanAm and TWA fell within the landing peak, whilst 25% of the landings by small domestic aircraft attracted peak charges; and

(vi) two-way charging would have reduced economic efficiency by halving the price incentive to schedule out of peak periods, unless the charges had been doubled.

11.10.3 With further reference to one-way charging, HMG said that USG had made no further comment on the passenger charge, and had not disputed HMG's point that the introduction of a separate arrivals charge and a separate arrivals peak period would not necessarily have saved U.S. airlines any money.

11.10.4 The position in practice was, HMG said, that it accepted that charging in one direction was a departure from the rigid application of economic theory. It was a departure which was required by the desirability of administrative simplicity and the need to limit total revenues. Prior to 1980 BAA had used two-way charging and when it had changed to one-way charging the airlines had not criticized the change. With the total revenue controlled, BAA had had the alternative of implementing two-way charges at a much lower rate. However, the size of each charge would have been on average only half the size of current one-way charges. It was, according to HMG, unlikely that charges so low overall would have made any impact on airlines' operating decisions. They would have been unlikely to contribute to economic efficiency or to capacity-rationing. The introduction of two-way charges would also have further complicated the charging structure which USG already regarded as "highly complicated". HMG said that BAA had therefore opted to levy charges in one direction only, to enable the charges to be set at a level which would be more likely to help manage the airport efficiently. It had selected the direction in which a charge was most appropriate. For runways, hourly landing capacity had been lower than take-off capacity throughout the period covered by the Arbitration and the rationing need had therefore been more pressing. In 1984, for example, landings capacity had been 34 movements per hour, whilst hourly take-off capacity had been 37 movements. Therefore the charge had been levied on landing, rather than on take-off. For passengers, the costs associated with departing passengers had been found to be higher than those associated with arriving passengers and the charge had therefore been levied on departure.

The decision of the Tribunal

11.10.5 In the judgment of the Tribunal, the only way to discover whether *in practice* sound economic principles require the adoption of two-way pricing is to identify the runway take-off peaks and the terminal arriving passenger peaks and the user charges that would be associated with them and then to run the figures through a computer to see how likely it is that two-way charging would produce a significantly different pattern of payments from one-way charging. If it would be likely to do so, then the departure from sound economic principles constituted by one-way charging would not, in the judgment of the Tribunal, be justifiable by reference to administrative convenience, especially since there was nothing to suggest that any administrative convenience would be more than minor.

11.10.6 The Tribunal notes that the position in this respect may differ as between runway charges and terminal charges. Thus, in respect of the former, there is no reason to doubt HMG's assertion that the U.S. airlines had experienced a lower than average proportion of arrivals in the peak period (paragraph 11.10.2(v) of this Section, above) and it may well be that for that reason there can be no complaint by USG under Bermuda 2 about one-way *landing* charges. However, the U.S. airlines appear to have experienced a significantly *above-average* proportion of passenger departures in the terminal peak period and terminal charges were far more significant, generally and for the U.S. airlines in particular, than were landing charges. This makes it particularly important to test for the practical effects of adopting one-way, rather than two-way, *terminal* charging.

11.10.7 Secondly, the Tribunal cannot accept HMG's submission that one-way charging is necessary to limit total revenues. On the same date as one-way charging was introduced, namely April 1, 1980, user charges were increased, as HMG accepted, by 40% (following on increases of 8% and 10% in April and November of the preceding year); according to USG, the average increase for U.S. carriers in April 1980 was in the range of 60-70% rather than 40% and that does not appear to be disputed. There is in the Tribunal's judgment no connection between the overall level of charges and whether they are levied by one-way or two-way charging.

11.10.8 Thirdly, the Tribunal is not persuaded by HMG's argument that two-way charging would reduce economic efficiency by halving the price incentive to schedule out of peak periods, unless the peak charges were doubled. So far as runway charges were concerned, the most substantial analysis of runway peak periods that was undertaken by BAA, in the course of the Medium Term Review, showed different peaks for arrivals and departures and effectively presupposed use of two-way runway charges.

11.10.9 There is no reason why the absolute difference between peak and off-peak *two-way charges* in the aggregate should be less than the absolute difference between peak and off-peak *landing charges*. However, with two-way charges, the incentive would operate in respect of usage of the runways

for take-off as well as for landing; if the resulting pattern of runway usage and of incidence of runway charges could reasonably be expected to be unaffected by the change in charging structure, then, in the interests of administrative simplicity, BAA could sensibly, in the exercise of its discretion, retain one-way charging. But if the resulting patterns of runway usage and of incidence of runway charges would be affected by the change, the Tribunal can see no reason to suppose that the total available runway capacity, for take-off as well as for landing, would not be utilized better rather than worse as a result of the change.

11.10.10 The Tribunal has also specifically considered HMG's point that BAA had levied both the runway charges and the terminal charges "in the direction where the greatest costs arose". It is not clear to the Tribunal that the question of relative cost is relevant since it is not suggested that substantially all the costs are incurred one way and virtually none the other. But relative capacity, where there are differences in one direction and the other[9], may well be relevant; and, to the extent that existing runway and terminal capacity can accommodate, without undue congestion, a greater throughput of departing than of arriving aircraft or of arriving rather than departing passengers, as the case may be, in any relevant unit of time, then the definition of peaks may well have to take that fact into account as well as simply the numbers, and patterns of numbers, per unit of time. Subject thereto, differing incidence of costs does not seem to the Tribunal to provide a reason here for departing from the general economic pricing principles by reference to which BAA and HMG elected to justify the charging structure.

11.10.11 Lastly the practice of other airport's, which do not use economic cost-based pricing, does not assist the Tribunal to answer the question whether one-way pricing accords with sound economic principles.

11.10.12 For these reasons the Tribunal concludes that HMG's obligation to use its best efforts to ensure that user charges at Heathrow should be set in accordance with the principles contained in Article 10(1) and (3) of Bermuda 2 required HMG to investigate the probable effects of adoption by BAA of a properly constructed two-way system of charging for runway and terminal use in order to see whether or not adoption of such a system would have made so little difference in practice to what airlines actually paid overall in runway and terminal charges and to their use of runways and terminals that adoption of two-way pricing would not have been worth such extra administration as would have been involved.

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[9] During the Arbitration period the maximum hourly capacity for *runway* use at Heathrow declared by the Civil Aviation Authority was higher for take-off than for landing: see paragraph 11.10.4 of this Section, above. The hourly capacities for *terminal buildings* declared by Heathrow Airport Limited (BAA) were 9-10% higher for arrivals than for departures in the case of Terminal I (International) and Terminal 3 but were otherwise the same for arrivals and for departures.

(11) Remote parking stand rebates

11.11.1 There was considerable dispute between the Parties about the timing of the introduction of a remote stand rebate and the amount of that rebate. The rebate was paid when an aircraft was parked at a remote stand; such a rebate was introduced in 1985/86 at the rate of £0.30 per passenger and was increased in 1987/88 to £0.40 per passenger. The U.S. airlines complained of the inadequacy of the rebate but, although they had been invited to submit figures to BAA showing the costs that they incurred in bussing passengers from a remote stand to the appropriate terminal, no such figures were, so far as the Tribunal is aware, supplied and none are before the Tribunal. Whilst this is something that an independent investigative body, such as ought to have been appointed, would no doubt have looked into, the Tribunal finds no basis for condemning HMG for not having intervened so as to require BAA to introduce such a rebate earlier than 1985/86 or to pay the rebate at a higher rate, especially as, in the circumstances under consideration, this is the kind of detail that an independent investigative body might well have concluded lay within the margin of discretion that BAA enjoyed in establishing user charges.

(12) Allegedly excessive delay in ameliorating the structure of user charges

11.12.1 During the Arbitration period the structure of charges was radically altered in favor of, amongst others, the U.S.-designated airlines. The question arises whether HMG not only failed to fulfil its best efforts obligations under Article 10(1) and (3) in relation to the structure of charges in the respects identified earlier in this Chapter but also, by way of a separately identifiable breach of those obligations, by failing to intervene in an effort to require BAA specifically to make the changes in question earlier than BAA did.

11.12.2 In this connection it is, in the view of the Tribunal, appropriate to look at the position in relation to long-haul international flights generally and not just those to and from the U.S.: the Airlines Settlement Agreement was made by BAA and HMG with not only the U.S.-designated airlines but also a relatively large number of other long-haul international operators; and both the object and the effect of the changes in BAA's charging structures were to lessen the average burden of user charges on long-haul international operators and, on average, to shift the burden onto short-haul international and domestic operators. There is nothing that the Tribunal has been able to find in the documentation relating to the Arbitration period establishing that BAA intended that structural changes in favor of long-haul international carriers generally should not benefit the U.S.-designated airlines or should benefit them less than other long-haul international carriers, although on occasions BAA took account of the fact that a possible change would prejudice specifically one or both of the U.S.-designated airlines as a reason for *not* making the change.

11.12.3 Accordingly the comparison that can here usefully be made is of the relationship between the average user charge per passenger on long-haul international flights (which are here taken as comprising international flights other than those to and from other European airports) and the average user charge per passenger for the airport as a whole over the Arbitration period. The comparison shows that the former average exceeded the latter average by the following percentages in the six years in question as follows.

TABLE 11.12.4

1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
45.8%	35.7%	27.9%	30.4%	28.6%	20.5%

11.12.4 It can be seen that the greater part of the effect of the change of structure had occurred by 1985/86, i.e. within the time it was reasonable for HMG to leave BAA to get on with the restructuring that was intended to follow the 1983 Airlines Settlement Agreement and the 1983 intergovernmental MoU. It is true that a further significant change took place in 1988/89 as a result of which the average user charge per passenger on long-haul international flights was 3.9% lower in 1988/89 than in 1985/86 whereas the average user charge per passenger on intra-European international flights and domestic flights was 7.8% higher in 1988/89 than in 1985/86.

11.12.5 However, the Tribunal is of the judgment that it would not be appropriate to hold HMG guilty of a separately identifiable breach of its "best efforts" obligations under Article 10(1) and (3) in relation to the structure of charges by reason of HMG's omission to intervene in an effort to require BAA specifically to make the structural changes that it did earlier than was in fact done.

XII. The Tribunal's broad conclusions

12.1 As already noted, generally speaking, throughout the Arbitration period BAA made conscientious efforts to ensure that the *changes* that it made to the structure of charges at Heathrow were in accordance with sound economic principles. With regard to landing charges, it was probably mistaken in reducing charges (to the greatest extent, both absolutely and relatively, for large aircraft such as were operated by the U.S.-designated airlines) as much as it did in the early years of the Arbitration period; but it did this on the basis of a bona fide belief (a) that terminal facilities, not the runways, were the bottleneck at Heathrow and (b) that the economic costs of runway usage were even lower than the greatly reduced charges. However, there was no reason why HMG should have appreciated that BAA was in error in making the landing charge reductions in question and should have intervened directly to reverse the trend, particularly as the reductions appeared to be especially beneficial to the U.S. airlines. On the other hand, HMG was wrong to have added to the pressure on BAA to differentiate off-peak landing charges by

weight in 1985/86 as it did and ought to have appreciated the need for separate peak periods for international and domestic terminal charges, in time to require their introduction by 1985/86.

12.2 However, much the most significant respect in which HMG failed to fulfil its best efforts obligation under Article 10(1) and (3) of Bermuda 2 was not in relation to *changes that were made* in user charges but in relation to the relationship between the charges that BAA put forward, after the 1982-84 Medium Term Review, as being economic-cost based and the economic costs relevant to the charges in question. Since the whole basis for BAA's charging structure was said to be founded in the economic cost structure, it was an elementary corollary of HMG's best efforts obligation that HMG should have investigated the relationship between the cost structure and the charging structure. Quite simple calculations by HMG itself would have disclosed that there were at least apparent anomalies of a glaring nature that required such investigation in depth.

12.3 Such investigation was all the more evidently required by reason of the pioneering nature of BAA's attempt to establish airport charges by reference to economic costs, the indisputable difficulties in the way of doing so in practice and the continuing complaints by the U.S.-designated airlines and USG.

12.4 It is true that substantial resources might well have needed to be devoted to a periodic investigation and review of BAA's charging structure in the depth that was, in the judgment of the Tribunal, required. But, if that is so, the Tribunal's judgment is that the obligations that HMG had accepted under Article 10(1) and (3) of Bermuda 2 made it necessary for it to devote such resources to the task.

12.5 The Tribunal therefore concludes that in the course of the last four years of the Arbitration period HMG failed to fulfil its obligations under Article 10(1) and (3) of Bermuda 2 in relation to the structure of charges at Heathrow in the various respects identified in the foregoing section of this Award.

12.6 If, as a result of a proper investigation, HMG had concluded that, at any rate in the conditions prevailing in the United Kingdom, the structure of user charges at Heathrow could not sensibly be set in practice in a manner that would conform to Article 10(1)-(3) of Bermuda 2, then the only course open to HMG would have been to revert to USG with the results of the investigation, with a view to finding a mutually acceptable solution.

CHAPTER 7

ARTICLE 10(1) AND (3) OF BERMUDA 2 : THE LEVEL OF USER CHARGES AT HEATHROW

I. The relationship between reasonableness of charges and profitability

1.1 HMG's "best efforts" obligation is required to be satisfied not only in respect of the *structure* of charges, which has been considered in Chapter 6 above, but also in respect of the *level* of charges. It is with the level of charges that this Chapter is concerned.

1.2 The first sentence of Article 10(3) of Bermuda 2 enunciates the principle that:

> "User charges may reflect, but shall not exceed, the full cost to the competent charging authorities of providing appropriate airport and air navigation facilities and services, and may provide for a reasonable rate of return on assets, after depreciation."

1.3 In paragraphs 4.2.1 *et seq.* of Chapter 5 above the Tribunal has concluded that Article 10(3) prescribes necessary conditions that must be fulfilled if charges are to be characterized as just and reasonable. It follows that charges cannot be characterized as just and reasonable if they give rise to unreasonably high profitability.

1.4 Therefore, one of the things that Article 10(1) and (3) requires the Parties to do is to use their best efforts to ensure that user charges do not give rise to unreasonably high profitability. The question is not whether user charges gave rise to such profitability; even if they did not do so, HMG may have failed to use its best efforts as required; and even if the charges gave rise to unreasonably high profitability, that in itself does not show that HMG failed to use its best efforts as required.

1.5 Pursuant to the words of the first sentence of Article 10(3), profitability must be measured by reference to the relationship between profits and capital employed ("rate of return on assets" or, simply "rate"): not only is that the yardstick used in Article 10(3); in a case such as this it is, in the judgment of the Tribunal, the only economically justifiable way to measure the reasonableness of profitability.

1.6 The reference in Article 10(3) to the fact that user charges may provide for a reasonable rate of return on assets makes it clear that, when applying the condition contained in Article 10(3), one is concerned with the profitability that was reasonably to be foreseen as likely to result if charges in an ensuing period were set at a particular level. Even if one is not, strictly speaking, applying the condition contained in Article 10(3), the result should, in the view of the Tribunal, be the same: Article 10(1) contains a "best efforts" obligation and any interpretation of it that could lead to a Party being held in breach because of the rate of return that in fact eventuated after the time when the Party was required to use its best efforts, rather than the rate of

return that was reasonably foreseeable at that time, would come close to converting the obligation *to use best efforts* to ensure that the rate of return was no more than reasonable into an obligation *to ensure* that result: see paragraphs 2.2.1 *et seq*. of Chapter 5 above.

1.7 For reasons already given:

(a) the rate of return with which one is here concerned is the rate of return resulting from the total relevant revenue, with user charges set at the level in question, rather than the rate of return resulting from each element in the total being set at the particular level in question (see paragraphs 6.2 *et seq*. of Chapter 5, above); the *composition* of the total accounted for by each element is therefore to be judged by reference to *structure* of charges (Chapter 5, above), rather than by reference to their level (this Chapter);

(b) the limitation on rate of return must be understood to take precedence over the other aspects of charges that are relevant to whether or not they are just and reasonable, including their conformity with sound economic principles (see paragraphs 4.2.1 *et seq.* of Chapter 5, above); this makes it particularly necessary to try to ensure that the methodology employed in connection with the measurement and appraisal of rate of return is itself in conformity with sound economic principles and does not, in the absence of cogent considerations requiring such a result, lead to condemnation of charges as being too high to be just and reasonable when those charges have been set in accordance with sound economic principles.

II. Historical Cost Accounting, Modified Historical Cost Accounting and Current Cost Accounting

2.1 As was explained by Mr. Lawrence of Coopers & Lybrand Deloitte, who gave expert accountancy evidence on behalf of HMG, in the preparation of accounts in the United Kingdom today, three different cost conventions are in use, namely Historical Cost Accounting ("HCA"), Modified Historical Cost Accounting ("MHCA") and Current Cost Accounting ("CCA"). Mr. Lawrence provided the following brief description of each.

> "Under HCA, all assets are stated in the accounts at their original cost, and depreciation is calculated by reference to that original cost. MHCA has many of the features of HCA, except that some or all of the fixed assets (often only land and buildings) are revalued from time to time, with appropriate restatement in the accounts. Depreciation is then based on this revalued amount. MHCA, which is now a common convention in the United Kingdom, produces a wide range of results, depending upon the extent, the basis and the frequency with which a company chooses to revalue its assets. CCA involves revaluing all non-monetary assets annually. The current cost or value to the business of any asset is defined as the lower of its current replacement cost and its recoverable value from either sale or future use over its remaining useful life."

2.3 Preparation of accounts on a CCA rather than an HCA basis generally increases the figure representing capital employed and, by

increasing associated depreciation, reduces profits, thus having a doubly depressing effect on the figure for rate of return; and the present case is no exception to that rule. The effects of use of CCA rather than HCA were summarised by USG as follows for the years ended April 1, 1982-1986:

TABLE 2.3A

Capital employed for BAA as a whole					
	1982 £m	**1983 £m**	**1984 £m**	**1985 £m**	**1986 £m**
(i) CCA	852	931	856	924	1,119
(ii) Unmodified HCA	348	408	363	423	585
(iii) Ratio of (i) to (ii)	2.45 : 1	2.28 : 1	2.36 : 1	2.18 : 1	1.91 : 1

TABLE 2.3B

Rate of return for BAA as a whole					
	1982 %	**1983 %**	**1984 %**	**1985 %**	**1986 %**
(i) CCA	4.5	3.4	5.5	7.9	8.1
(ii) Unmodified HCA	23.9	19.6	23.1	28.0	25.6
(iii) Ratio of (i) to (ii)	5.3 : 1	5.8 : 1	4.2 : 1	3.5 : 1	3.2 : 1

2.4 This led USG to contend that BAA's use of CCA exemplified its use during the Arbitration period of "accounting practices that consistently reduced its stated rate of return". However, in the end this raised no issue for determination by the Tribunal since USG conceded that BAA's use of CCA was consistent with generally accepted accounting principles for UK nationalized industries and was therefore permissible under Bermuda 2. (Of course if accounting rates of return on capital employed are used to assess the reasonableness of profitability, it is necessary to take into account whether the figures have been prepared on a CCA basis or an HCA basis; a given percentage figure might very well be regarded as showing reasonable profitability if prepared on an HCA basis but not if prepared on a CCA basis.)

2.5 Moreover, one of the very few questions on which there was a measure of agreement between the expert witnesses of the two Parties was that use of CCA had substantial advantages.

2.6 Thus, giving evidence for HMG, Mr. Lawrence testified that:

> "CCA is conceptually superior to HCA.
>
> "I believe that it is widely accepted among those who concern themselves with such matters, that pure HCA is unsatisfactory as a basis for preparing accounts in an economy suffering inflation to any significant degree, although pure HCA remains generally accepted accounting practice. Historic cost accounts measure only the cost incurred to acquire assets. They ignore changes in the value of money during the working lives of the assets and therefore do not act as a discipline on the reporting entity to set aside funds sufficient to replace the asset in due course. CCA is designed to achieve this necessary objective, which can be expressed in the broadest terms as recognising the effects of inflation before distributing profits. It is of particular relevance, and application, for asset intensive industries and public utilities, such as BAA. This is because the effects of inflation are significant for entities which depend upon the use of capital assets. Such entities need to maintain their asset bases by building up funds to replace assets as they wear out."

2.7 Similarly, in the written evidence prepared jointly by Professors Brealey and Myers on behalf of USG in relation to the measurement of rates of return on assets, they too testified that CCA accounts had "some advantage" over historical cost accounts and, for that reason, they relied on the data in the CCA accounts.

2.8 In his oral evidence Professor Brealey went further, saying:-

> "I personally somewhat *favor* CCA accounts. I am quite happy to see BAA producing its accounts this way. The reason that replacement cost, I think is *very appropriate* in cases like this, is that it is the cost of entry to any industry. It is in what is referred to as contestable markets, competitive markets, what a competitor would have to pay to enter the business. That's what BAA would have to pay if it were, setting up today, and in that sense, it is *the appropriate measure* to calculate the rate of return on" (emphasis added).

2.9 Dr. Kolbe of The Brattle Group, an economic, management and environmental consulting firm, who gave expert evidence on behalf of USG in relation to the measurement of the economic rates of return on assets earned by BAA, gave evidence to a similar effect. In his written evidence he said:-

> "As an economist, I prefer the concept of CCA asset value to HCA asset value as a standard, because the CCA value has a better chance of tracking net replacement cost, which is the market value of the assets in competitive equilibrium."

In his oral evidence Dr. Kolbe commented that it was BAA and HMG who had "started the test [of rate of return on assets] using CCA valuation … [As] an economist I applaud that."

III. Accounting and economic rates of return

Accounting rates of return

3.1 Mr. Lawrence testified that accounting rates of Return On Capital Employed ("ROCE") were widely used to measure company performance in the United Kingdom, although there was no indisputedly correct definition of

either the profit or the capital employed figure used to calculate ROCE. However, the most commonly used figures were:

- for profit: the company's profit for the year before interest and tax as shown in the profit and loss account;
- for capital employed: total assets less current liabilities.

Mr. Lawrence explained that use of such figures produced ROCEs that were unaffected by sources of funding (equity or debt) and unaffected by the tax positions of those concerned, so that comparisons of the resulting ROCEs could be used to measure comparative *performance* of companies in the marketplace.

3.2 In the United States it is more common to express accounting rates of return on assets on an after-tax basis; but in the event, as will appear from what is said below, this difference in practice does not affect the result in the present case.

Economic rates of return

3.3 The calculation of economic rates of return was helpfully described for the Tribunal in the following terms by Professor Franks who gave evidence on behalf of HMG.

> "An asset's economic rate of return for a single period is its economic income (that is the combined sum of the net cash flow received during the period and the change in the value of the assets over the period) expressed as a proportion of the value of the assets at the beginning of the period. For example, if the net cash flow received is £100 and the value of assets at the beginning of the period is £1000 and at the end is £1050, the rate of return is (100 + 50)/1000 or 15 per cent. For simplicity I have assumed in this example that the cash flows of £100 are received at the end of the period. The cash flows may be positive or negative, and there may be capital gains or capital losses on the assets. …
>
> "If an asset's economic rate of return is measured over say, ten years, a return may be calculated for each particular year or a single rate of return may be calculated over all the years. This single economic rate of return is often referred to as an asset's discounted cash flow rate of return or its internal rate of return.
>
> …
>
> "Similar principles may be used to calculate the economic rate of return for a group of assets or for the assets of an entire company."

3.4 Thus, an economic rate of return may be calculated for each particular year under review or for all of those years taken together. As Professor Franks indicated, the latter is generally called an Internal Rate of Return (or "IRR") and will differ from the average of the economic rates of return for each of the constituent years according to whether the positive cash flow is generated earlier or later in the period.

An important difference between accounting and economic rates of return

3.5 It will be observed that a fundamental difference between an accounting rate of return and an economic rate of return is that the former

takes no account of unrealized capital gains or losses whereas the latter includes in the relevant "return" any appreciation in the value of the assets of the business the profitability of which is being measured.

IV. Comparative yardsticks for use with accounting and economic rates of return

4.1 The accounting rate of return earned by a company is commonly compared with other accounting rates of return with a view to drawing inferences about the relative "profitability" or "performance" of the first company. On the one side, the comparison may be made of the whole of the activities of the company under consideration or an identified part of its activities in respect of which it is practicable to draw up separate accounts; and on the other side, the comparison may be made with particular undertakings or with national averages or averages for particular industrial or commercial sectors. Thus, HMG tendered in evidence such comparisons in respect of the ROCE earned by BAA generally and at its South East Airports (Heathrow, Gatwick and Stansted) and at Heathrow alone, which purported to show that BAA was not earning a supra-normal or supra-competitive profit.

4.2 An alternative approach to the assessment of the reasonableness or otherwise of the rate of return on assets earned by a business was advocated by USG. It contended that the economic rate of return earned by the business should be compared with the cost of capital to that business. This approach has been increasingly adopted by regulatory agencies in the United States for rate-setting purposes. The approach is implemented by use of the Capital Asset Pricing Model ("CAPM") and is described by S. Breyer in his book *Regulation and its Reform* (Harvard University Press, 1982), Chapter 2 of which was reproduced by USG in an Exhibit to its written pleadings. The chapter includes the following passage:

> "*The capital asset pricing model.* Regulatory commissions have begun to use a third method for determining return on equity, a method derived from an academic model that relates returns on investments in common stock portfolios to their risks. The theory essentially states that an investor, by buying a portfolio of stocks instead of just one, can, by diversifying, avoid many risks attached to concentrating investment in an individual firm (for example, bankruptcy or raw material shortage). He cannot avoid the risk that the stock market as a whole will decline (or rise). For this reason, investments in common stocks tend to pay higher returns than risk-free assets (such as Treasury bills and savings accounts). Portfolios of volatile stocks (which sink lower than the average in bad times, but rise higher than the average in good times) tend to vary in their performance more than the stock market as a whole and tend to pay a higher return. In general, the potential investor will require an expected return equal to the risk-free rate of return plus a premium for investing in a risky stock. This premium must equal the average premium for all stocks if the returns paid by the stock vary in just the same way as the stock market in general; the premium can be less if the stock varies less, but it must be more if the stock is likely to vary more (if its performance is supercyclical). If the theory is right, the regulator can determine the expected return necessary to prompt investment in utility shares (R_u) by determining the risk-free rate (R_f), the stock market risk premium (R_m), and the comparative variability of the utility stocks and the market in general (typically referred to as the coefficient beta, ß). $R_u = R_f + ß_u (R_m - R_f)$. Regulators sometimes set the firm's return to equity at this level."

4.3 In the present case USG advocated comparison of (a) the economic return to providers of BAA's long term capital irrespective of source (i.e. whether equity or debt) with (b) BAA's weighted average cost of capital (i.e. the weighted average of the cost to BAA of its equity capital and of its long term debt). The weighted average cost of capital was sometimes referred to as "WACC" and may be so referred to subsequently in this Award.

V. "Nominal" and "real" calculations

5.1 As already noted (at paragraphs 3.3 and 3.5 of this Chapter, above), economic rates of return include in the return any appreciation in the value of the related assets. They were therefore described by USG's witnesses as "nominal" because they were to be compared with nominal interest rates (that is, interest rates that disregard changes in the value of money). Hence, BAA's year-by-year economic rates of return, which were based on BAA's CCA accounts, were called, by USG's witnesses, BAA's "nominal CCA rates of return".

5.2 If capital appreciation is *excluded* from such a return, then, adopting the terminology of USG's witnesses, it becomes a "real CCA rate of return". A real CCA rate of return is to be compared with a "real rate of interest" which, according to Professors Brealey and Myers, meant here "an adjusted cost of capital that ignores the effect of specific asset appreciation". The expressions "nominal" and "real", as used here, thus have highly technical meanings unrelated to their meaning in everyday usage.

5.3 Dr. Kolbe, in his oral evidence, explained that Professor Myers had evolved the idea of the possible use here of "real" calculations of the kind described above in case the Tribunal was, as a matter of law, precluded from including unrealized capital appreciation in the relevant return, when calculating a rate of return: "it was Professor Myers' thought that …, if you had to work within that constraint, we could provide you a benchmark in the cost of capital to test against those earnings by backing inflation out of the cost of capital instead of by adding it into the CCA return".

5.4 Whilst in any given situation the nominal rate of return would be higher than the real rate of return and the nominal cost of capital would be higher than the real cost of capital, using the methodology devised by USG's witnesses the *relationship between the rate of return and the cost of capital* is unaffected by whether one uses nominal or real calculations. Thus Dr. Kolbe in evidence agreed that, provided that identical definitions were adopted and the values were calculated using a common and consistent methodology, then, as a matter of logic and arithmetic, the *results* of the real calculations were bound to be identical with the *results* of the nominal calculations.

5.5 The Tribunal is concerned with the substance and not with merely the form in assessing whether the rate of return was such as to render the charges unreasonably high in level. Therefore to the extent that it were to take account of unrealized capital appreciation of assets, there would be no reason for it to

reject use of nominal calculations; equally, if it were to feel constrained to exclude from consideration unrealized capital appreciation of assets, it would not feel free to reintroduce its effect "by the backdoor", as it were, through making a deduction from cost of capital "for the effect of specific asset appreciation". Accordingly the Tribunal dismisses real calculations from further consideration.

VI. The RPI-1 price cap formula to which BAA was subject after April 1, 1987

6.1 On April 1, 1987, i.e. prior to the privatization of BAA in July 1987, BAA ceased to be subject to direct annual review and control of its user charges in the coming year by the U.K. Department of Transport. Instead, increases in its charges at the South East Airports, *viz.* Heathrow, Gatwick and Stansted, became statutorily subject to a form of price-cap control known as RPI-X. The operation of that formula, so far as is relevant to these proceedings, is further explained below.

6.2 Within the Arbitration period, the RPI-X formula applied for a 5 year period from April 1, 1987. At the end of that and each succeeding 5 year period the U.K. Civil Aviation Authority was and is normally required to make a reference to the U.K. Monopolies and Mergers Commission to investigate and report on the maximum amounts capable of being levied by BAA by way of user charges for the following 5 years. On such a review, the Monopolies and Mergers Commission review substantially the whole of the designated airport's business, including the commercial activities notwithstanding that the commercial charges themselves are not subject to the price-cap. In the light of the recommendations made by the Monopolies and Mergers Commission, the Civil Aviation Authority may modify the conditions imposing the price formula.

6.3 The price conditions can be changed by the Civil Aviation Authority during the period between each review only with the agreement of BAA. However the price formulae may be overridden at any time by a direction by the U.K. Secretary of State for Transport, made in order to discharge the United Kingdom's international obligations.

6.4 The price formula that came into operation in respect of the user charges for the 5 years commenced April 1, 1987, placed limits on the maximum annual average revenue per passenger for the South East Airports (*viz.* Heathrow, Gatwick and Stansted) as a group *and* for Heathrow and Gatwick airports individually. The principle of the formulae, which were the same for Heathrow and Gatwick individually and for the South East Airports as a group, was that, when airport user charges were set for the following year, the forecast increase in the average revenue per passenger from airport charges should not exceed the rate of inflation, as measured by the percentage increase in the Retail Price Index, minus *one* percentage point.

6.5 In setting charges, BAA had to forecast elements of the formulae for the year ahead. Since forecast and actual results were unlikely to be exactly the same, the formulae incorporated a correction factor which allowed for any under-charging or over-charging in one year to be corrected once the actual results were known (i.e. two years subsequently). The correction factor in any one year represented the difference between the actual average revenue per passenger and the maximum average revenue per passenger calculated according to the price formulae, adjusted for interest. If the actual average revenue per passenger were *less* than the maximum permitted by the formulae, that shortfall could be recovered, together with two year's interest on the amount of the difference at an average rate attributable to U.K. Treasury Bills. If actual average revenue per passenger were *greater* than the maximum permitted by the formulae, the permitted maximum was reduced by that amount, together with two year's interest charged at 3 percentage points above an average rate attributable to U.K. Treasury Bills.

6.6 The calculation of the maximum average revenue per passenger included a security charge which reflected changes in the costs of providing airport security which were incurred as a result of any changes in HMG's aviation security requirements. The U.K. Civil Aviation Authority would investigate and certify any such cost changes to be taken into account in the formulae, of which 75 per cent would then be recoverable two years after a raising of standards. If standards were eased, the permitted maximum would be correspondingly reduced. Security standards were increased in the year ended March 31, 1987, and the associated costs were taken into account in the permitted maximum from April 1, 1988.

VII. The appropriate treatment of commercial income

7.1 *HMG* argued that the return to be taken into account in deciding whether user charges were just and reasonable was the difference between the user charges in question and the operating costs of providing the airport services and facilities in question. At Heathrow, in 5 of the 6 years of the Arbitration, the latter costs exceeded the revenues from the charges; only in the first of the 6 years did the revenues exceed the costs, and then only by £1.6 million; for the 6 years as a whole the "loss" on traffic activities amounted to £37.8 million. Thus, according to HMG, more than the whole profit of the airport was derived from the commercial activities there.

7.2 For the reasons already given at paragraphs 4.1-4.7 of Chapter 6, above, the Tribunal is unable to accept that contention and takes the view that BAA's commercial income must be brought into the reckoning in any assessment of rate of return for the purposes of Article 10(1) and (3) of Bermuda 2.

VIII. USG's submissions and principal evidence that the rate of return was unreasonably high and that HMG failed to use its best efforts to prevent or remedy that state of affairs

(a) *The "single airport" approach versus the "system" approach*

8.1 USG conceded that in theory and under appropriate circumstances Bermuda 2 could permit user charges at an airport to be set at a level that would provide returns on assets at another closely associated airport. However it contended that, in assessing the reasonableness of the level of user charges at Heathrow in the circumstances of the present case, it was the rate of return earned by BAA at Heathrow and only at Heathrow that was relevant; the fact that BAA might earn a lower rate of return at the South East Airports as a group was, in USG's view, irrelevant. HMG had itself publicly recognized that cross-subsidies between BAA airports would distort the demand for air transport between the airports in the London system and airports in other parts of the country; and the RPI-X price-cap that it had adopted for BAA regulated charges at Heathrow separately and at Gatwick separately as well as for the South East Airports system as a whole, expressly so as to limit the scope for rebalancing the charges as between Heathrow and Gatwick. Article 10(3) of Bermuda 2, by its reference to the relationship between charges and the cost of providing "appropriate" airport facilities and services effectively incorporated a requirement that only "used and usable" assets should be included in the rate base used in connection with the regulation of charges at Heathrow. Although Gatwick and Stansted had been developed as overspills for Heathrow and relieved congestion at Heathrow, users of Heathrow could not be said to benefit from Gatwick and Stansted because they did not use the facilities there.

8.2 USG had, it said, never argued that each airport should have the same rate of return: it might take years before a new enterprise, especially one with high capital costs such as an airport, earned any accounting profit. During that period, its profitability would be below that of a successful established airport such as Heathrow. Secondly, as Professors Brealey and Myers said in their principal written evidence for USG, "Of course charges at airports with more congested facilities should be higher than those with less congested facilities". But those considerations provided no reason why Heathrow users should subsidize Gatwick and Stansted instead of the owner of each of those airports, in its capacity as such, looking for an adequate return on its investment in the long term, as it would in competitive conditions. If necessary, Professors Brealey and Myers testified, non-distortive subsidies could be provided to promote the development of the alternative facilities that were required.

8.3 Professors Brealey and Myers, in their principal written evidence given on behalf of USG, took the view that the correct way to achieve the necessary differentials between the charges for the more congested facilities at Heathrow and the less congested facilities at Gatwick and Stansted was by means of non-distortionary government subsidies to the latter rather than by

permitting BAA to achieve a reasonable level of profitability on the operation of the three airports taken together, if this would mean that the profitability of Heathrow taken in isolation would be unacceptably high.

8.4 On this issue USG concluded that BAA was a monopolist and required to be separately regulated at Heathrow. USG's case on level of charges was therefore put forward exclusively on the basis of the rate of return at Heathrow.

(b) ***The "rate base"***

8.5 The expression "rate base" was used by USG to denote the assets as a percentage of which the return was to be expressed to arrive at the relevant rate of return. Enlargement of the rate base will reduce the percentage rate of return (unless the enlargement results from inclusion of revenue-producing assets and they generate at least proportionately great additional revenue).

(i) Inclusion of "investment properties" in the rate base

8.6 "Investment properties" may be defined as land and/or completed buildings which are held for their investment potential, any rental income being negotiated at arm's length; properties occupied by the owner or by an associated company, in either case for its own purposes, are excluded from the definition of investment properties. It is a characteristic of investment properties, as that expression is used for the purposes of U.K. generally accepted accounting practices, that the disposal of the properties would not materially affect the manufacturing or trading operations of the enterprise. In computing rates of return, whether for Heathrow alone or for the South East Airports as a system, BAA included, in the return, income derived from investment properties and, in the asset base, the book values of those properties.

8.7 USG's case as put forward in its First Memorandum would have confined the "rate base" to assets at Heathrow "airport" (using the expression "airport" as it is defined by Article 1(d) of Bermuda 2, *viz.* "a landing area, terminals and related facilities used by aircraft"):

> 'The United States does not contend that [the provisions of [Article 10(3)] of Bermuda 2 require an exact correspondence between particular charges and the particular airport assets used by a carrier. The text does not so provide and such an interpretation would not correspond to charging practice in either country. But unless a significant connection exists between charges paid and the assets upon which a rate of return is included, the charges violate Bermuda 2."

Elsewhere in its First Memorandum USG expressed the same point by stressing that assets had to be used by the airlines if they were to be included in the rate base.

8.8 The principle enunciated by USG which is quoted above, would unconditionally necessitate the exclusion of investment properties from BAA's rate base. However, elsewhere in its First Memorandum USG adopted the position that *either* investment properties should not have been included in

BAA's relevant asset base or users should have benefited from their capital appreciation (in the sense that that appreciation should have been included in the return, and profitability should thus have been judged by reference to an *economic* rate of return). USG's conclusion was that in any event there had to be a satisfactory and consistent treatment of BAA's "non-operational property" at Heathrow.

8.9 In its Second Memorandum USG's position significantly altered in that it then firmly contended that capital appreciation, including the substantial capital appreciation of BAA's investment properties at Heathrow that has in fact occurred, *had to be* included in profits when determining Heathrow's earnings under Bermuda 2 (and the inter-governmental MoU). This followed USG's espousal of the use of economic rates of return, which include capital appreciation, whether or not realized, in the figure for profit: clearly, if the capital appreciation of investment properties was to be included in profit for the purposes of computing the relevant rate of return, the capital value of the investment properties themselves had to be included in the rate base.

8.10 On September 17, 1991, after completion of the substantive hearing, the Tribunal advised the Parties by letter that it thought that it could be assisted if they were to furnish it with figures for the rates of return in issue in the proceedings if investment properties were excluded from their calculation.

8.11 Accordingly, the Tribunal invited the Parties to make any proposals that they might wish for enabling the Tribunal to be supplied with figures for the rates of return in issue in the proceedings if investment properties were excluded from their calculation. The Parties found themselves unable to agree on how the Tribunal's request might best be satisfied and under cover of a letter dated November 21, 1991, HMG filed with the Tribunal calculations:

(a) that excluded investment properties at the time when they were first defined as such;

(b) that excluded those properties throughout the Arbitration period;

(c) that treated the properties as if they had never been reclassified as investment properties.

8.12 By a submission sent to the Tribunal under cover of a letter dated April 15, 1992, USG strongly objected to any consideration by the Tribunal of the rates of return at Heathrow without the investment properties. It did so on the basis that such an analysis would violate the inter-governmental MoU and would have no basis in Bermuda 2; that no expert economist or accountant had given testimony that endorsed the notion that the rates of return could or should be computed without the investment properties for the purposes of the present Arbitration; that HMG by its First Memorandum had pleaded that investment properties had been, and had properly been, included in the relevant rate base; and that thereafter there had been no issue about this on the pleadings which USG was required to address. Finally USG raised a large

number of technical issues about the practicality of excluding investment properties, at least on the basis of the evidence before the Tribunal on a number of relevant questions, and about the nature of, and the methodology underlying, the calculations put forward by HMG in the calculations that it had filed with the Tribunal in November 1991.

(ii) Inclusion of Assets In Course of Construction in the rate base

8.13 USG pointed out that Assets in Course of Construction ("AICC") had been included in the rate base. Thus the user charges paid by U.S. carriers included a rate of return on assets usable only in the future, quite possibly by other users. Bermuda 2 precluded the adoption of such an approach: AICC were not "facilities" that could be used, nor were they currently "appropriate" for any need of the U.S. carriers. Although, USG said, there was some U.S. case law that supported inclusion of AICC in the rate base, it was inapplicable to circumstances such as those here under consideration; the appropriate course here would have been to roll-up in the capital values of the resulting assets the interest on Average Funds Used During Construction ("AFUDC") which avoided inequitable discrimination against present users in favour of future users and bore a greater affinity to the competitive outcome.

8.14 The AICC included in the Heathrow rate base were quantified by USG absolutely and as percentages of the total rate base during the Arbitration period as follows:

TABLE 8.14

	£ million	**Percentage of total Heathrow rate base**
1983/84	£99.1m	19.7%
1984/85	£154.9m	25.9%
1985/86	£100.7m	15.0%
1986/87	£16.7m	2.3%
1987/88	£24.4m	3.1%

As an ancillary point, USG observed that to the extent that any interest or financing costs had also been included in the rate base, they should be excluded or, given the inclusion of AICC, BAA would be getting double recovery of development costs. (Since the amounts involved were, on the evidence given on behalf of HMG, not material, this point is not considered further in this Award.)

(iii) Use of CCA rather than HCA

8.15 As pointed out at paragraph 2.4 of this Chapter, above, use of CCA rather than HCA, enlarges the figure for the rate base, but for the reasons there given, this raises no issue for determination by the Tribunal. However, USG raised one specific criticism of the way in which, as it believed, BAA's CCA figures were prepared, namely that USG believed that BAA's airport facilities were valued in its accounts at their reproduction cost rather than, as they should have been for CCA purposes, at the cost of duplicating today their productive capacity (that belief turned out to be erroneous and is not consIdered further in this Award.)

The regulatory system operated by HMG

8.16 With reference to the regulation of profitability prior to privatization in 1987, USG commented briefly that the performance targets set by agreement between BAA and HMG could hardly be considered meaningful regulatory scrutiny since during that period HMG and BAA were not independent actors.

8.17 With regard to the use of RPI-X price formula (described at paragraphs 6.1 *et seq*. of this Chapter, above) USG said that it did not claim that the formula could not be used successfully under a regulatory system such as Bermuda 2, which requires that rates be "just and reasonable"; however, the actual formula, as it was applied, was in fact no substitute for HMG's obligations under Bermuda 2 and the inter-governmental MoU. In particular:

(a) Pre-privatization charges were excessive; regulation of post privatization charges took those excessive pre-privatization charges as their starting point. Reduction of those charges in real terms by 1 per cent a year provided no assurance that post-privatization charges would be or were reasonable.

(b) As applied by BAA, the formula merely embedded BAA's monopoly profits into the level of charges at Heathrow. HMG had exercised no meaningful check on BAA's rate of return prior to 1986. To the extent that BAA's "rate base" (i.e. the capital value of the assets that were used and usable by the airlines) was influenced by reason of the earning before then of monopoly profits, even a fair return on that rate base thereafter would reflect capitalized value of those monopoly profits and would, *a fortiori* and forever, be excessive. Since BAA's investment properties at Heathrow were revalued on April 1, 1988, from £89.0 million to £332.4 million, the effect of the revaluation could not be dismissed as immaterial.

(c) The value of X was not set by HMG as it ought to have been, namely in order to make BAA cut costs and achieve ever-greater efficiency; rather HMG decided what earnings it desired for BAA and set the value of X accordingly so as to allow BAA to maintain its pre-privatization level of profits without increasing efficiency.

(d) The control by the formula of increases in the average total of user charges per passenger rather than of increases in the user charges themselves was defective since the former was liable to rise less rapidly than the latter due to traffic, in response to the increases in charges made by BAA itself, moving away from higher charges to lower ones ("the dilution factor").

(e) The five-year periods during which the formula remained unchanged were too long; profitability could rise to excessive levels within a quinquennium with no possibility of a remedy for a considerable time.

The economic rates of return earned by BAA

8.18 In the view of USG, the only reliable way to measure the reasonableness or otherwise of the level of BAA's charges at Heathrow was to ascertain the economic rate of return earned by BAA at Heathrow and to compare that rate of return with BAA's cost of capital. Since BAA's cost of capital at Heathrow was lower than its average cost of capital, its operations at Heathrow being exposed to even less risk than BAA's other operations, the asymmetry of USG's comparison was, it said, favourable, rather than the reverse, to HMG.

8.19 USG's preliminary calculations, as set out in an Exhibit to its First Memorandum, suggested, USG said, that BAA's nominal post-tax rates of return at Heathrow were on the order of twice BAA's cost of capital for the six years at issue. These preliminary calculations indicated, according to USG, that the charges paid by U.S. carriers should not have included any component whatsoever to contribute to BAA's return of its cost of capital and showed that some £42.6 million constituted an excessive and impermissible return on assets[1].

8.20 The specific calculations of BAA's economic rate of return on assets was carried out for USG by Dr. Laurence Kolbe. Dr. Kolbe's calculations of rate of return related principally to Heathrow alone. Dr. Kolbe progressively refined his calculations in light of both additional information and comments by HMG's witnesses on his earlier calculations. In consequence Dr. Kolbe reduced his estimate of the *Internal Rate of Return* earned by BAA at Heathrow over the Arbitration period as a whole from 24.0 per cent to 19.4 per cent, though he accepted that if part of the appreciation in the value of BAA's investment properties were treated as unanticipated inflation and therefore removed from the final value of BAA's assets at Heathrow, the Internal Rate of Return fell to 18.3. Similarly he reduced his estimate of the

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[1] According to USG, total user charges paid by the U.S. airlines over the six years 1983/84 - 1988/89 was £79 million; according to HMG the figure was £70.6 million.

nominal CCA rate of return for Heathrow from 20.7 per cent (though perhaps as much as 22.7 per cent depending on the treatment of AICC in BAA's accounts) to 19.3 per cent or 19.4 per cent (depending on alternative treatment of tax liabilities) or (if the increase in asset values were spread in time in accordance with what HMG's expert value testified to be a realistic spread) 17.6 per cent or even, eliminating an element of the unrealized capital appreciation as being perhaps unanticipated windfall gain, 17.2 per cent, which Dr. Kolbe ultimately regarded as the bottom of the range.

8.21 The annual figures for the nominal CCA rates of return giving rise to the averages of 19.3 per cent, 17.6 per cent and 17.2 per cent respectively are shown in Table 8.21 below. It was effectively common ground that line 1 in the Table did not give a realistic picture since the high returns shown for 1987/88 - 1988/89 reflected revaluations of assets carried out in the two years in question whereas the appreciation of the assets to which the revaluations related had taken place over a substantially longer period. Lines 2 and 3 of the Table show the figures arrived at by Dr. Kolbe after he had spread the appreciation in asset values over the 6 years of the Arbitration period; this he did in the proportions that were said to be appropriate in the evidence of the expert valuer who gave evidence for HMG. Dr. Kolbe spread the whole of the appreciation over the 6 years of the Arbitration period and he confined it to that period notwithstanding the fact that, according to the evidence of HMG's expert valuer, some of the appreciation had occurred before the start of the Arbitration period. Dr. Kolbe proceeded on that basis because, in his view, whatever the actual temporal incidence of the appreciation, it was unacceptable to attribute any of it to years before the Arbitration period (and therefore to exclude it from the profits under review) when in 1983 there had been a settlement between USG and HMG of the dispute about the earlier years and no appreciation of assets attributable to those earlier years had been taken into account at the time of that settlement.

TABLE 8.21

Dr. Kolbe's ultimate figures for BAA's nominal CCA rates of return at Heathrow (including AICC)

	1983/84 %	**1984/85 %**	**1985/86 %**	**1986/87 %**	**1987/88 %**	**19888/89 %**	**6 year average %**
1. With actual CCA book values	8.9	11.3	13.1	4.5	21.1	56.5	19.3
2. With capital growth disclosed by 1988/89 revaluation spread over the 6 years as per HMG evidence	13.3	15.6	17.9	9.6	27.4	21.8	17.6
3. As 2, but eliminating an element of capital growth as being perhaps windfall gain	12.6	14.9	17.3	8.9	27.4	21.8	17.2

8.22 With regard to the BAA's cost of capital, to arrive at the risk-free rates of interest ruling during the Arbitration period Dr. Kolbe used the U.K. Treasury bill rate after corporate tax. He took the market risk premium for equities in general at the generally accepted figure of 9 per cent and, using as his source the latest edition of the Risk Measurement Service of the London Business School available to him when he prepared his principal evidence, he took BAA's *beta* as 0.75 (which implied that BAA's equity shares carried significantly below average risk for the investor). Since BAA shares had been traded on the International Stock Exchange (London) only since privatization in mid-1987, the time-series of share price movements available during the Arbitration period for the calculation of *beta* values was limited and Dr. Kolbe accepted that the relatively low *beta* of 0.75 was significantly affected by the relative stability of the BAA share price at the time of the October 1987 stock market "crash" which followed within months of BAA's flotation. As the crash receded into the past, share price movements at that time carried decreasing weight in the calculation of BAA's *beta*. In consequence, during the post-crash period the *beta* moved upwards from 0.67 (based on the Risk Measurement Service, April to June 1989) which Dr. Kolbe had used when making calculations underlying USG's First Memorandum to 0.77 in the Risk Measurement Service, April to June 1991 (i.e. 0.02 higher than the earlier figure of 0.75 used by Dr. Kolbe). Nevertheless Dr. Kolbe took the view that, in assessing BAA's cost of capital during the Arbitration period, it would be wrong to exclude the crash period, which formed part of the history as it had actually been.

8.23 Indeed Dr. Kolbe believed that, in assessing BAA's cost of capital at Heathrow for the purposes of the Arbitration, use of a *beta* value as high as 0.75 was favorable to HMG for the following two reasons.

(i) BAA's debt-to-debt ratio had risen from only 5 per cent at the beginning of the Arbitration period to approximately 16 per cent at the end of the financial years 1989 and 1990 (i.e. after the end of the Arbitration period but within the period used to estimate BAA's *beta*); as the period for measuring beta was extended into 1990, the influence of BAA's increasing debt meant a higher beta for BAA equity shares (i.e. as gearing increases, the risk incurred by an undertaking falls increasingly on the holders of a smaller proportion of the total capital of the undertaking - the holders of the equity shares - and therefore bears proportionately more heavily on them).

(ii) The ratio of BAA's fixed costs to its revenues ("operating leverage") at Heathrow was, Dr. Kolbe said, almost certainly lower than at its other airports, conducing to higher and more stable profits at Heathrow; BAA's cost of capital at Heathrow was therefore lower than BAA's cost of capital overall.

8.24 Having revised his calculations, Dr. Kolbe arrived at a weighted average cost of capital for BAA of 12.8 per cent, or if the figures were

adjusted to reflect the March 1989 capital structure, 12.1 per cent. Dr. Kolbe's view was that the 12.1 per cent value was probably closer to Heathrow's cost of capital than the 12.8 per cent.

8.25 In commenting upon the alternative figure of 15.2 per cent put forward on behalf of HMG by Professor Franks, Dr. Kolbe agreed that the differences attributable to Professor Franks's use of one year inter-bank rates rather than 3 month Treasury bill rates were very small. Dr. Kolbe further agreed that it was not possible to take a strong stand on the choice of corporate tax rates, which Dr. Kolbe had used, rather than personal tax rates, which Professor Franks had used, although Dr. Kolbe, and Professor Brealey, both believed that corporate rather than personal tax rates should be used. Finally, Dr. Kolbe agreed that the difference made to the end-result by use of the higher value for *beta* espoused by Professor Franks, rather than the lower value espoused by Dr. Kolbe, was 1.8 per cent. Dr. Kolbe's figures for BAA's cost of capital (without adjustment to reflect the March 1989 capital structure), with Professor Franks's figures shown beneath them for ease of comparison, are set out in Table 8.25 below.

TABLE 8.25

Estimates of BAA's cost of capital

	1983/84 %	**1984/85 %**	**1985/86 %**	**1986/87 %**	**1987/88 %**	**1988/89 %**	**6 year average**
1. As per Dr. Kolbe	10.9	11.8	13.3	13.2	12.5	15.1	12.8
2. As per Prof. Franks	15.34	14.41	16.46	15.36	14.97	13.85	15.1

8.26 In commenting upon the gap between USG's calculations of BAA's weighted average cost of capital (12.1 per cent to 12.8 per cent at a *beta* value of 0.75) and its estimates of BAA's average economic rate of return (17.2 per cent at the bottom of the range), Professor Brealey testified that if a company made efficiency gains unexpectedly, one would expect that it would make a return in excess of its cost of capital. Similarly if the economy went up unexpectedly, one would expect companies to make a return in excess of their cost of capital; it was the expectation that counted. Professor Brealey said that he certainly would not recommend that BAA's charges should have been reduced to the point at which BAA would have earned simply its cost of capital over the six years of the Arbitration period, although he believed that the gap in the present case was excessive.

8.27 Professor Brealey specifically identified an unexpected increase in the property market as an example of the kind of unexpected development that could result in a return in excess of cost of capital. And Dr. Kolbe testified that the effect of the revaluation of BAA's investment properties towards the end of the Arbitration period had been greatly to magnify the returns in excess of cost of capital earned by BAA during the period. Like Professor Brealey, Dr. Kolbe agreed that gains realized in excess of the cost of capital were not necessarily monopoly profits.

IX. HMG's defence in respect of the level of BAA's charges at Heathrow

9.1 With regard to the first four years of the Arbitration period, HMG pointed out that the charges set by BAA, as a nationalized undertaking were subject to supervision by HMG of a kind that HMG exercised generally over such undertakings. In exercising its supervisory role, HMG's express policy objective had been that nationalized undertakings should use resources efficiently and that they should produce a return to the nation comparable to that which they would have achieved elsewhere in the economy.

9.2 During the pre-privatization period BAA had been required to provide to the U.K. Department of Transport monthly income and expenditure compared to budget, quarterly borrowing and lending, quarterly sources and application of funds, quarterly expenditure on fixed assets and annual use of external finance.

9.3 In addition, under Article 73 of the Air Navigation Order 1980 and Article 76 of the Air Navigation Order 1985, the Secretary of State for Transport had the power at any time to direct BAA to alter its charges if he considered that they were not in accordance with Bermuda 2. However, the Secretary of State had never exercised those powers, in particular because his Department had regularly monitored the level and structure of the charges and involved itself in the formulation of those charges every year and had engaged in a continuing dialogue with BAA on nationalized industries' pricing policy.

9.4 More particularly, HMG explained, BAA's user charges were formulated by BAA and approved by HMG against a background of (i) a financial target for BAA set by HMG and expressed as a CCA return on capital employed, (ii) a required rate of return on new investment (which over time could be expected to be close to the financial target) and (iii) performance targets.

9.5 For the first three years of the Arbitration period, 1983/84 through to 1985/86, BAA's financial target implied a projected CCA rate of return for BAA as a whole of 4.7 per cent (budget figures) or 5.6 per cent (planning figures). In the fourth year, 1986/87, the financial target was 5.5 per cent plus one-fifth of the percentage growth in terminal passengers in the year.

9.6 Performance targets set for BAA for the same three years looked to a reduction in costs per terminal passenger, varying according to growth in passenger traffic and rising to, for example 6.5 per cent in the three years if

the growth in that period amounted to 15 per cent. The opening of Terminal 4 led to an expectation of a temporary decline in labor productivity until capacity was again more fully utilized.

9.7 HMG further recalled that under the 1983 Airlines Settlement Agreement the airlines, including the U.S. airlines, effectively accepted the charges that had been proposed by BAA for 1983/84. HMG observed that, from that starting point and under the régime described above, although Heathrow's trading profit had grown by 19 per cent between 1983/84 and 1986/87, inflation had been 15 per cent and the number of passengers had grown by 18 per cent. In consequence, Heathrow's trading profit per passenger had fallen in real terms. This has been the result of:

(i) real reductions in both revenue and expenditure per passenger;

(ii) a real reduction in expenditure per passenger which was smaller than the real reduction in revenue because of the increase in the depreciation charge in 1986/87, following the opening of Terminal 4; and

(iii) a real reduction of 16 per cent in revenue per passenger from traffic operations.

9.8 Thus, in respect of the period before privatization HMG here relied on:

(i) its retention of a statutory power to prescribe charges to ensure conformity with Bermuda 2; and

(ii) the steps that it had actively taken throughout the period to fulfil its "best efforts" obligation.

9.9 With regard to the fact that the methodology that it had adopted in fulfilment of that obligation had involved review and control by reference to, generally, accounting rather than economic profitability and in particular CCA rather HCA profitability, HMG drew attention to the fact that in the 1983 litigation the U.S. airlines, amongst others, had used accounting profitability as the relevant yardstick and neither they, nor (until the present proceedings) USG, had referred to economic profitability as constituting the yardstick which, under Bermuda 2, HMG was required to use.

9.10 Passing to the post-privatization period, HMG explained the rationale for the adoption for BAA of an RPI-X price-cap formula. Régimes that were similar in nature had been adopted for a number of other privatized undertakings, the prices or charges of which required regulation.

9.11 In the view of HMG, the main disadvantage of *rate-of-return* regulation, as opposed to *price-cap* regulation, was that it did not provide an incentive to efficiency because any gains in efficiency were (more or less) immediately passed on to customers. In particular, it encouraged over-investment and led to cost-plus pricing. Furthermore, it could result in protracted negotiations over price increases between the companies an their

regulatory bodies, for which large bureaucracies developed. In effect this amounted to continuous regulation, with the regulatory body taking all strategic decisions. For those reasons, in many instances rate-of-return regulation did not operate in the interests of consumers.

9.12 HMG said that it could be argued that price-cap regulation was just rate-of-return regulation with a time lag because the rate of return was one of the factors taken into account in setting and reviewing the price-cap. However, the differences between the two systems were sufficiently important to support the claim that price-cap regulation was superior to rate-of-return regulation because it provided an incentive to efficiency by allowing a company to keep the rewards of better-than-anticipated cost reductions during the period between reviews. At the time of a review, the regulatory body could decide how efficiency gains were to be distributed between a company and its customers. Under a rate-of-return régime, there would probably be no gains to distribute.

9.13 If, between reviews, the regulated concern were able to earn above-average returns as a result of exceptional improvements in efficiency, in the view of HMG that was reasonable, especially as the greater efficiency ultimately enured to the benefit of the customers of the concern.

9.14 The Tribunal here observes that, contrary to what was implicit in HMG's contentions, on-going review by HMG of the reasonableness of BAA's rate of return within a quinquennium would not destroy all the claimed advantages of the RPI-X price-cap régime as applied to BAA, although it would involve an element of asymmetry. As to the asymmetry, an unexpected elevation of BAA's profitability due to, for example, an unexpectedly high level of traffic within the quinquennium was liable to lead to HMG imposing on BAA in the course of the quinquennium an enforced reduction of charges, whereas the price-cap régime made no provision for an ameliorative revision of the formula in the course of the quinquennium in the event of an unexpected depression of BAA's profitability due to an unexpectedly low level of traffic. But, given the obligations accepted by HMG under Bermuda 2, the asymmetry results from its own voluntary act in adopting an RPI-X price-cap system of regulation. Moreover, an elevation of profitability within a quinquennium that is demonstrated to have resulted from exceptional measures to improve efficiency beyond those that the regulator was entitled to look for in any event is not unreasonable.

9.15 HMG drew attention to the fact that NERA, an experienced economic consultancy organization, had recommended adoption of a price-cap formula for BAA and that subject to modification of certain details of NERA's proposals, HMG had accepted the recommendation.

9.16 HMG claimed that, having decided to adopt a price-cap formula, it recognized the importance which the 1986/87 charges would have as the base year charges for determining the value of X in the RPI-X price-cap formula.

With regard to the 1986/87 charges themselves, BAA therefore submitted them to the Secretary of State at an earlier stage than usual.

9.17 The consequential review undertaken by the responsible officials within the Department of Transport concluded that, at 3.8 per cent increase overall, the charges represented a marginal price fall in real terms, whilst achieving an acceptable rate of return of around 6.7 per cent; BAA were right to point out to the airlines that current real rates of return were high, with risk-free interest rates of around 7 per cent in real terms; compared with the Bank of England September 1985 estimates of average real returns on capital of 11 per cent achieved by larger industrial and commercial companies the total BAA return was low, whilst that at Heathrow, at 8.4 per cent was not at all unacceptable - contrary to the claims of the U.S. airlines.

The Financial Model

9.18 Having decided on price regulation through an RPI-X formula, it had then been necessary for HMG to consider the choice for a value of X, given two considerations which at the time the responsible officials identified as relevant:

(i) the need to secure HMG's position with respect to international obligations, which, *inter alia*, specified that airports should not earn more than a reasonable rate of return;

(ii) the need to ensure that BAA would be able to continue as an on going concern and undertake the continued expansion of London's airports to meet expected demand.

9.19 The steps taken by the Department to establish the value of X are described in contemporaneous material which amplified the evidence of the principal British official who had been concerned. As appears from that material, in order to provide what it believed would be the best possible basis for determining the value of X, the Department of Transport and BAA used a financial model developed by BAA to carry out a detailed analysis of BAA's likely trading performance and potential financial structure over the period 1986/87-1991/92.

9.20 As a result of its discussions with BAA, the Department finally agreed estimates of BAA trading performance in the base year (1986/87) and each year of the first quinquennium. Those estimates were then presented for three traffic scenarios:

(i) a "high growth" case, in which traffic was projected to grow by about 5½ per cent a year;

(ii) a "central" case, which represented the Department's best estimate, in which traffic was projected to grow by about 4½ per cent a year; and

(iii) a pessimistic "low growth" case, in which traffic was projected to grow at less than 3 per cent a year;

and for three different values of X (X = 0, X = 1, X = 2).

9.21 The central financial projections reflected what the Department believed to be the most likely pattern of development in BAA's business over the next 6 years. The Department noted that, with the opening of several new tranches of terminal capacity at the South East Airports, culminating in Stansted's opening in 1991/92, the recent steep downwards trend in BAA's operating costs per passenger was faltering and the rise in CCA trading profits seen over recent years was being dampened. Nevertheless, continued increases in efficiency were envisaged in the central scenario, with increasing numbers of passengers per employee and falling real costs were passenger.

9.22 With unusually high capital expenditure commitments to complete the delayed North Terminal at Gatwick, to refurbish Heathrow's T3 and to develop Stansted, BAA's cash demands were expected to exceed internally generated funds and it was expected that new borrowing would be necessary. The foregoing features of BAA's prospects were expected to be reflected in an increasing level of debt on the balance sheet, an increasing depreciation charge, and relatively moderate growth in CCA trading profits over the period - under any scenario for X and the initial level of additional debt.

9.23 The low and high financial projections showed the great importance of traffic growth to BAA's financial performance and, in the view of the Department, gave an indication (in the low case) of the potential business risks.

9.24 The differences between the Department's (more optimistic) and BAA's (less optimistic) projections of traffic growth and costs per passenger had the effect, according to HMG, of increasing the forecasts of BAA's profits, for any given value of X, by £30 million, or about 25 per cent, by 1991/92.

9.25 In interpreting the results of the exercise, it had been necessary to bear in mind a number of constraints that would be applicable to a private sector company in the position of BAA, as advised to the Department by its outside financial advisers. Expressed in HCA terms, those constraints were that:-

(i) the debt-equity ratio should be no greater than 40 : 60: alarm bells might ring in the minds of investors if "gearing" reached 50 per cent;

(ii) interest cover should be no less than 4 times;

(iii) dividend cover should be no less than 2.5 times;

(iv) pre-tax profits should not decline in real terms after 1986/87.

9.26 Applying those constraints to the HCA output for the central traffic growth case (see paragraph 9.20(ii) of this Chapter, above), both interest cover

and dividend cover were regarded by the Department as satisfactory throughout. Gearing ratios were also within the constraints, but only just, with £75 million additional debt: in the view of the outside advisers, it would be unwise to plan on a basis that gearing should rise so close to the prudential limit, bearing in mind that, on the low traffic forecast, injection of £75 million of additional debt would produce excessive gearing if X were 1 or 2.

9.27 According to the contemporaneous commentary, the forecast growth in profits before tax, either on a CCA or an HCA basis, was relatively modest, even on the central traffic forecast. This reflected increased operating costs and financing charges as new facilities opened, as well as the assumed value of X. If X were set at 2, HCA pre-tax profits would actually fall in money terms, and therefore quite substantially in real terms (except when, contrary to what was expected, there was no additional debt) and return on capital employed would decline quite sharply, reflecting not only the fall in profits but also the expected level of additional fixed assets.

The Department's views

9.28 The Department believed that if it were to persuade BAA to accept that X should be higher than 0, it would need to meet the following arguments:-

(i) Any value of X greater than 0 was projected to produce no real growth in CCA post-tax profits (and a decline from 1985/86, which was an exceptional year with very low unit operating costs due to nearly 100 per cent utilisation of terminal capacity).

(ii) Return on capital employed would be hardly sparkling. Although the overall CCA returns at 6 per cent - 7.1 per cent might be below the U.K. average (11 per cent), they compared reasonably well with the U.K. average (8 per cent in 1984, but rising), when one took out the oil sector, and BAA was less exposed to risk than most companies, being a monopolist in a high growth industry which rarely if ever experienced a drop in business volumes. The Department believed that it also had to bear in mind that with an RPI-1 formula, BAA could increase the CCA return at Heathrow (nearly 10 per cent in 1985/86) to about 13 per cent by 1991/92. That would become apparent to the U.S. airlines and would have to be defended.

(iii) CCA dividend cover was barely adequate with no additional debt, and was projected to drop below 1 with £30 million of additional debt. As the Department believed, BAA would argue that that level of CCA cover was not sustainable over time, since a stable company should not distribute to its shareholders more than it earned, after allowing for replacement of its assets, and a growing company would normally expect to distribute less.

9.29 Officials at the Department were conscious of the fact that (despite the fact that the higher the value of X, the lower would be the proceeds of sale

on the privatization of BAA in which the U.K. Treasury had an interest), the Treasury were disappointed that those dealing with it at the Department felt constrained to recommend a value for X of 1 rather than 2. The Department officials also expressed their recognition of the fact that Ministers would be similarly disappointed. However the Department officials had concluded that, at any value of X in excess of 1, BAA would not be able to operate in accordance with the prudential constraints that would govern it as a company in the private sector, as those constraints, in their specific application to BAA, had been identified by HMG's independent financial advisers.

9.30 The Department officials were also influenced by the argument that a value of X as high as 2 would make it more difficult for BAA to remunerate required capital investment. The most vulnerable point in HMG's privatization policy for BAA was perceived within the Department to be that it was not doing enough to ensure that BAA would provide sufficient capacity to meet demand or to ensure that BAA had incentives to encourage traffic growth rather than the growth of non-aeronautical activities. The Department has considered in detail the possibility of making the price-cap formula variable within quinquennia if BAA appeared to be under-investing or making excessive returns. However the Department had concluded that BAA had a commercial interest in expanding capacity so as to avoid loss of commercial takings due to congestion and loss of traffic to the fiercely competitive Continental hubs for interlining traffic.

9.31 If BAA were tempted deliberately to run down its investment programme and invest elsewhere or distribute the resulting cash, the regulatory system should operate to discourage it from so doing. First, there would be the threat of severe treatment at the quinquennial review of the formula. But if BAA were tempted to take a more short-term view, there would be the threat of a direction from the Secretary of State, which could amend the formula, because BAA was no longer complying with international obligations that charges should be related to costs and allow only a reasonable rate of return on assets. The airlines would certainly keep a close watch on the rate of return on assets and be quick to protest if they saw it becoming excessive.

9.32 In light of the foregoing the Department favored a price regulation formula for BAA's London airports as a whole of RPI-1, with no more than £30 million additional initial debt (the exact amount to be decided later in the light of market conditions nearer the time of flotation). It believed that that formula should provide a stimulus to efficiency, but allow a sufficient return to remunerate new capital investment. It further believed that it should be defensible to airline customers since it would provide an assurance of continuing real reductions, but it would not appear to be so onerous as to make the market perceive BAA as heavily regulated.

9.33 As noted at paragraphs 6.1 and following of this Chapter, above, HMG adopted an RPI-1 price-cap formula of the kind favored by the

Department. With regard to the details of the formula HMG further explained to the Tribunal why it favoured application of the cap to average revenue yield per passenger rather than to the “traffic basket”; use of the Retail Price Index rather than an index of costs specific to BAA; use of forecast inflation plus a correction factor (biased in favour of under-estimating and against over-estimating future inflation) rather than actual (i.e. past) inflation; and the making of an allowance for changes in security costs but not changes in capital expenditure plans.

Profitability of the South East Airports as a “system” and profitability of Heathrow in isolation

9.34 With regard to whether the profitability generated by BAA’s South East Airports as a whole (described by HMG as the South East Airports as a “system”), rather than or as well as the profitability generated by Heathrow in isolation, was relevant to an application of the reasonableness of user charges at Heathrow, HMG contended that the profitability of the system was highly relevant.

9.35 HMG drew attention to the fact that Gatwick and Stansted had been developed as overspills for Heathrow and that they relieved congestion at Heathrow. HMG further relied on the proposition that charging should encourage the use of the less congested facilities and that if charges for highly congested airport facilities were set below the charges for facilities at less congested airports, then users would be given perverse incentives to increase their demand for the more congested facility.

9.36 HMG further contended that, applying principles that were familiar in the field of antitrust law, the South East Airports formed a single market. An associated economic test of the “separateness” or otherwise of Heathrow and Gatwick was, HMG said, the degree to which their costs and revenues were independent of each other. In truly separate markets, the actions of a producer in one market would not affect the costs and revenues of a producer in another market. That was clearly not so in the London airports’ case. The costs of developing Gatwick arose because of the exclusion of traffic from Heathrow and the diversion of its growth to Gatwick. Similarly the revenues from airlines and passengers at Gatwick had resulted largely from the exclusion of that traffic from Heathrow.

9.37 HMG also relied on the differences in the “maturity of investment” at each of the three South East Airports as necessitating use of a single rate of return for the whole system, taken over time, in order to measure profitability for the purposes of Bermuda 2. However, HMG did not develop that argument in the written expert evidence tendered on its behalf; Mr. Lawrence, a Chartered Accountant called on behalf of HMG testified orally that he did not think that any specific analysis had been done in respect of differences in maturity of investment as between Heathrow, Gatwick and Stansted and the effects of any such differences but that it exemplified part of the difficulty of looking at one airport that was operated as part of a multi-airport system.

Commenting on a paper prepared by Professor Brealey and tendered by USG in the course of the hearing as a result of a question by the Tribunal, HMG described the topic as a difficult technical area (and Professor Brealey's comments as controversial). In the circumstances, the Tribunal has concluded that it would not be right to have regard to the "maturity of investment" argument.

9.38 HMG denied that user charges at Heathrow were used by BAA to cross subsidize operations at Gatwick or Stansted. In this context HMG relied first on the fact that user charges generally did not cover "traffic costs" (a contention which the Tribunal has already dismissed in relation to the structure of user charges: see paragraphs 4.1-4.7 of Chapter 6, above). Secondly, however, HMG here also relied on the argument that, as it had been growth in traffic at Heathrow that had necessitated investment at Gatwick and Stansted, marginal cost pricing required that Heathrow users should pay for that investment to the extent, if any, that it was not paid for out of commercial income; HMG added that USG had not disputed the fact that absence of additional capacity at Gatwick and Stansted would have put additional strain on Heathrow, to the detriment of established airlines, such as PanAm and TWA. HMG summarized the benefits of Gatwick and Stansted to them as having been to:

(i) allow them more capacity than would otherwise have been available to them at Heathrow (the preferred location for most airlines, a fact that USG had not disputed);

(ii) reduce Heathrow congestion below the levels that would otherwise have existed; and

(iii) consign their competitors to less attractive airports.

9.39 HMG here further referred first to U.S. Court decisions which established that commercial income earned at one airport could properly be devoted to the financing of the construction of another airport being developed by the airport operator; secondly, HMG referred to U.S. Court decisions relating to utilities other than airports where a particular facility had been recognised to form part of an integrated system. Thirdly, HMG referred to the U.S. Budget Reconciliation Act which permitted the levy of passenger facility charges for financing development of *any* airport that the charging authority controlled.

9.40 With regard to USG's contention that the reference in Article 10 of Bermuda 2 to "appropriate facilities" was to be equated to "used and useful assets", HMG argued that the reference to appropriate facilities was intended to exclude charging airlines for excessively lavish facilities; "used and useful assets" was a term of art and if the Parties had intended to incorporate in Article 10 of Bermuda 2 a "used and useful assets" test they could easily have done so by using that expression itself.

Assets in Course of Construction

9.41 With regard to inclusion of AICC in the rate base, HMG relied on the fact that both U.K. general company law and generally accepted accounting practice actually *required* AICC to be shown in a company's balance sheet under the heading of tangible assets.

9.42 Mr. Lawrence, giving expert evidence on behalf of HMG, testified that adjustments to take out AICC were not normally made for the purposes of comparing the return on capital employed of different companies and that such adjustments were wrong in principle because the money that was invested in assets in the course of construction was just as much a part of the capital tied up in the business as the stock-in-trade of companies that had substantial stocks or inventories; it was part of the capital employed in the business tied up in assets which were not yet directly useful for the business but would be brought into use in the future. Mr. Lawrence said that in BAA's case, very little money had been invested in goods that were going to be used in the future in the same sort of way as were AICC; to start taking out a part of the assets on the ground that they had not yet been brought into use would be, in Mr. Lawrence's view, a "dangerous game to play".

BAA's accounting rates of return on capital employed

9.43 Table 9.43 below sets out the figures for the accounting (as distinct from economic) profitability for BAA, the South east Airports and Heathrow during the Arbitration period, together with comparable figures for returns on capital employed for British industry generally, as presented to the Tribunal by Mr. Lawrence, supplemented by one set of figures contained in HMG's first written memorandum.

TABLE 9.43

ACCOUNTING RETURNS ON CAPITAL EMPLOYED

	CCA					**HCA**				
	(1) Heathrow %	**(2) South East Airports** %	**(3) BAA as a Whole** %	**(4) "All [UK] industrial and commercial companies" (Note 1)** %	**(5) All [UK] industrial & commercial companies excluding N. Sea (Note 1)**	**(6) BAA as a whole (Note 2)** %	**(7) Top 1,000 U.K. companies (Note 3)** %	**(8) BAA as a whole (Note 4)** %	**(9) All [U.K.] industries (Note 5)** %	**(10) [All U.K. industries]: non-manufacturing excluding oil (Note 5)** %
1983/84	9.0	6.0	5.4	9	5	16.4	15.6	19.2	14.8	13.3
1984/85	10.0	7.6	6.9	11	5	17.2	16.7	20.3	16.4	14.6
1985/86	9.9	7.8	7.5	11	7	18.1	17.1	20.3	16.8	15.5
1986/87	8.7	7.7	7.6	9	8	14.9	17.7	16.9	15.4	16.0
1987/88	11.7	9.5	9.3	10	9	15.0	19.8	17.2	18.6	17.5
1988/89	8.5	5.9	N/A	11	10	10.5	19.8	13.5	20.1	18.3
Average	**9.6**	**7.4**	**7.3**	**10.1**	**7.3**	**15.3**	**17.8**	**17.9**	**17.1**	**15.9**

NOTE 1: Columns (4) and (5) of the Table sets out figures published by the U.K. Department of Trade and Industry ("DTI") for "all industrial and commercial companies". The figures are based on national accounts data collected and published by the U.K. Central Statistical Office ("CSO"). The definition used to compile the returns on capital employed are as follows:

(a) Profit comprises gross operating surplus on U.K. operations, less capital consumption at current replacement cost (i.e. operating profit before interest and tax).

(b) Capital employed comprises the net capital stock of fixed assets (excluding land) at current replacement cost plus the book value of stocks (i.e. an unusual definition which is not the same as capital employed).

The source of column (5) is HMGs First Memorandum

NOTE 2: Column (6) gives figures for BAA on an Historical Cost Accounting basis (not a Modified Historical Cost Accounting basis). The figures are calculated as operating profits expressed as a percentage of closing capital employed (including short term borrowings).

NOTE 3: The source of the figures in column (7) is a survey published by Datastream, a company specialising in the collection and interpretation of published accounts in the U.K. The figures express the aggregate of historical cost profit before interest and tax for the sector as a percentage of the aggregate closing capital employed excluding intangibles.

NOTE 4: The figures for BAA in column (8) represent gross trading profit plus other revenue income and prior year adjustments, less depreciation as a percentage of the average net assets in the opening and closing balance sheets.

NOTE 5: The figures in column (9) are drawn from Section E of a DTI publication entitled "Companies in 1989-90", Section E of which contains company data provided by the CSO and relating to the top 2,000 and smaller industrial and commercial companies registered in the U.K. excluding companies whose main activity is insurance, banking or finance and non-profit making organizations. The methodology used is that described in Note 4.

9.44 With regard to the comparison of the CCA figures for BAA and components of BAA in columns (1), (2) and (3) of Table 9.42 with the figures for the U.K. industrial and commercial average, in column (4), Mr. Lawrence referred to considerations that suggested that the figures in column (4) tended to understate the average overall rate of return actually being earned.

9.45 Mr. Lawrence also compared BAA's return on capital employed, on one or another basis, with that of a number of individual U.K. companies and with sectoral returns as published by Datastream (see Note 3 to Table 9.42 above). Basing himself on an essentially comparative analysis using these and the comparisons reproduced in Table 9.42 above, Mr. Lawrence concluded that the accounting returns on capital employed achieved by BAA as a whole and at the South East Airports as a group and at Heathrow individually were reasonable. For reasons that will be apparent from the next following subsection of this Award, the Tribunal finds it unnecessary to discuss the criticism made by USG of Mr. Lawrence's analysis and conclusions.

9.46 Professor Franks criticized even Dr. Kolbe's final estimates of BAA's economic rates of return during the Arbitration period. According to Professor Franks, the economic rate of return at Heathrow during the period, adjusted to spread capital appreciation over all the years when, according to HMG's expert valuer, it took place, were as set out in Table 9.46 below.

TABLE 9.46					
Professor Frank's estimates of the economic rate of return at Heathrow					
1984	**1985**	**1986**	**1987**	**1988**	**1989**
10.3%	11.7%	11.8%	13.0%	16.6%	31.3%

The Internal Rate of Return for Heathrow for the entire Arbitration period was, on Professor Franks's calculations, 15.1%.

9.47 A part of the difference between Professor Franks's figures and Dr. Kolbe's was attributable to the fact that Professor Franks (unlike Dr. Kolbe: see paragraph 8.21 of this Chapter, above) spread part of the capital appreciation back to years before the Arbitration period. The remainder of the difference was due to use of different definitions and/or what Professor Franks claimed were inconsistencies in the approach used by Dr. Kolbe which fundamentally flawed that approach. There was considerable controversy as to whether Professor Franks's starting values included (as USG claimed and as Professor Franks denied) a capitalization of monopoly profits (if so, then, according to USG, Professor Frank's starting values were too high and, in consequence, his estimates of economic profitability during the Arbitration period were too low).

9.48 The principal cause of difference between Professor Franks's and Dr. Kolbe's estimates of BAA's cost of capital (as to which see Table 8.25 of this Chapter, above) was that Professor Franks used a beta of 0.95 compared with the figure of 0.75 used by Dr. Kolbe. Professor Franks arrived at the higher figure by excluding October 19, 1987 through to April 30, 1988 (the period which, according to Professor Franks, was affected by the October 1987 crash). Professor Franks claimed that that approach was commercially realistic and denied that it involved "data-snooping".

9.49 Professor Franks summarized his conclusions by saying that, applying USG's methodology, its complaints must be confined to the last two years of the Arbitration period and that the apparently high economic returns in those two years had nothing to do with the exercise of monopoly power but resulted from changes by BAA in its accounting conventions and from the very significant property boom in the south-eastern part of the U.K. during the final 2 years of the Arbitration period, resulting in a very significant increase in the values of BAA's assets classified as investment properties.

9.50 Finally Professor Franks testified that an economic rate of return earned by a company which exceeded its cost of capital was not necessarily evidence of monopoly profits but might result from increased efficiency or an appreciation in the value of assets held by the company due to generally favorable economic conditions.

X. The Tribunal's conclusions on the level of charges

10.1 In relation to the level of charges, the Tribunal is mindful of the necessity to bear in mind the specific issue with which the Tribunal is here concerned, namely whether HMG used its "best efforts" as required by Article 10 of Bermuda 2 - in the present context its best efforts to ensure that user charges should not provide for more than a reasonable rate of return on assets after depreciation.

10.2 The first question is whether that obligation required HMG to put in place a regulatory system that would have ensured that the economic rate of return on assets should not exceed BAA's cost of capital. If HMG's obligation under Article 10 did impose such a requirement, there can be no doubt that HMG failed to fulfil it.

10.3 The Tribunal here concludes that the obligation under Article 10 fell far short of imposing any such requirement. When Bermuda 2 was negotiated such regulatory systems were only beginning to be used in the United States; even by the date of the hearing in the present proceedings, they were still not used at all in the United Kingdom where only one regulator even made an explicit comparison of the economic rate of return of the regulated undertaking in question, British Telecom, with its cost of capital as a relevant process in establishing the value of X for the purposes of operating an RPI-X price-cap.

10.4 If the Parties had intended to require the general adoption of rate of return regulation by reference to the economic rates of return at Bermuda 2 airports compared with the cost of capital at those airports, it seems inconceivable that USG would not have referred to that intention at the time of the 1980-83 airlines' litigation, the 1983 Airlines Settlement Agreement and the 1983 inter-governmental Memorandum of Understanding. But USG did not in fact raise the use of a comparison of economic rates of return and cost of capital for any purposes connected with the implementation of Bermuda 2 until the present proceedings themselves.

10.5 Moreover the wording of Article 10(1) and (3) of Bermuda 2 is scarcely capable of bearing the required interpretation to impose such an obligation on HMG. The interpretation would in effect impose on HMG an obligation *to ensure that* user charges did not *provide* a more than reasonable rate of return on assets, after depreciation rather than to use *its best efforts to ensure* that user charges should not *provide for* such an unreasonable rate of return. Early drafts of Article 10 of Bermuda 2 did in fact allow for user charges to be based on, to reflect or to provide for (according to the draft) an "economic rate of return" but the word "economic" was then dropped from the text.

10.6 It follows that, in the view of the Tribunal, HMG did not go beyond the legal limits imposed by Article 10(1) and (3) of Bermuda 2 in omitting to establish a system of regulating BAA's charges directly by reference to the relationship between BAA's economic rate of return and its cost of capital.

10.7 Related to, but separate from, the question just discussed is the point that, contrary to what was implicit in some of the debate before, and evidence given to, the Tribunal, the Tribunal is not concerned whether BAA's return on assets at the relevant airport(s) *was* more than reasonable; the question that the Tribunal has to decide is whether HMG used its best efforts to prevent charges being set at a level that could be expected to give rise to such a return. In the present context, the distinction is very important not only because of the prospectivity of the exercise which, given the use of the expression "provide for", HMG was required to undertake. Of even greater importance here is the fact that the appraisal of level of profitability is capable of raising, and in the present case raised, a host of more or less technical accounting and economic problems.

10.8 A comparison of the economic rates of return with cost of capital, if undertaken (and whilst Article 10 of Bermuda 2 does not require such a comparison, it certainly does not preclude it), raises the problems discussed earlier in this Chapter, primarily in connection with Dr. Kolbe's evidence for USG. A comparison of the accounting rates of return with those of other hypothetically comparable, but competitively-placed, companies raises equally numerous and thorny problems, as the reply and rejoinder evidence of Mr. Newham, filed by USG, amply demonstrated. HMG contended that that evidence was inadmissible on procedural grounds. However, the Tribunal

finds it unnecessary to rule on that objection by HMG because it finds that Mr. Newham's evidence, although perceptive and interesting, makes no difference to the Tribunal's ultimate conclusion. The question is not whether HMG would have been better advised to have made the sophisticated allowances proposed by Mr. Newham when it assessed BAA's profitability by reference to BAA's profits and its capital employed. The question is whether, in making the efforts that it made in respect of level of charges, HMG did *its* best or whether one would have expected it to have done better if HMG's own pocket had been adversely affected by a more than reasonable level of profitability for BAA.

10.9 Before answering that question, there are two preliminary questions to be answered. First, whether the Tribunal should look at profitability (a) including or excluding investment properties and (b) at Heathrow alone or also at the South East Airports as a system.

Investment properties

10.10 USG has persuaded the Tribunal that, on the state of the written pleadings, BAA's profitability must be judged, for the purposes of these proceedings, by reference to the totality of BAA's "activities", i.e. not only the operational "traffic" and "commercial operations" but also the "investment properties". This might not be the approach that the Tribunal, left to its own devices, would have adopted since it might result in BAA being left a substantial latitude to raise user charges purely because the market for property in the Greater London area was currently depressed or because BAA had made ill-advised investments or even, for whatever reason, had conveyed interests in investment properties on unduly favourable terms to particular airlines. Nevertheless, the Tribunal accepts USG's submission that, for the purposes of the present Arbitration, the Tribunal is bound to take the figures with investment properties included in the capital employed and with allowance for the revenue from, and costs associated with, the investment properties in the figures for profit.

Heathrow versus South East Airports as a system

10.11 In the judgment of the Tribunal, Bermuda 2 requires one to consider the rate of return on assets at the airport in question in assessing whether charges at that airport exceed the full cost of providing appropriate airport facilities and services plus a reasonable rate of return on assets. But whether or not the return on assets at the airport is "reasonable" must be decided in light of all the circumstances that are relevant to the airport in question, including expected future demand and its economic implications for development of additional airport capacity.

The Tribunal's Conclusion

10.12 The Tribunal now comes to consider:

(i) whether HMG made *efforts* to ensure that throughout the Arbitration period user charges at Heathrow provided for no more than a reasonable rate of return on assets; and, if so,

(ii) whether those efforts are to be characterized as HMG's *best efforts*.

10.13 In the judgment of the Tribunal HMG's evidence establishes that throughout the Arbitration period HMG did make *efforts* to ensure that user charges at Heathrow would not provide for profitability at a level that was more than reasonable. In the first four years of the Arbitration period those efforts consisted of reviewing and approving the charges before they came into force. USG has contended that since BAA was wholly owned by HMG at that period, such control could scarcely be considered regulatory scrutiny since BAA and HMG were not independent actors at that time. That is true, but the relationship does not present a *prima facie* case of HMG's failure to meet its Treaty obligations. However, Bermuda 2 put the burden onto HMG to use *its* best efforts to ensure the required results regardless of that relationship.

10.14 Thus, the remaining question regarding level of charges that the Tribunal must determine in dealing with Question 1 is whether the efforts made by HMG in this regard may be characterized as HMG's *best efforts*. Again, as discussed elsewhere in this Award, Article 10 imposes obligations of conduct, and regardless of many other issues which might be relevant to a determination of damages, it is the task of the Tribunal at this stage in the proceedings to consider and analyze the factual behaviour of the Parties to ascertain whether their conduct was consistent with the mandates of Article 10.

10.15 For purposes of this analysis on the level of charges, the Tribunal will divide the Arbitration period into two periods, as broken down above: the period 1983/84-1986/87 and the period 1987/88-1988/89. This initial period will be examined first.

10.16 At the time of the settlement of the litigation and the Parties entering into the Intergovernmental MoU, the charges for the year 1983/84 had been set by BAA. The Tribunal concludes that HMG could rightly assume that these charging proposals were not challenged by the USG in view of HMG's undertaking to resolve the issue in the future. These proposals are relevant, however, in viewing HMG's conduct in subsequent years for reasons set forth below.

10.17 In reviewing the conduct of HMG during this period, in the first instance the Tribunal must look to what information was available to HMG, what calculations and figures were utilized by it in the performance of its obligations, what factors were brought to its attention, and whether the actions it took in response to these elements were reasonable in regard to its obligations.

10.18 The steps taken by HMG in the period before April 1, 1987, which may be used in evaluating its best efforts, may be grouped into four categories:

(a) retention of a statutory power to prescribe user charges;

(b) the setting of targets for BAA;

(c) the examination each year of BAA's charging proposals;

(d) involvement in the "medium-term review".

10.19 As recorded in paragraph 9.3 above, the Secretary of State with responsibility for aviation matters retained, for the period of the Arbitration up to 1986/87, power, under the Air Navigation Orders 1980 and 1985, to prescribe charges for the use of airports. For the reasons set out in paragraph 2.2.2 of Chapter 5, above, the Tribunal does not consider that HMG's "best efforts" obligation was satisfied solely by the retention of that power.

10.20 In accordance with its general policy for nationalized industries, HMG set a number of targets for BAA which may be briefly described as follows:

(a) A financial target: BAA was to seek to achieve, by way of return on its activities, a specified minimum percentage that was subject to an increase related to any growth in traffic.

(b) A first performance target (cost reduction): BAA was to seek to reduce its costs per passenger by a specified percentage (1983 - 1986) or amount (1986/7) per year.

(c) A second performance target (labor productivity): BAA was to seek to increase the number of terminal passengers handled per payroll hour by a specified percentage (1983 - 1986) or to seek to ensure that it did not fall below a specified minimum (1986/87). The performance targets (save the 1986/87 labor productivity target) were also subject to an increase related to any growth in traffic.

(d) A required rate of return on new investments: HMG sought to insure that resources invested by nationalized industries produced a return as if the resources had been used in the private sector. Throughout the period in question, the rate of return BAA was required to earn on its new investment programs was 5%.

10.21* The Tribunal confines itself for the moment to noting two particular features of these targets. First, each of them represented *minimum* goals which BAA was to seek to achieve and they were not accompanied by any limitation on the rate of return to be earned from its activities; indeed,

* The asterisked paragraphs contain the judgment of the majority of the Tribunal. Mr. Lever's dissenting Opinion is printed at the end of this Award.

HMG specifically stated, in a letter of November 12, 1984 from the Department of Transport to BAA's Chief Economist, that "the capping of the rate of return for *individual* airports" (emphasis added) would not be consistent with its policy for nationalized industries. Secondly, BAA's targets were set by HMG on the *assumption* that there would be no increase in real terms in Heathrow charges, but no requirement to that effect was imposed.

10.22* Each year BAA notified HMG of its charging proposals for its forthcoming financial year commencing on April 1 and of its consultations with the airlines thereon. The data supplied to HMG by BAA included the latter's estimates of the CCA rate of return on assets that would be earned from the totality of BAA's activities if the proposals in question were adopted. As can be seen from the following table, BAA's estimates exceeded, for two of the charging years, the percentage rate of return which, on the basis of BAA's budget traffic forecasts, was implied by the financial target set for it by HMG.

Year	BAA's forecast	Return implied by target
1983/84	[figure not yet traced]	3.4%
1984/85	4.6%	4.6%
1985/86	6.2%	5.9%
1986/87	7.2%	6.25%

10.23 Following the entry into force of the Settlement Agreement and the Intergovernmental MoU, BAA embarked, in consultation with users, on the "medium-term review" of the structure of charges as contemplated by those instruments. Although it was not directly a party to the consultations which began in August 1983 and concluded in 1984, HMG followed them and kept itself informed as to their progress.

10.24 As regards the question whether the steps described above may be said to constitute fulfilment by HMG of its "best efforts" obligation in the matter of BAA's rate of return, the Tribunal would in the first place recall two points to which it has already alluded. First, policy considerations cannot be relied on to justify a failure to use best efforts. Hence, the fact that HMG's actions during the period before April 1, 1987 reflected its general policy in the matter of nationalized industries cannot, irrespective of the merits of that

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policy, excuse a failure to take steps which the Tribunal considers should otherwise have been taken. Second, the obligation to use best efforts does not arise solely on receipt of a complaint. Nevertheless, the existence of complaints, especially when they take the form of a prolonged series of alleged grievances such as those voiced by USG and the U.S.-designated airlines from 1983 onward during this period in question, must be regarded as a relevant factor in assessing the sufficiency of the efforts deployed.

10.25* As the Tribunal has pointed out in paragraph 2.3.3 of Chapter 5, above, Article 10 of Bermuda 2, on its plain words, obliges the Parties to use their best efforts to ensure that a situation in which unjust and unreasonable charges are imposed on the designated airlines *shall not* arise. This suggests that, as regards the rate-of-return limitation contained in Article 10(3), a Party is not entitled to abstain from acting until such time as the rate of return provided for by user charges approaches or attains the unreasonable; on the contrary, if there are factors which would lead a reasonable Party to anticipate any excess profit, it follows that a Party is required to take preventive action calculated to ensure that the limitation in question will not be surpassed. What is more, taking preventive action before the event will in principle avoid the problem of determining how the situation should be remedied if an excessive rate of return is produced. In this connection, an obvious preventive action would be the imposition of some form of maximum, if not on the rate of return itself, at least on the quantum of user charges. HMG did not take any such step prior to April 1, 1987.

10.26* The Tribunal recognizes that a reasonable government in the position of HMG would reasonably have believed the imposition of such a maximum was unnecessary if it was perfectly clear that BAA's rate of return was unlikely to approach or attain an unreasonable level. However, the Tribunal considers that the following factors would have sufficed to cause such a government to conclude that the aforesaid state of affairs was not perfectly clear.

(a) The targets set for BAA by HMG included a cost-reduction target, the attainment whereof could have been expected to lead to an increased rate of return.

(b) A similar result could have been expected to flow from the fact that throughout the period in question BAA was subject to external financial limits, and thus was under an incentive to maximize profits to fund future capital projects.

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(c) For two of the charging years in question, BAA's own forecast of its rate of return exceeded the financial target set for it by HMG.

(d) A growth in traffic was expected, as is evidenced by the fact that all but one of the targets set by HMG for BAA included a built-in adjustment in this connection; yet, as HMG acknowledged, changes in the volume of traffic have little effect on BAA's costs.

(e) HMG cannot have failed to observe, when BAA's accounts were published, that its actual rate of return consistently exceeded the forecast it provided to accompany its charging proposals, as the following table shows:

Year	BAA's forecast rate of return	Actual rate of return
1983/84	[figure not yet traced]	5.4%
1984/85	4.6%	6.9%
1985/86	6.2%	7.5%
1986/87	7.2%	7.6%

10.27[*] Perhaps even more relevant than each and all of these factors set forth above, is the Comparison of BAA's actual accounting rates of returns (CCA) at Heathrow with its own average rate of return from U.K. industries (exclusive of North Sea oil) as set forth in Table 9.43 above, for the years in issue. That table reveals the following:

ACCOUNTING RETURNS ON CAPITAL EMPLOYED - CCA		
	Heathrow %	**UK Industries – ex North Sea** %
1983/84	9.	5.
1984/85	10.	5.
1985/86	9.9	7.
1986/87	8.7	8.

[*] The asterisked paragraphs contain the judgment of the majority of the Tribunal. Mr. Lever's dissenting Opinion is printed at the end of this Award.

10.28[*] It is the Tribunal's conclusion that if HMG's own pocket had been adversely affected by a more than reasonable level of profitability for BAA, upon reviewing the evidence/factors set forth above, it would have taken steps to lower the level of charges prior to April 1, 1987. It follows that the Tribunal finds that HMG failed to use its best efforts as required by Article 10, for that period, exclusive of the charging year 1983/84. Having reached this conclusion, by viewing the situation through the eyes of HMG in the performance of its obligations during the period of time in question, it is unnecessary at this point for the Tribunal to inquire further as to whether BAA should have used other methods to calculate and determine its levels of charges or to calculate its rate of return during the period.

10.29 That takes the Tribunal to a consideration of the alleged inadequacy of the RPI-1 price-cap formula applied in 1987/88 and 1988/89. USG criticized the price-cap régime on a number of grounds. First, it said that when use of the régime was introduced, the level of charges was such as to generate excessive profitability and the régime enabled BAA to continue to levy charges at that excessive level subject only to an inadequate 1 per cent reduction in real terms each year.

10.30 The evidence of Mr. Baker, the official at the U.K. Department of Transport who was principally involved with the matter, was to the effect that since 1986/87 was the base year, the Department obtained the relevant financial material from BAA earlier than usual, and were able to analyze it in depth using the financial model that had been developed in connection with BAA's projected privatization. As already noted at paragraphs 9.17 *et seq.* of this Chapter above, contemporaneous documentation confirms that the Department, having applied their minds to the material, were satisfied that the projected profitability associated with the proposed charges would be reasonable.

10.31 USG's calculations failed to cast convincing doubt on the tenability of the Department's conclusions in light of the evidence available at the time. In particular USG's calculations failed to support the contention that profitability in the base year, 1986/87, was unacceptably high. On the contrary, even using exclusively Dr. Kolbe's figures, the *highest* nominal economic rate of return (CCA) that he showed for Heathrow for 1986/87 was 9.6 per cent (and this included capital growth disclosed by the subsequent revaluation, spread back over earlier years of the Arbitration period); and the economic cost of capital (CCA) that he estimated for 1986/87, using a beta of 0.75, was 13.2 per cent, i.e. substantially more than the rate of return. Similarly, reference to Table 9.43 of this Chapter, above, indicates that in 1986/87 the *accounting rate of return* (CCA) whether at Heathrow alone or at

[*] The asterisked paragraphs contain the judgment of the majority of the Tribunal. Mr. Lever's dissenting Opinion is printed at the end of this Award.

the South East Airports, did not diverge significantly from U.K. industrial averages.

10.32 USG's contention that the RPI-1 régime consolidated pre-existing excessive profitability must, therefore, be rejected.

10.33 With regard to the Department's prospective calculations relevant to the efficacy of an RPI-1 régime in containing profitability to no more than a reasonable level in the next two years (i.e. the last two years of the Arbitration period), the Department's calculations showed that, on the "Central Traffic Case" (see paragraph 9.20(ii) of this Chapter, above), the accounting return on capital employed, whether calculated on an HCA basis or a CCA basis was expected to be virtually the same in the two years 1987/88 and 1988/89, taken together, as it had been in the base year 1986/87. It follows that at the time when the RPI-X formula was introduced, the Department had no reason to expect that it would result in, let alone virtually guarantee, more than a reasonable level of profitability to BAA.

10.34 The second principal criticism of the RPI-1 formula advanced by USG was that a value of 1 (rather than 2) was arrived at for political reasons or in order to make BAA marketable to the public on privatization at a higher price and without regard to the requirements of Article 10 of Bermuda 2. Again the contemporaneous documents establish that USG was mistaken in believing that that was so. In fact the Department had grave doubts whether a value of X *as high as* 1 should be adopted and was influenced to recommend 1 because of what was perceived to be the overriding need to have a positive value of X (i.e. to have X = 1 rather than X = 0). Secondly, in considering the effects of different values of X, the Department was concerned that BAA, after privatization, should be in a position to operate in accordance with principles that were generally accepted as prudent for a private sector company and should not be put into a position which would make it difficult for it to remunerate the capital investment which the Department regarded as desirable in the interests of users.

10.35 USG also criticized a number of details of the RPI-l-X régime including the use of figures for forecast inflation with retrospective adjustment (albeit biased against forecasts that turned out to be too high) rather than *ex post* use of figures for actual inflation; and use of average revenue from user charges per passenger rather than of a tariff basket approach. In both of those respects HMG decided not to follow the recommendations made to it by NERA, the economic consultants commissioned by HMG to advise it about an appropriate regulatory régime for application to BAA after its privatization.

10.36 In both cases HMG applied its mind to the relevant questions and there is no sufficient reason to conclude that, in reaching its ultimate decision, it took into account considerations that it ought not to have taken into account or failed to take into account considerations that it ought to have taken into account. In all the circumstances, the fact that HMG came down in favor of the detailed solutions that it did does not provide an adequate foundation for a

finding that its relevant efforts are to be characterized as less than its best efforts.

10.37 Accordingly, having reviewed the circumstances surrounding the introduction of the RPI-X régime and the details of that régime, including the adoption of 1 as the value of X, the Tribunal concludes that HMG's efforts in relation to level of charges were not in themselves insufficient to satisfy the requirements of Article 10(1) and (3) of Bermuda 2.

10.38 The third and last criticism made by USG of HMG's efforts in respect of the level of charges at Heathrow was that it was insufficient for HMG in relation to the charges imposed in the last two years of the Arbitration period simply to have put in place the RPI-1 price-cap régime and retained a statutory power to reduce charges if international obligations so required; USG's contention was that a best efforts obligation required ongoing active scrutiny by HMG and intervention by it of its own motion if such scrutiny disclosed that, for whatever reason, the level of charges proposed by BAA would provide for an excessive return on assets.

10.39 The Tribunal has already pointed out that Article 10(1) and (3) creates an obligation of conduct and not an obligation of result and that the conduct required involves active effort and not merely the retention of reserve powers. The very fact that HMG retained a statutory power to reduce charges below those permitted by the RPI-X price-cap régime if HMG's international obligations so required, shows that it recognized that that régime could *not* be *guaranteed* to keep charges at no more than the level permitted by Bermuda 2; and it is, in the view of the Tribunal, self-evident that that must be so since circumstances such as unexpected traffic growth within a quinquennium may result in excessive profitability if charges are set at the highest level permitted by the price-cap régime.

10.40 In the judgment of the Tribunal it was therefore incumbent on HMG under Bermuda 2 to establish a mechanism whereby it could continue to review the level of Heathrow's profitability after the introduction of the RPI-1 price-cap régime, as part of its obligation to use its best efforts on an ongoing basis to ensure that the level of charges was no more than reasonable. It was necessary that such a mechanism should also have imposed a positive obligation on BAA to consult with HMG before taking any measure that could be expected to affect the rate of return at Heathrow and thus HMG's performance of its obligations under Bermuda 2.

10.41 So far as the charges proposed for 1987/88 are concerned, HMG is entitled to rely on the work that it did in 1986 in connection with the establishment of the value of X for the purposes of the RPI-X formula, which came into operation on April 1, 1987. Given the coming into use of Terminal 4 and the resultant reduction in capacity utilization at Heathrow, HMG was satisfied, in October/November 1986, that application of the RPI-1 formula to charges at their level in the base year 1986/87 would not provide for excessive profitability in 1987/88 and there is no evidentiary basis on which the

Tribunal can find that HMG's efforts in respect of the level of charges in 1987/88 lacked the necessary quality of best efforts.

10.42 The same cannot be said of the charges for 1988/89. Irrespective of the result in that year, HMG failed to fulfil its obligation of conduct since it simply and passively relied on the maintenance in place of the RPI-1 formula without reference to the level of profitability to which its application might be expected to give rise.

10.43 Accordingly the Tribunal concludes that in two further respects HMG failed to fulfil its obligation to use its best efforts to ensure that user charges at Heathrow should not provide for more than a reasonable rate of return on assets:

(i) after the introduction of the RPI-X price-cap régime HMG failed to establish a mechanism whereby within the quinquennium it could continue to review the level of Heathrow's profitability and to require BAA to consult with it before taking any measure that could be expected to affect the rate of return at Heathrow and thus HMG's performance of its obligations under Bermuda 2 (paragraph 10.40 of this Chapter above); and

(ii) specifically, HMG failed to deploy any efforts to ensure that the charges proposed and implemented by BAA for 1988/89 would provide for no more than an reasonable rate of return on assets (paragraph 10.42 of this Chapter, above).

CHAPTER 8

ARTICLE 10(2): PROHIBITION AGAINST DISCRIMINATORY USER CHARGES

1. Article 10(2) of Bermuda 2 provides:

> Neither Contracting Party shall impose or permit to be imposed on the designated airlines of the other Contracting Party user charges higher than those imposed on its own designated airlines operating similar international air services.

The provision is based on and derived from Article 15 of the Chicago Convention (see paragraph 1.2 of Chapter 2, above), which, itself, imposes an independent affirmative duty on the Parties to take necessary actions.

2. There is no real dispute between the Parties that Article 10(2) imposes an independent, mandatory obligation on each to take corrective measures to prevent discriminatory user charges; and that obligation is over and above the best efforts obligation imposed by Article 10(1).

3. While the Parties are in agreement that the obligation to act in Article 10(2) is mandatory, they disagree on the nature of the discriminatory conduct that triggers their need to act. In particular, the Parties differ

(i) on whether the prohibited discriminatory practices must be "overt" and thus readily recognizable by anyone as demonstrating disparate treatment, as opposed to less obvious conduct such as may be discernable only from a consideration of the impact of the totality of relevant charges and rules on the complaining Party's airlines; and

(ii) on whether a proper determination of discriminatory behaviour should take into account the alleged discriminating Party's treatment of its national carriers generally, rather than confining the analysis to a comparison of those charges paid by, and the rules affecting, that Party's own designated airlines offering international air services that are similar to those provided by the complaining Party's designated airlines.

4. As to these matters, *HMG* takes the position that Article 10(2) should be read literally. It therefore sees no need for a Party's intervention unless the schedule of applicable charging rates is higher for the other Party's designated airlines. Other considerations, such as the actual operational flexibility available to the other Party's airlines to offset or reduce the impact of charges through taking advantage of such measures as off-peak scheduling, free over-night parking of aircraft, and so forth, should not be taken into account. HMG would also compare the schedule of charging rates applicable to the other Party's designated airlines only with those applicable to its own airlines *offering similar international air services*, to determine discrimination. Charges paid by and related rules affecting its own airlines offering *other types of air services* would not be relevant in that assessment.

5. By contrast, *USG* reads Article 10(2) more broadly. It contends that the evaluation of whether user charges are being imposed discriminatorily should take into account both the charges paid by, and the rules affecting, a Party's own airlines generally, and not only those airlines offering "similar international air services". USG also contends that Article 10(2) requires more than a simple comparison of the schedule of charging rates to determine whether discrimination is, in fact, occurring. Thus, USG finds an obligation imposed on the Parties to look beyond such "overt" or obvious discriminatory conduct. Rather, the Parties have a duty to inquire whether -- in the light of all the relevant circumstances affecting "similar" air services -- the charges and related rules operate to produce lower total user charges for the charging Party's designated airlines.

6. The Tribunal is in agreement with some aspects of the positions taken by both Parties on these issues. The Tribunal does not agree with USG's contention that charges and rules applicable to a Party's own airlines generally, without regard to the nature of their operations, are required by Article 10(2) to be taken into account in determining whether discrimination is occurring.

To consider charges to national operators "generally", as USG urges, simply departs too far from the plain language which confines the comparison to "charges ... imposed on ... designated airlines operating similar international air services". Thus, the Tribunal finds no basis in either the Treaty language or in logic to expand the scope to include dissimilar air services as USG suggests.

7. At the same time, however, it is the opinion of the Tribunal that HMG goes too far by suggesting that the only measure of discriminatory behavior should be a simple comparison of the applicable charging rates and nothing else -- that is, to confine the inquiry to nothing more than an objective determination of whether the airlines of each side offering similar international services are subject to the same schedule of charging rates. It is the very nature of discrimination that it can take many forms. The Tribunal finds nothing in Article 10(2) or, indeed, in Article 15 of the Chicago Convention on which it is based, to support the proposition that discrimination need be assessed only by reference to "overt" behavior, which may, in fact, mask actual discrimination, when other operational factors are taken into account, such as the actual availability of off-peak arrival and departure times near the peak price break times, the practical ability to use "free" parking facilities and to avoid peak passenger terminal charges, and so forth.

8. When one finds differences in charging rates in different circumstances in a Party's territory, and that the designated airlines of the other Party pay the higher rate (whether or not also, sometimes, the lower rate) and the first Party's designated airlines offering international air services pay the lower rate (whether or not also, sometimes, the higher rate) it is necessary to ask first whether there is any material difference between the circumstances that attract the imposition of the higher rate and those that attract the imposition of the lower rate. In this connection a difference is material if it would be regarded by a reasonable charging authority as providing an objective justification for *a* difference in charging rate (e.g. because of *a* difference in cost to the airport operator).

9. If there is a material difference in that sense, then Article 10(2) of Bermuda 2 is not infringed since an airline operating in the one set of circumstances will not be offering international air services that are, in the sense of Article 10(2), "similar" to those offered by the airlines operating in the other set of circumstances.

10. Even if there is no material difference in the sense discussed above, the airlines in question may nevertheless not be offering "similar international air services" for some other reason connected with the character of the service. In the present Arbitration there was no suggestion that there were differences in the character of the international air services offered by U.K. airlines and U.S.-designated airlines operating into and out of Heathrow (being differences that were unrelated to the circumstances that attracted the operation of different charging rates) and that those differences meant that the U.K. airlines and the U.S.-designated airlines were not offering similar international air

services. The Tribunal therefore expresses no opinion on the criteria that might be applicable where a Party invoked such differences as a ground for excluding the operation of Article 10(2) of Bermuda 2.

11. The foregoing analysis implies that Article 10(2) of Bermuda 2 seeks to guarantee, as between airlines offering international air services equal treatment of equal situations; it does not seek to guarantee that differences in the treatment of unequal situations shall be proportional to the differences in the situation. Article 10(2) of Bermuda 2, read in isolation, like Article 15 of the Chicago Convention, is therefore a relatively blunt instrument; hence the more elaborate provisions of paragraphs (1) and (3) that were included in Article 10 of Bermuda 2 when that Treaty was negotiated in 1977.

12. The foregoing analysis is consistent with the Tribunal's conclusions that an examination of potentially discriminatory practices requires more than a superficial comparison of the schedule of charges on a flight by flight basis; rather, it mandates a closer inquiry into the overall effect of charges and related rules, particularly in a case such as presented here, where one Party has contended that there is no rational basis for the other Party's prices and rules in the allocation of scarce airport and other facilities.

13. The application of the foregoing analysis in the present case can be illustrated by comparing the Parties' differing positions on the availability and allocation of peak hour and shoulder landing slots. *HMG* asserts that all airlines have a choice with respect to the timing of their use of airport facilities. HMG therefore disputes USG's argument that its airlines are forced into higher cost peak periods because of the scarcity considerations. HMG believes that a comparison of applicable charging rates, flight by flight, during the various charging periods, is all that the Treaty requires when it uses the expression "similar international air services". HMG contends that actual differences in the total amounts paid by its airlines compared to the total amounts paid by the US airlines providing "similar services", such as transatlantic flights, simply reflect conscious choices by the airlines' respective commercial managers, and do not serve as a proper measure of discrimination within the meaning of Article 10(2).

14. *USG* argues the point differently. It contends that there are instances where its airlines wanted to move out of the high cost peak charge periods, but were unable to do so due to the unavailability of suitable slots out of peak. USG submits that the BAA has ignored scarcity considerations in establishing peak slot periods, with the result that the designated "off-peak" times are arbitrary and have no rational basis in terms of allocating scarce resources. As for the terminal passenger charges, USG argues that there is no identifiable passenger congestion differential which justifies the peak period, rendering that pricing differential arbitrary. In sum, USG believes that "somehow the BAA's definitions of peak charging hours seemed generally to correspond with the hours in which US airlines were required to conduct a large percentage of their operations".

15. In the judgment of the Tribunal, in the present case the relevant inquiry to determine the existence of a discriminatory practice is not a simple comparison of the schedule of charging rates on a "flight by flight" basis, such as a comparison simply of the peak hour charges for flights operated by each side's designated airlines. Rather, the inquiry must be in greater depth and must include an evaluation of the factors that USG raised in its arguments. For example, if scarcity of facilities and runways exists for a far longer period than the designated "peak hours", peak pricing would lack a rational basis and could well work to discriminate against airlines that could not adjust their flights to the less costly operating hours. In such circumstances, so far as Article 10(2) is concerned, there would be no material difference between the international air services offered by the U.S.-designated airlines in "peak hours" and those offered by British airlines in "non-peak" hours and the higher charges imposed on the former than on the latter could not be excused under Article 10(2) on the basis that the services offered at the different times were not "similar international services".

16. Finally, it remains to be considered whether Article 10(2) imposes only an *ex post facto* review obligation on the Parties. The Tribunal concludes that the Parties have undertaken by this provision (as also by the underlying Article 15 of the Chicago Convention), to conduct both an *ex ante* and an *ex post facto* review. The Parties here are clearly among the most sophisticated aviation nations in the world. User charges applied at this stage in their histories will not be developed without reference to that extensive aviation experience. Each Party is thus capable of appraising and predicting quite closely, *ex ante*, the full cost burden of user charges on the likely patterns of operations to be performed by the designated airlines of the other Party and, by comparison, on their own airlines "operating similar international air services". Discrimination can thus be avoided at the start. Thereafter, the Parties are similarly well-equipped, by their experience and by the documentation on charges actually paid, to assess, *ex post facto*, whether impermissible discrimination is occurring and to take the corrective steps which both sides concede are mandated by Article 10(2).

17. With the foregoing as background, the Tribunal is of the opinion that in order to find a violation of Article 10(2), the record must contain clear and sufficient evidence to support such a serious charge. After careful evaluation, the Tribunal concludes that the record before it does not contain evidence sufficient for it to make such a finding and to sustain such a charge. However, the allegations and indicia of conduct, as delineated above and referenced elsewhere in this Award, which give rise to USG's claims of a violation of Article 10(2), are troublesome to the Tribunal. This is particularly so as to the allegations and evidence regarding the inability of U.S. airlines to schedule outside of the peak. It is for that reason that the Tribunal has felt it desirable to provide the interpretative rulings contained herein, for the guidance of the Parties in their future conduct pursuant to the Treaty.

CHAPTER 9

ARTICLE 10(4) AND 10(5) OF BERMUDA 2: CONSULTATION BY BAA AND EXCHANGE OF INFORMATION BETWEEN BAA AND AIRLINES

I. The Parties' arguments

(1) USG's arguments in its First Memorandum

1.1.1 USG argued that the system of consultations at Heathrow had never worked well, because BAA had failed to provide the information needed to make consultations meaningful. Both USG and U.S. airlines had repeatedly brought that failing to HMG's attention but, even though HMG had the power to require BAA to consult in good faith, to no avail. USG concluded that HMG had therefore failed to meet its obligation to encourage consultations.

The legal standard

1.1.2 Article 10(4) and (5) required the Parties to encourage consultations in good faith. The principle of good faith in the implementation of treaties demanded action if questions arose about compliance. Therefore, if one Party raised questions about the quality of consultations or the lack of information, it was incumbent on the other Party to investigate and, if necessary, encourage consultation. USG stressed the fact that because of the complexity of Heathrow's charges, BAA's unusual theoretical premises and the uneven application of the charges to different carriers, far more information was required to permit the review of Heathrow's charges than simpler and more traditionally set charges would have required.

HMG had not encouraged productive and meaningful consultations and had not used its best efforts to encourage the exchange of needed information

1.1.3 USG described the historical background to the negotiation of Article 10(4) and (5) of Bermuda 2 and said that both Parties had hoped that the Treaty would avoid governmental involvement in the commercial relationships between airports and users; unfortunately, however, it had failed to prevent the Governments from coming into conflict over the adequacy of information provided by BAA soon after Bermuda 2 had come into existence. USG described how the carriers had failed to get the needed information, so that USG itself had had to seek the information to ensure that its rights under Bermuda 2 were respected. USG argued that, despite HMG's clear statutory authority to remedy the situation, no changes had been made. HMG had maintained that the airlines had received sufficient information and that therefore no further efforts had been required by HMG.

1.1.4 USG stated that the conclusion was inescapable that the airport-user consultative process had broken down, primarily because BAA would not divulge how its charges were determined. USG alleged that BAA determined

its complex charges quite differently from other airport operators, leaving excessive scope for discretion and discrimination. Each year BAA had proposed changes in the charges but had failed to disclose how they had been calculated or how they conformed to the principles of Bermuda 2. After complaints by U.S. and other airlines, BAA had sometimes provided some, but still incomplete, additional information. For the most part the proposed charges were put into effect.

1.1.5 To illustrate the process of providing insufficient information USG described the process in 1985/86. That year had (a) followed a U.S. protest to HMG over the quality of the consultations, (b) followed completion of the mid-term review, and (c) preceded privatization (after which even less information had been provided). The initial information from BAA had not explained how the international peak passenger charge was set at £9.40, or why a peak parking multiplier of 4 had been used, or how the new peak charging hours had been selected. It had not shown that the charges were "equitably apportioned among categories of users" or how they related to BAA's costs.

1.1.6 U.S. and other airlines had been intensely dissatisfied with the information supplied and BAA had consequently provided its estimated rates of return by airport, showing that Heathrow was expected to reach a rate of return between 9 per cent and 10 per cent. After the consultations, KLM, British Airways and PanAm had complained about the lack of justification of the proposed charges. BAA had simply responded by stating that its marginal cost studies indicated that the charges in the *preceding* charging year (original emphasis) had been set broadly at marginal cost, offset by commercial revenue, that the information provided was substantially the same as that which the BAA Board had considered when approving the proposals and that the requests for additional accounting information simply reflected the view of many users that accounting costs should be used.

1.1.7 USG contended that the argument that users had been given substantially the same data as the Board of BAA was specious. Even if the users had received "substantially" the same information, this would not show that the information had been adequate to review the charges' reasonableness under Bermuda 2. The position of the users and the position of the BAA Board were not comparable, because the BAA staff was accountable to the latter and not to the airlines; moreover, neither the Board nor the staff had seemed to feel bound by Bermuda 2. As to the accounting cost argument, USG stated that the airlines were entitled to know what BAA's costs were, however defined.

1.1.8 USG further contended that BAA's information had been not only insufficient, but also late. With regard to the sample year (1985/86), airlines had had eleven days to review the information before the consultation meeting on December 14, 1984. BAA had supplied its rate of return projections by airport on December 31. Final written comments were due on January 11,

1985, and charges were announced on February 21, 1985. The situation had become even worse with privatization. In 1985 BAA had informed the carriers that profit forecasts could not be released in light of the scheduled flotation. When USG expressed its concern about this, HMG replied that the "present facility for consultation between the BAA and its users should continue". USG argued that nevertheless, the information flow had not continued. In 1987, when U.S. airlines had sought cost, traffic and revenue data needed to review the 1987/88 charges, BAA had refused to provide the data, citing the "commercial realities" of privatization. Similarly, BAA had refused to provide the "Policies and Programmes" material which had previously been supplied on a routine basis. USG had protested about this. After privatization the main explanation of charges had consisted of BAA's calculations of its allowed revenue yield under the RPI-1 price formula. That information had no necessary connection to the standards of Article 10.

HMG had failed to encourage consultations and had not used its best efforts to encourage provision of necessary information

1.1.9 USG referred to the diplomatic history of the present dispute to support its contention that USG had regularly informed HMG of U.S. concerns about the consultation process. HMG had taken no affirmative steps in response, despite its statutory duty to direct BAA to provide the requested information. USG also contended that there were indications that HMG did not share USG's views as to the importance of the consultation process: in this connection USG referred to a letter dated June 1, 1976, in which the U.K. Department of Trade had suggested that the consultations were a "public relations exercise".

1.1.10 USG emphasized that the British Government had not lacked the power to ensure effective consultations. USG here referred to section 2(8) of the Airports Authority Act 1975 (before privatization) and section 83(5) of, and Schedule 6 to, the Airports Act 1986 and section 35 of the Civil Aviation Act 1982 (after privatization). However, merely providing facilities for consultations and monitoring them were insufficient. HMG was required to take concrete action to redress the concerns expressed by USG.

The Tribunal should require the minimum information required to ensure compliance with Bermuda 2

1.1.11 USG contended that the only possibility of providing complete relief to USG and its airlines was a concrete declaration of British obligations. It submitted that an effective remedy should specify (i) the exact types of information to be provided to permit an accurate review of the reasonableness of the charges and (ii) the timing of the required information exchange.

1.1.12 Consequently, USG requested that the Tribunal should declare that information of the certain specific kinds be provided and described that information under the following headings:

(a) Concept of the charging structure.

(b) Calculation of the charges.

(c) Results of the charging structure:

(i) Cost accounting data;

(ii) Activity data;

(iii) Financial and investment data.

Timeliness of information

1.1.13 Finally, USG observed that in order to be able to form meaningful opinions, airlines should receive all data at the outset of the consultations. In fact, between 1983 and 1988, the time between initial proposals and the Board Meeting at which charges had been set, had generally been less than 3½ months.

(2) HMG's arguments in its First Memorandum

Action taken with respect to the consultation and information issue

1.2.1 HMG described the actions that it had itself taken prior to and during the Arbitration period. As to the period 1979-1981, HMG stated that USG's account of events was misleading, but that the period was irrelevant as a result of the intergovernmental MoU and the Airlines Settlement Agreement.

1.2.2 With respect to the period covered by the Arbitration, HMG referred to examples of the close interest that it had taken in the consultation process.

1.2.3 USG had completely misrepresented HMG's position when it had stated that "the British Government quickly fell into ranks behind the BAA". On the contrary, the letter referred to by USG had contained assurances that HMG had been following the progress of the medium-term consultations with great interest and that it would continue to monitor consultations closely.

1.2.4 HMG cited further examples from 1985 onwards to illustrate its concern over the consultations. HMG here referred to the written request made by the Minister for Aviation to the Chairman of BAA on April 15, 1985 (following on receipt of a complaint by the airlines), that BAA should reconsider its decision to withhold certain financial information because of the prospect of privatization in light of the fact that privatization was unlikely to occur for at least another two years. BAA had responded that, although initially withheld, the relevant information had subsequently been provided, in good time for the consultation process. In relation to the 1986/87 charges, HMG had emphasized its desire to be fully consulted and had requested copies of documents to be provided to the airlines, so that, if necessary, it could submit its views to the Board of BAA as to the issue of consultations and the substance of the charges.

1.2.5 HMG further alleged that when it planned the privatization of BAA it had been fully aware of the need to ensure that the privatized company would continue to consult and provide information. HMG had therefore maintained in force the statutory duty formerly contained in the Airports Authority Act 1975. When the new regime had been explained to USG, the provision of financial information had been discussed, and it had been noted that the present facility for consultation should continue.

1.2.6 HMG had also been involved in the consultations concerning structure, and in this context had reminded BAA of the need for HMG to be kept in touch with the review. HMG had emphasized that it would have to satisfy itself that the conclusions of the review were consistent with its international obligations and had recorded that BAA had agreed to send to HMG copies of BAA and other papers circulated and notes of any meetings between BAA and others. With these, HMG should be able to satisfy itself that relevant issues were covered, could reach an immediate judgment on the outcome of the review, and, if necessary, could warn BAA that its position might be inconsistent with HMG's international obligations.

1.2.7 The letter (dated June 1, 1976) in which HMG had referred to the consultation process as a "public relations exercise" (see paragraph 1.1.9 of this Chapter, above) had in fact emphasized that consultations provided an opportunity for the airlines to feel that BAA had been able to take account of their views and that they would understand BAA's constraints and reasons.

1.2.8 HMG also described: BAA's actions in relation to charges between 1983/84 and 1988/89; the annual consultations on specific charging proposals for the following year; the regular consultations in relation to associated areas; and less regular consultations on longer-term issues. HMG stated that although the annual consultations had generally taken place through the relevant trade associations, PanAm's request for special treatment had been accommodated.

Progress and results of consultation

1.2.9 HMG contended that BAA had not disregarded the results of consultations and that in three of the six relevant years BAA had amended its initial proposals significantly, to the benefit of, *inter alia*, the U.S. airlines. HMG further argued that USG relied heavily, selectively and in certain respects misleadingly on the consultations for 1985/86 (USG's sample year).

1.2.10 HMG described some of BAA's actions following the consultations on the 1985/86 charges. BAA had withdrawn its proposal to extend the terminal peak from 5 to 7 hours, and had reduced off-peak charges for aircraft under 50 metric tonnes. Although USG had represented this as a benefit to domestic airlines, one of the main beneficiaries had been PanAm since it had operated a fleet of 49-tonne Boeing 737s on short-haul routes from Heathrow. HMG further noted that BAA had increased the remote stand rebate after complaints during the consultations with the airlines, despite the

fact that the airlines had failed to provide information on the costs that they incurred as a result of the coaching of passengers from remote stands to the terminal. HMG also noted that in some respects, BAA had provided more, not less, information after privatization, namely the full balance sheet for each airport, details of key transactions between BAA companies, and statements of cost allocation principles. HMG stated that the first two items were relevant to the airlines' complaints regarding cross-subsidization. BAA had also reduced its aircraft parking charges, to the benefit of, especially, long-haul carriers such as PanAm and TWA, and had increased the peak landing charge, to the disadvantage of, in particular, short-haul carriers.

Exchange of information

1.2.11 Finally, HMG referred to the provisions of Article 10(5) and of the Airlines Settlement Agreement that required the *exchange* of information, and contended that the U.S. airlines had generally disregarded those provisions.

The request for a declaration

1.2.12 HMG raised two general objections to USG's request for a declaration requiring supply of specific types of information. First, the airlines could and should have exhausted their local remedies. Secondly, it would be inappropriate for the Tribunal to direct *BAA* to produce information even if it were concluded that *HMG* had failed to fulfill its obligations under Bermuda 2. The only proper remedy would be a declaration indicating to what extent HMG had fallen short of fulfilment of its obligations; since neither BAA nor the U.S. airlines were parties to the Arbitration, the Tribunal lacked the power to direct BAA to provide information to the airlines.

Confidentiality of the information

1.2.13 HMG further contended that a substantial part of the requested information was confidential. Some was of a price-sensitive nature and would therefore have to be released to the Stock Exchange; and some, such as the income and expenditure details for individual parts of BAA's commercial activities, would be a valuable source of confidential information for suppliers, franchise bidders or competitors. Moreover, HMG argued, BAA could not make such information available only to U.S. airlines and not to other airlines. Finally, HMG argued that the regulatory system in place (involving the Civil Aviation Authority and the Monopolies and Mergers Commission) guaranteed that sufficient information, with proper safeguards, was available to the independent bodies charged with regulating BAA.

HMG's responses to USG's specific requests

1.2.14 As to USG's specific requests, the following were the principal points made by HMG in response:

(a) *Concept of the charging structure*: BAA already provided this type of information in the form of the medium-term policy statements and

a yearly statement of factors taken into account in determining charges.

(b) *Calculation of the charges*: USG's request was based on the faulty assumption that a cost-allocation formula was used.

(c) *Results of the charging structure*

(i) *Cost accounting data*: Much of Heathrow's cost and revenue data was commercially sensitive, unusual, or not in fact used by BAA (such as the ICCSs after 1984/85). USG had also failed to provide similar information for U.S. airports. USG's demand for details of individual commercial concessions and separate airport terminal data was unusual and unreasonable and the traffic revenue data sought were broadly equivalent to data already provided.

(ii) *Activity data*: Patterns of Traffic (constituting activity data) were already provided.

(iii) *Financial and investment data:*

(1) Similarly balance sheets and profit and loss accounts, sufficiently covering the request for financial and investment data, were already provided; U.S. airports generally did not provide full balance sheets for each airport. Profit center reports would be redundant because they were not used by BAA.

(2) Capital spending information was available (though, contrary to USG's assertion, it could not be used to verify revenues or rates of return).

(3) Cash flow information was also available (although it was not produced for U.S. airports).

(4) Investment base date were provided (though not divided per terminal: only fixed assets, and not net assets, could be classified by terminal).

Timeliness of information

1.2.15 HMG stated that BAA normally provided the following documents at or before the start of consultations: BAA's Annual Report and Accounts; each airport company's Annual Report and Accounts; the Patterns of Traffic document; and an explanatory document. According to HMG, BAA already followed the practice requested by USG, namely provision to the airlines of all data necessary to review the proposed charges at the same time as the proposal was received.

The conclusion drawn by HMG

1.2.16 HMG concluded that, if PanAm and TWA had regularly complained about the consultation process, they had perhaps done so because their views had not always been accepted. The fact that the process had not always operated smoothly should be attributed to the airlines' underlying hostility. HMG noted, with respect to USG's assertion that HMG had the power to require BAA to consult in good faith and to direct BAA to provide the required information, section 2(8) of the Airports Authority Act 1975 and section 35 of the Civil Aviation Act 1982, as amended by Schedule 6 to the Airports Act 1986 were not empowering provisions, but rather imposed a statutory duty on BAA which could be enforced at the instance of any airline user. If convinced that BAA had been in breach of its statutory duty, the airlines should therefore have taken action in the English courts.

(3) USG's arguments in its Second Memorandum

Commercial sensitivity and other airports' practice concerning in formation

1.3.1 USG argued that forecast data upon which BAA's charges had been based had not been provided even though projections of changes in traffic volume, costs and revenues (and the underlying assumptions) were necessary to determine the reasonableness of proposed charges. HMG had conceded that it had stopped providing projected revenues and operating costs of Heathrow after privatization. It had also stopped providing its annual projected capital expenditures. Consequently, USG argued, only *post hoc* review was possible, which, according to USG, was contrary to what Article 10(4) required. Furthermore, USG emphasized that HMG's argument that this information "would be relevant only if the Tribunal found [that a particular mechanical cost-allocation formula] applied was mandatory" was not correct. Only if BAA charges were completely arbitrary would the information be irrelevant.

1.3.2 Secondly, USG argued, BAA had provided inadequate financial and cost accounting data regardless of whether BAA's charges purported to reflect economic or accounting costs. Financial and cost accounting data were required in order to determine whether user charges reflected, and did not exceed, full costs of providing facilities and services; whether any distinction was made as to the source of revenue; whether all traffic bore its share of operating costs; and whether, with respect to certain facilities, a peak but no off-peak charge was assessed. The primary source which was usually available to users was BAA's Annual Reports and the Heathrow Financial Statements. But they failed to provide certain critical information, namely expense information by charging element and revenues by category of user. USG emphasized that, whether or not accounting data were used in setting charges, they were necessary to review whether charges were equitably apportioned and whether they reflected the application of sound economic principles.

1.3.3 Thirdly, USG stated that traffic data had not been provided even though they were used as the basis for BAA's charges. Those data were necessary to determine whether charges were equitably apportioned, whether charges discriminated in favor of domestic airlines and whether charges were based on sound economic principles. Although BAA provided some data in "Patterns of Traffic", the data so provided did not distinguish between peak landing and departure patterns and did not contain any information about patterns of parking. Moreover, no data were provided on aggregate international passenger flows by time of day, as needed to determine the reasonableness of BAA's peak definitions and their effect on the apportionment of charges among categories of users.

1.3.4 HMG had implied that airlines were given five full months to analyze charging proposals before the annual consultations. USG alleged that the period had been much shorter and that in fact the timetable had typically been very tight. USG concluded that U.S. airlines would not be afforded a meaningful opportunity to consult with BAA until all necessary information was provided in time to enable the airlines to present their views to BAA (and if necessary, for USG to consult with HMG) before the BAA Board adopted its final charges.

1.3.5 USG contended that HMG had overstated the commercial sensitivity of information of kinds included in USG's request. HMG had specified only one type of sensitive information, namely income and expenditure details for individual parts of BAA's commercial activities. USG expressed its doubts as to the legitimacy for a regulated monopoly to conceal information. As to HMG's objection that provision of detailed information concerning income and expense data relating to individual concessionaires would disadvantage BAA in negotiations with them, USG stated that in the past that problem had been solved by submitting aggregate versions of information: it would not be necessary to submit income and expense data on individual concessionaires or "individual flight records". Moreover, airlines could guarantee to limit the use of data to reviewing the reasonableness of charges.

1.3.6 As to HMG's argument that after privatization, London Stock Exchange rules prevented BAA from divulging information, USG observed that the privatization occurred at HMG's behest and did not affect HMG's obligations under Bermuda 2; accordingly HMG could not rely on privatization as a ground for non-disclosure of information, especially in light of HMG's assurances at that time that "the present facility for consultation" should continue. In any event, USG disputed HMG's claim that Stock Exchange rules prevented BAA from disclosing information.

1.3.7 More generally, USG argued that the complex economic basis of BAA's charges justified the large amount of information sought. USG stated that other airports' practices were irrelevant as airport charging systems varied and the information necessary to review them varied accordingly. USG argued

that, unlike Heathrow, U.S. airports were legally required to disclose all information showing the basis of the charges and that the charges complied with U.S. laws.

1.3.8 Whilst HMG had certainly taken certain steps in connection with the consultation process engaged in by BAA, those steps had been insufficient: in particular, HMG had taken no action with respect to the following concerns: BAA's failure in 1984 to substantiate the use of a peak parking multiplier of 4; BAA's failure in 1986 to provide, in a timely manner, information concerning increases in charges; the possibility that, after privatization, BAA would no longer provide crucial forecast information; BAA's failure, in the 1987/88 consultation papers, to explain the increase in the charges in relation to costs, and its reliance instead on its authority to increase charges up to the permitted price ceiling; the absence of raw information to support BAA's proposed 1988/89 charges cited in the January 7-8, 1988 intergovernmental consultations; and BAA's continued failure to show why U.S. airlines should bear a disproportionate share of Heathrow's charges, leading USG to suspect that BAA's goal was to maximize revenues by overcharging U.S. airlines, discussed in intergovernmental consultations held on July 18-19, 1988.

1.3.9 USG argued that although HMG was not ordinarily required to involve itself in the minutiae of user charge consultations, it was required to take concrete action to address specific concerns raised by its bilateral partner. Merely imposing a statutory obligation on BAA to hold consultations was insufficient. It also should have been prepared to use its power and influence to make the consultation process work as contemplated by Bermuda 2. Furthermore, it was not sufficient to suggest that the U.S. airlines could seek relief through British domestic remedies. HMG had done little to facilitate a constructive consultation process and had merely accepted BAA's assertions that privatization had rendered BAA unable to provide material and that the BAA Board received the same information. As to HMG's argument that the airlines would never be satisfied as a result of their hostility to BAA's pricing approach, USG stated that friction would be reduced once BAA's rate of return were reduced to reasonable levels and charges conformed to Bermuda 2 and if sufficient data were made available.

The 1985/86 consultations

1.3.10 With regard to HMG's criticism of USG's use of 1985/86 as a sample year in relation to charges consultations, there was no basis for HMG's suggestion that 1985/86 had been an irregular year because privatization had already been in prospect: 1985/86 had preceded privatization by two and a half years. HMG had even proposed 1985/86 as an appropriate sample year for the Arbitration to test the conformity of BAA's charges with Article 10. Furthermore, HMG would have found objections to any year chosen as an illustration.

(4) HMG's Second Memorandum

Actions taken: HMG's actions

1.4.1 HMG contended that, in USG's Second Memorandum, USG had abandoned the allegation that HMG had the power to require BAA to consult and any reliance on the period before 1981. As to the Arbitration period, HMG argued that it was difficult to imagine what more compelling step HMG could have taken than to impose the statutory duty on BAA and that USG had ignored HMG's analysis of the progress and results of consultation. As to USG's assertion that HMG had failed to take action to meet USG's complaints, HMG argued that it had considered those complaints.

1.4.2 Specifically HMG stated that:

(i) BAA1 (one of BAA's medium term review consultation papers) had contained a detailed analysis justifying peak parking charges even in excess of a multiplier of 4.

(ii) Although, as HMG had explained to USG, BAA had initially been advised to withhold certain financial information, BAA had subsequently decided to provide it to the airlines.

(iii) USG had failed to substantiate its assertion that the required forecast information would be crucial.

(iv) With respect to the 1987/88 charges, BAA had provided substantial information showing the relation between the increase in charges and information, building on 1985/86 financial results. Further information had been provided with the notification of the charges and subsequently.

(v) HMG had stated at the intergovernmental meeting on January 7-8, 1988, that it had a duty to encourage consultations and would not expect a privatized BAA to be less open than before.

(vi) Requiring BAA to show why U.S. airlines had to pay a disproportionate share of Heathrow's costs amounted to asking BAA to accept and to substantiate USG's complaint and its refusal could not be used to impugn the quality of the information provided.

Actions taken: BAA's actions

1.4.3 As to the annual consultations, HMG emphasized that USG had acknowledged that there was little dispute about the kind of information typically provided by BAA but had failed to acknowledge the amount of other information provided by BAA, such as BAA's Annual Reports, Patterns of Traffic, supplementary traffic information, inflation forecasts, commentary on the reasons for proposals, security costs information, yield dilution assessments, assessments of the effects of charges proposals on individual airlines and terminals, indications of major capital expenditure plans and

breakdowns of revenues by element. As to the associated and longer-term consultations, HMG stated that USG had failed to appreciate that those consultations constituted a serious attempt by BAA to take into account the views of the airlines. HMG argued that USG's allegations that BAA did not respond to complaints from the U.S. side were unfounded, and referred to BAA's withdrawal of its proposals to extend the peak period from 5 to 7 hours, and how BAA made other changes following the 1985/86 and 1988/89 consultations. With respect to USG's failure to fulfill the "exchange" of information requirement, HMG responded to USG's comment that HMG had never called on USG to take any action, and argued that this suggested that USG took action only in response to complaints.

USG's request for an order requiring disclosure of specific information

1.4.4 HMG repeated its objections in principle to the making by the Tribunal of any order in the present connection, namely that the U.S. airlines should have exhausted British local remedies and that the Tribunal lacked the power to require any action from BAA; HMG stated that USG had failed to respond to those objections.

1.4.5 HMG argued that USG erroneously attributed to HMG an argument that the sufficiency of the information supplied by BAA to the U.S. airlines was established by the fact that that was the information that had been provided to the BAA Board. HMG contended that, although it was true that BAA had at times told the airlines that they had received that information, HMG had not set that as a test of sufficiency. It added that at issue was not what information might be necessary or not but whether HMG had encouraged BAA to consult *etc.*

1.4.6 HMG had argued that the information requested went far beyond what a private company would normally be expected to provide. USG had failed to rebut that argument. With regard to USG's contentions that the information provided was insufficient and that further information was required, HMG commented as follows:

(i) *Forecasts*: HMG acknowledged that BAA had stopped providing financial forecasts when it was privatized, out of fear of privileging the recipients of the information and thus creating a false market. The only alternative, namely making the same information available to all other actual and potential shareholders, was not practicable; however, as BAA had, in the meantime, acquired experience in the private sector, it had found that it could properly provide some forecast information.

(ii) *Financial data*: HMG pointed out that all such information, including detailed allocations of costs and revenues, had been provided by BAA in response to USG discovery requests, and that USG had used little of it. Indeed, USG had not used cost allocations to show what charges should have been set or to calculate the claim, but instead

had argued that all cost allocations were “unwise” or otherwise subjective or arbitrary. HMG rejected USG’s argument that cost accounting information was necessary to determine whether peak charges were assessed for any facility for which no off-peak charge was assessed and argued that all that was needed was a list of charges.

(iii) *Traffic data*: HMG argued that Patterns of Traffic constituted a very comprehensive document, and that in addition U.S. airlines received other traffic information such as hourly flow data for international passengers, ATMs and copies of the Heathrow Scheduling Committee reports which analyzed forecasts in detail. Moreover, HMG had provided large amounts of this kind of information in discovery for this Arbitration, none of which had been used.

1.4.7 With respect to USG’s complaints concerning the timing of the provision by BAA of information, HMG emphasized the following points:

(i) The 1983/84 timetable had been determined by the negotiations for the settlement of the 1980/83 litigation.

(ii) With respect to the 1984/85 consultations, the airlines had received detailed cost analyses from BAA in August 1983.

(iii) The formal announcement of the 1985/86 proposals had been preceded by an informal announcement.

(iv) The 1986/87 proposals had been preceded by a letter of August 16, 1985, setting out general intentions.

(v) The 1988/89 proposals had been preceded by the circulation in July 1987 of the Heathrow review of the Structure of charges, including Coopers and Lybrand Associates’ report of July 1987.

1.4.8 With regard to the commercial sensitivity of certain of the information, the provision of information as to the turnover and profit attributable to individual commercial concessions could influence the bids made by concessionaires. It could also affect the airlines’ strategies in marketing and pricing duty-free goods on board aircraft. USG’s argument that it did not need information on individual concessions but only a breakdown by terminal was invalid because there was only one duty-free, one banking, and one other concessionaire per terminal; it was also inconsistent with USG’s argument elsewhere that cost and revenue allocations by terminal were “unwise”. HMG argued that provision to the U.S. airlines of information not provided to others would constitute discrimination: contrary to USG’s allegation, nothing in Bermuda 2 would justify such behaviour.

1.4.9 With respect to the issue of price-sensitivity, HMG argued that USG had misinterpreted the Stock Exchange Rules, because, although the Rules would permit the release of information, it would then have to be released

generally and not, as USG seemed to envisage, only to the airlines using Heathrow. HMG summarized the basic points in this respect as follows:

(i) The information in question could influence decisions to buy or sell BAA shares and therefore the share price.

(ii) Information of this kind included forecasts of profits and much of the information requested by USC fell into that category.

(iii) Providing such information to a selected group only would place them in an advantageous position in trading shares compared with third parties and would create a false market, since not all participants would be equally informed.

(iv) This would infringe Note 1 to paragraph 1.1 of the Stock Exchange General Rule 1 which stated that "[i]nformation should not be divulged outside the company and its advisers in such a way as to place in a privileged dealing position any person or class or category of persons".

(5) Evidence and submissions at the hearing

1.5.1 Evidence given at the hearing established that in or about mid-1986 BAA informed the U.K. Department of Transport that it would like to reduce the amount of information that it provided to airlines when consulting them on proposed charging increases. BAA proposed not to provide in future any financial forecasts. Such forecasts would be seen by the Stock Exchange as price- sensitive information; its production and continuous up-dating would require a great deal of additional effort by BAA senior personnel; and release of the information would greatly complicate the projected flotation of BAA as a company in the private sector and could have a negative impact on the flotation.

1.5.2 In the view of the Department, the problems caused by publishing profit forecasts would not cease after privatization: if profit forecasts were provided to the airlines, they would also, according to the advice received by the Department, have to be posted at the Stock Exchange to be available to all other potential investors and BAA would be required to update them whenever there was any material change. The Department believed that it would not be feasible to provide the information to the airlines on a confidential basis.

1.5.3 The standard of the forecasts would, the Department thought, have to be much higher than the estimates which had up to that time been provided by BAA to the airlines, with BAA taking an expressed judgment on profits for a period of 18 months ahead and regularly up-dating it. The Department concluded that such a burden would be unprecedented for a private sector company and would inhibit the effective operation of the privatized BAA.

1.5.4 The Department therefore decided to support BAA's proposal to reduce the information provided to airlines. In so deciding, the Department was influenced by the consideration that, if BAA did not do so when price regulation was introduced, BAA plc would have missed its best opportunity to escape from what it and the Department regarded as an onerous requirement which would put it in the unique position for a private sector company. In the view of the Department, BAA could argue that the introduction of price regulation would provide airlines with protection against excessive prices; that it would be appropriate in the future to consult airlines only on the structure of charges rather than the overall level; and that this made the production of profit forecasts irrelevant.

1.5.5. The Department accordingly agreed with BAA that it should no longer provide "price-sensitive information" to the airlines when it consulted them on charges in October 1986 or in future years. In the view of the Department, BAA would still continue to provide "a great deal of information", including traffic forecasts and detailed analysis of the effect of proposed changes in the *structure* of charges. But it would no longer provide profit forecasts or information from which such forecasts might be derived (e.g. costs and revenue forecasts).

1.5.6 The Department considered that Bermuda 2 gave rise to a potential difficulty in relation to discontinuance of supply of information about forecast revenue, costs and profits in the year ahead for which user charges were proposed but, in effect, hoped that the assurances provided by the RPI-X price cap that was about to be published would satisfy the U.S. airlines and USG.

1.5.7 Because, therefore, reduction by BAA of the amount of information that is supplied to the airlines would not be without legal risk, the Department decided that it would keep private its support for BAA decision not to supply the information in question at the time of the October 1986 consultations by BAA with the airlines and would retain a neutral public stance and see what happened. BAA would thus "test the water" and, if all went well, would again in future years not provide to the airlines such information in respect of the charging year ahead about which consultations were taking place.

II. The decision of the Tribunal

(1) Article 10(4) of Bermuda 2 : Consultation

The history of the consultation requirement in Bermuda 2

2.1.1 Although the U.S.-U.K. Agreement relating to Air Services dated February 11, 1946 (*Bermuda 1*) referred to the "intention of both Governments that there should be regular and frequent consultation between their respective aeronautical authorities and that there should thereby be close collaboration in the observance of the principles and the implementation of the provisions outlines herein ...", Bermuda 1 made no provision for consultation by the Parties' airport operators with *airlines*.

2.1.2 The early drafts of *Bermuda 2* similarly did not refer to consultation by airport operators with airlines, though the initial draft, put forward by USG, would have required the provisions *by the Parties to each other*, on request, of information relevant to an assessment of the reasonableness of user charges. HMG rejected that proposal but, in order to meet USG's point made a counter-proposal for the inclusion of a provision in the following terms:

> "Parties shall use their best endeavours to ensure that issues relating to user charges and proposals to change user charges are subject of consultations between competent authorities and designated airline so far as possible within established international framework for such consultations; that reasonable notice is given of proposals for changes in user charges; and that consultations are conducted promptly after announcement of proposed changes."

2.1.3 The subsequent drafts of Bermuda 2 all contained provision for governmental encouragement of consultation by their competent authorities with the other Party's designated airlines; and Article 10(4) of the Treaty, as made, makes such provision in the following terms:

> "Each Contracting Party shall encourage consultations between its competent charging authorities and airlines using the services and facilities, where practicable through the airlines' representative organizations. Reasonable notice should be given to users of any proposals for changes in user charges to enable them to express their views before changes are made."

Relevant U.K. legislation

2.1.4 The Airports Authority Act 1975, which came into operation on December 13, 1975, i.e. before the making of Bermuda 2, already contained provisions with regard to consultation by BAA with amongst others, users. Thus, section 2(8) of the 1975 Act provided that:

> "In the management and administration of any aerodrome [BAA] shall provide for users of the aerodrome, … adequate facilities for consultation with respect to matters affecting their interests, and shall, in doing so, give effect to any direction given to it by the Secretary of State."[2]

2.1.5 That provision remained in force until August 1, 1986 when, by virtue of section 83(5) of, and Schedule 6 to, the Airports Act 1986 and the statutory instrument made under section 2(1) thereof, section 35(2) of the Civil Aviation Act 1982 was applied to BAA. In consequence, since August 1, 1986, the 1982 Act has imposed on BAA a statutory duty to "provide ... for users of [its airports] adequate facilities for consultation with respect to any matter concerning the management or administration of [those airports] which affects their interests."

2.1.6 Proposals by BAA for user charges, their continuance or their change, are clearly matters concerning the management or administration of the airport in question, affecting the interests of users of that airport.

[2] So far as appears from the record before the Tribunal, no directions were given to BAA by the Secretary of State pursuant to section 2(8) of the 1975 Act.

Accordingly, throughout the Arbitration period (up to August 1, 1986, by virtue of the Airports Authority Act 1975 and thereafter by virtue of the Civil Aviation Act 1982 as applied by the Airports Act 1986) BAA was under a British statutory duty to consult, amongst others, the U.S.-designated airlines about user charges.

The juridical nature of the statutory duty under U.K. law

2.1.7 Under English law, if a statute creates a duty but, as with the statutory duties with which the Tribunal is here concerned, imposes no remedy, civil or criminal, for breach of that duty, there is a presumption that a person who is injured by breach of the duty will have a right of action, at any rate where, again as here, the statute was intended to benefit designated individuals or a particular class of persons rather than the public at large (*Clerk & Lindsell on Torts*, 16th ed. (1989), paragraph 14-07). A claim that such a duty has been broken may be enforceable by a civil action for breach of statutory duty (i.e. a private law remedy) brought by a person who has suffered special damage as a result of the breach complained of (and HMG submitted that that would have been the appropriate procedure to be followed by a U.S.-designated airline that wished to pursue such a claim here, citing *Cutler v. Wandsworth Stadium Limited* [1949] A.C. 398). Alternatively, where the duty in question is properly to be characterized as a public law duty involving the exercise of discretion by the body on which the duty is imposed, a claim that the duty has been broken may and should be brought by proceedings for judicial review, i.e., a public law remedy (and that was the conclusion for which USG, without elaboration, contended in its oral submissions).

2.1.8 In the present case, it is a moot point whether the statutory duty in question was and is enforceable by private or public law remedies. On the one hand, BAA, even before privatization, was not a public authority (H.W.R. Wade, *Administrative Law*, 6th ed. (1988), pages 169-171); and since privatization it has been a publicly listed company operating in "the private sector". On the other hand, the duty to consult is owed not only to airline users but also to any affected local authority and to any other organization representing the interest of persons concerned with the locality in which the "aerodrome" is situated; and consultation is required not only in relation to airport user charges but to any matter concerning the management or administration of the "aerodrome" which affects the interests of the person or organization that is consulted. These latter considerations may point to the applicability here of public, rather than private, law.

2.1.9 If the statutory duty is enforceable as a matter of private law, any person who has suffered special damage as a result of breach of the duty has an unqualified right, under English law, to bring civil proceedings for damages or other relief within 6 years; by contrast, if the statutory duty is enforceable only as a matter of public law, an application for judicial review

can be brought only with leave of the Court and the application for leave must generally be made within 3 months.

2.1.10 The Tribunal finds it unnecessary to decide whether the duty to consult imposed by the Airports Authority Act 1975 and the Civil Aviation Act 1982 was and is enforceable as a matter of public law or as a matter of private law. In either event, the duty was a legal duty and BAA would have known that a dissatisfied airline user of Heathrow would have had a right of recourse to the Courts. It seems highly improbable that the statutory duty would have "encouraged" BAA to consult airline users of Heathrow less if the duty was enforceable only as a matter of public law than if it was enforceable as a matter of private law.

The requirement for valid consultation under U.K. law

2.1.11 As a matter of U.K. law, it is well established that four basic requirements are essential to a consultation process if it is to be satisfactory for the purposes of performing a statutory duty such as that here imposed:

(i) consultation must be at a time when proposals are still at a formative stage;

(ii) the proposer must give sufficient reasons for any proposals to permit of intelligent consideration and response;

(iii) adequate time must be given to permit of intelligent consideration and response; and

(iv) the consultation process as a whole must not result in unfairness.

In this connection, reference may be made to *R.* v. *Governors of Haberdashers' Askes Hatcham Schools, ex parte Inner London Education Authority* [1989] Crown Office Digest 435 and *R.* v. *Warwickshire District Council, ex parte Bailey* [1991] Crown Office Digest 284.

Whether in the circumstances HMG duly encouraged consultation

2.1.12 The first question that the Tribunal has to decide is whether, having imposed upon BAA a statutory duty with the legal incidents described above, HMG has done all that is required of it by Article 10(4) of Bermuda 2, or whether Article 10(4) requires HMG to interest itself in the actual process of consultation by BAA with the airlines and to encourage the satisfactory performance by BAA of its duty. If the answer to that question is that the maintenance in force by HMG of the statutory duty satisfied the requirements of Article 10(4), that is an end of the matter so far as Article 10(4) is concerned. But if not, then it is necessary to consider whether the particular steps taken by HMG sufficed for the purpose.

2.1.13 The Tribunal does not absolutely exclude the possibility that, even where a Party has introduced a régime, such as that operative in relation to Heathrow throughout the Arbitration period, which *legally requires*

consultation by an airport authority with its airline users, that Party may nevertheless fail to perform its obligations under Article 10(4) of Bermuda 2 to *encourage* consultation. However, in the present case, as was demonstrated by the evidence to which HMG referred (see paragraphs 1.2.1 - 1.2.8 of this Chapter, above), throughout the Arbitration period HMG did encourage BAA to consult the airlines as required by Article 10(4), as well as imposing upon it a statutory duty to do so. Even if, on a fair construction, a letter from a British Government official to BAA dated June 1, 1976, meant that, in the view of that official, consultation was nothing more than a public relations exercise:

(i) the letter preceded by over a year the making of Bermuda 2 and was therefore written at a time when HMG was under no treaty obligation to encourage consultation by BAA with the airlines;

(ii) over 6 years elapsed between the date of the letter and the commencement of the Arbitration period; and the 1980-83 litigation intervened.

In the result, the letter cannot be taken to reflect HMG's attitude during the Arbitration period.

2.1.14 In any event, USG's real complaint was not that BAA failed to consult the airlines but that it failed to provide them with enough information. In the circumstances the Tribunal finds that HMG did not fail to fulfill its obligations under Article 10(4) of Bermuda 2 during the Arbitration period and that the only question for determination here is whether HMG failed to fulfill its obligations under Article 10(5). It is to that question that the Tribunal now turns.

(2) Article 10(5) of Bermuda 2: Provision of information

The history of the inclusion of Article 10(5) in Bermuda 2

2.2.1 Paragraphs 2.1.1 and 2.1.3 of this Chapter, above, refer to the history leading up to the inclusion in Bermuda 2 of an obligation relating to the provision to airlines by charging authorities of information relevant to the reasonableness of user charges.

2.2.2 In its final form Bermuda 2 defined that obligation in Article 10(5) in the following terms:

> "For the purposes of paragraph (4) of this Article, each Contracting Party shall use its best efforts to encourage the competent charging authorities and the airlines to exchange such information as may be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in this Article."

The interpretation of Article 10(5) has already been considered at paragraphs 7.1-7.9 of Chapter 5 above.

The relevance or otherwise of the U.K. statutory duty to consult

2.2.3 By its oral submissions HMG recalled that the statutory duty imposed by HMG on BAA to consult airlines about proposed user charges

was expressed to be a duty to provide "*adequate* facilities for consultation". HMG then in essence adopted the submission made by TWA in its pleadings in the 1980-83 litigation in the English High Court to the effect that "that statutory duty included within it a duty to provide at least some information"; by imposing the statutory duty and monitoring the question of whether or not information had been exchanged, the best efforts obligation imposed by Article 10(5) was, HMG submitted, discharged.

2.2.4 USG did not address the Tribunal on, or in relation to, the submission that the statutory duty imposed on BAA to provide adequate facilities for *consultation* included within it a duty to provide at least some information; and HMG did not elaborate the submission, in particular by indicating what kind of information would need to be provided by BAA pursuant to its statutory duty to *consult*.

2.2.5 In this connection only limited assistance is to be derived from the now well-established statement of the basic requirements that are essential to a consultation process if it is to be satisfactory for the purposes of performing a statutory duty: see paragraph 2.1.7 of this Chapter, above. However, that statement is to some extent amplified in respect of provision of information by the following *dicta* of Webster J. in *R.* v. *Secretary of State for Social Services, exparte Association of Metropolitan Authorities* ("the *AMA* case") [1986] 1 All E.R. 164 at page 167:

> "[The] essence of consultation is the communication of a genuine invitation to give advice and a genuine consideration of that advice. In my view it must go without saying that to achieve consultation sufficient information must be supplied by the consulting to the consulted party to enable it to tender helpful advice. … By helpful advice, in this context, I mean sufficiently informed and considered information or advice about aspects of the form or substance of the proposals, or their implications for the consulted party, being aspects material to the implementation of the proposals as to which the Secretary of State might not be fully informed or advised and as to which the party consulted might have relevant information or advice to offer."

2.2.6 Although the *AMA* case concerned consultation in circumstances where it was a precondition for the making of delegated legislation, the *dicta* referred to above have been judicially cited in relation to other situations where, as a matter of law, consultation was a prerequisite for the taking of action: see, for example *Re NUPE and COHSE's Application* [1989] I.R.L.R. 202 (High Court of Northern Ireland). In that case, with reference to the *dicta* of Webster J. cited above, Carswell J. also observed, at pages 206-207:

> "The *AMA* case contains some further assistance on the nature and extent of the consultation required. It should be borne in mind that this is likely to vary widely with the circumstances, and may well vary between the different classes of persons or bodies to be consulted. The obligation in a case of a statutory requirement may also not necessarily be the same as that in a procedural propriety case of the present type. Bearing in mind the differences in context, however, the observations of Webster J. … afford one assistance."

2.2.7 It seems reasonably clear from an analysis of the *AMA* case and *Re NUPE* and *COHSE's Application* that, in so far as a person who is under a duty to consult is, by virtue of that duty, required to provide information to

those whom he consults, the information that he must provide is information *about the proposals* and, unless evident from the proposals themselves, what they imply in practice. The Tribunal's researches have revealed no U.K. authority for the proposition that, in addition to information of that kind, information relevant to a determination of the reasonableness of the proposal must also be provided by the person who is under a statutory duty to consult; and the Opinion of the Privy Council in *Port Louis Corporation* v. *Attorney General of Mauritius* [1965] A.C. 1111 affords some positive support for the Tribunal's conclusion that, under U.K. law, a statutory duty to consult third parties about a proposal does not itself include a duty to provide those third parties with information relevant to a determination of the reasonableness of the proposal. (In this respect U.S. law may well go further than U.K. law: see the comparative study by Allan D. Jergesen, of the Bar of California, "The Legal Requirements of Consultation" [1978] Public Law 290; but it is unnecessary in this Arbitration to consider that question further.)

2.2.8 The view of the legal effect of the statutory duty on BAA to consult users here expressed by the Tribunal is the same as that evidently expressed by BAA's lawyers in 1981 when, by letter dated January 29 of that year, BAA's Chief Economist wrote to PanAm in, *inter alia*, the following terms:

> "I am advised that you are not entitled to the information for which you ask …
>
> "Under section 2(8) [of the Airports Authority Act 1975] the BAA would accept that they should give to the users an opportunity to consider and comment upon any proposals for changes in charges and should take those comments into account when making their decision. If and to the extent that the BAA are under any obligation to give additional information, this goes no further than information as to the proposals themselves, for example clarification as to a proposal which may be unclear. There is no obligation to give information about the calculations upon which the proposals are based and the reasoning lying behind them."

2.2.9 The Tribunal accordingly concludes that, in assessing HMG's efforts to encourage BAA to provide to the U.S.-designated airlines such information as might be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in Article 10 of the Treaty, little, if any, assistance is to be derived from the fact that HMG imposed on BAA the statutory duty to consult referred to at paragraphs 2.1.4 and 2.1.5 of this Chapter, above.

The adequacy of the information provided by BAA about its proposals themselves

2.2.10 In so far as the U.K. statutory duty to consult that was imposed on BAA throughout the Arbitration period required BAA to give to the airlines in advance of the establishment of charges for the next charging year an adequate description of the charges that were proposed, so as to make it clear what the proposals implied in practice, BAA undoubtedly discharged the duty. The consultation documents in question, which are dated, or were circulated on, (i) December 15, 1982, (ii) November 16, 1983, (iii) December 3, 1984 (apparently preceded by an informal announcement), (iv) October 7, 1985, (v)

December 17, 1986 and (vi) November 26, 1987, all contained full and clear descriptions of what BAA was proposing. In content therefore they satisfied the requirements of U.K. law. For reasons already stated, under U.K. public law, the airlines then had no right to further information such as might "be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in [Article 10 of the Treaty]" (to use the words of Article 10(5) of the Treaty).

Paragraph 8(b) of the Arrangements as to the future in the Airlines Settlement Agreement

2.2.11 However, the provision of at least some such information was one of the subjects of the Airlines Settlement Agreement of February 22, 1983, to which, both PanAm and TWA, amongst others, on the one hand, and the U.K. Secretary of State for Trade and BAA on the other hand, were party. The relevant paragraph of the Agreement was contained in the section entitled "*Arrangements as to the future*" which was prefaced by, *inter alia*, a statement that "BAA and the Airlines have agreed upon [those arrangements]" and by the following paragraph:

> "III. The Airlines acknowledge that the BAA's acceptance of these arrangements is, as it must be, given within the framework of, and subject to all duties and powers from time to time applicable to the BAA (including the BAA's statutory duty to provide adequate facilities for consultation for all users of BAA's airports and other persons or bodies specified in Section 2(8) of the Airports Authority Act 1975). The Airlines are happy to accept that, subject thereto, it is the intention of the BAA to implement and give effect to them. The BAA for its part is happy to accept that the Airlines will collaborate to that intent with the BAA."

2.2.12 The *Arrangements for the future* then included, at paragraph 8(b), the following words:

> "If marginal cost calculations are used in the setting of proposed charges, the BAA in its consultations will, if so requested, disclose basic forecasts and assumptions used in those marginal cost calculations and such calculations."

2.2.13 The Tribunal has, of course, no jurisdiction in respect of the Airlines Settlement Agreement and USG, not being a party to it, could not, and did not seek to, rely upon it. It may however be noted that the U.S. airlines appear never to have suggested that BAA failed to fulfill its obligations under paragraph 8(b) of the *Arrangements as to the future* contained in that Agreement, presumably because they were satisfied that the very extensive documentation provided to them as part of the medium term review included an adequate disclosure of the marginal cost calculations used (or purportedly used) by BAA in the setting of proposed charges, including the basic forecasts and assumptions used in those marginal cost calculations; and, subject to a qualification referred to at paragraphs 2.2.21 - 2.2.23 of this Chapter, below, that does indeed appear to the Tribunal to have been the case.

The kinds of information covered by Article 10(5)

2.2.14 However, in order to conduct an accurate review of the reasonableness of the structure of proposed user charges at Heathrow in accordance with the principles set out in Article 10 of Bermuda 2, it is necessary to have access not only to the raw data by reference to which those user charges have been proposed and an explanation of the methodology used by BAA in preparing the raw data but also to an explanation of the process of reasoning whereby BAA used the raw data to arrive at the particular charges proposed.

2.2.15 In the opinion of the Tribunal a Party will fail to fulfill its obligations under Article 10(5) of Bermuda 2 if:

(a) a charging authority of that Party only makes available to the interested airlines relevant raw data, without any explanation of how that data has been used to arrive at the actually proposed charges, leaving it to the airlines to deduce or intuit the nexus between the data and the actually proposed charges (unless the nexus is self-evident) and

(b) the Party, if it knows or ought to know of (a), fails to encourage the charging authority in question to provide to the airlines such an explanation.

2.2.16 With a charging structure having the complex and sophisticated theoretical foundation and the discretionary elements of the structure of BAA's charges at Heathrow, the nexus between relevant raw data and proposed charges will not necessarily be self-evident; and, on the facts as found by the Tribunal in the present case, the nexus was not self-evident but cried out for explanation.

2.2.17 Moreover, in the judgment of the Tribunal it is a corollary of Article 10(5) of Bermuda 2 that, unless a charging authority of a Party has prepared not only the raw data but also explanations in respect of the user charges that it proposes, then the Party in question should encourage it to do so, so that it will be possible for that charging authority to make both such data and such explanations available to airlines upon which the proposed charges are to be imposed.

The information provided by BAA with regard to structure of charges

2.2.18 In the present case, so far as the structure of **terminal charges** and **parking charges** are concerned, BAA provided to the airlines, as part of the medium term review, adequate raw data in respect of the *economic costs* computed by BAA and an adequate explanation of how BAA had computed those economic costs; whilst a point of time must be reached when such costs will require to be recomputed on an up-to-date basis, it has not been established that that point was reached during the Arbitration period, for the

remainder of which it continued to be permissible to use the economic costs calculated in the medium-term review for the purposes in hand.

2.2.19 Whether or not BAA provided to the airlines all the raw data necessary to permit an accurate review of the *definition of the peak hours* by reference to which terminal and parking charges were levied is more difficult to determine since many hundreds of pages of documentation are potentially relevant and neither Party has analyzed that material for the Tribunal for the purpose of answering this specific question. In any event it is unnecessary to answer the question since the Tribunal is satisfied that in another important respect BAA did not provide to the airlines necessary information and, if it had provided the information, the relevant raw data, if provided, would almost automatically have been identified.

2.2.20 The important respect in which BAA did not provide necessary information comprised its failure to explain its process of reasoning whereby it used the relevant raw data to arrive at the particular terminal and parking charges proposed. It is, of course, true that BAA did explain its use of long-run marginal costs as a basis for setting terminal and parking charges. But that explanation does not by itself permit an "accurate review" of the particular terminal and parking charges proposed.

2.2.21 It has to be said that the responsibility for this omission on the part of BAA was not exclusively BAA's. If the U.S. airlines had analyzed the raw data that BAA had made available to them and had raised the kinds of question that the Tribunal has raised in Chapter 5 of this Award, above, with regard to the relationship of the charges to the costs etc. on which they were purportedly based, BAA might well have been prompted to essay an explanation of its thought processes, at any rate in subsequent years. Rather, the U.S. airlines concentrated on advocating the use of a charge-setting methodology other than that proclaimed by BAA to be the basis of its user charges at Heathrow. Indeed in the course of the Arbitration USG requested and obtained discovery of a very large volume of BAA accountancy data such as might have been relevant to a review of the reasonableness of user charges at Heathrow if the principles set out in Article 10 required such charges to be established on the basis of accounting costs but which were wholly or largely irrelevant once it was accepted, as in the end it was by USG, that charges should be established on the basis of economic costs.

2.2.22 USG seeks only declaratory relief in respect of its claim that HMG has failed to fulfill its obligations under Article 10(5) of the Treaty. At the present stage of the Arbitration, the Tribunal records a finding that Article 10(5) required HMG to use its best efforts to encourage BAA to provide to the airlines an explanation of the process of reasoning whereby it had used the relevant raw data to arrive at the particular terminal and parking charges proposed for the four years *1985/86 - 1988/89*. As to the *first 2 years* of the Arbitration period, the reasoning in respect of the application of Article 10(1) and (3) of the Treaty to the structure of charges in those years, given at

paragraphs 9.6-9.9 of Chapter 5 above, applies equally to the provision of information in relation to those charges. In the judgment of the Tribunal, therefore, in respect of the last four years of the Arbitration period, HMG failed to discharge this obligation that it owed to USG under Article 10(5) of the Treaty.

2.2.23 With regard to **runway** (or landing) **charges**, the position is somewhat different. The principal problem arises with regard to the "raw data" required to assess the computation of the economic costs, here the short-run marginal costs. On the record before the Tribunal it is possible to conclude that the level of both peak and off-peak landing charges clearly exceeded BAA's own marginal cost of operating the runway. Therefore, if BAA was using SRMC as the basis for the runway charge, as it claimed that it was, it must have believed that imposition of runway charges equal to merely its own marginal costs of operating the runway would have led to demand at all times, though to a varying extent according to the time, exceeding runway capacity (and Dean Levine's evidence on behalf of USG was fully consistent with such a belief on the part of BAA). The economic or marginal costs of runway usage were therefore to be determined by reference to what users were prepared to pay for the privilege of access to the runway in peak hours and out of peak. Such costs are not something that can be "calculated" in the same sort of way as BAA calculated the long-run marginal cost of usage of terminal and parking stands.

2.2.24 One would therefore expect the "raw data" in respect of runway charges to be different in kind from the LRMC calculations disclosed to the airlines by BAA as part of the medium-term review. The problem is that BAA provided the airlines with no data in respect of the SRMC that it was using, or had in mind, when it set landing charges from 1985/86 onwards.

2.2.25 It may be that, given the existence of a limitation imposed by Bermuda 2 on the overall rate of return that BAA may earn on its relevant activities and given the complication that commercial income makes such a substantial contribution to BAA's profits at Heathrow, BAA will be bound to exercise a substantial discretion in setting all the user charges, including in particular runway charges, at Heathrow. Nevertheless, if an airport authority claims to use SRMC as a basis for the establishment of landing charges, the Tribunal cannot see how one can avoid the conclusion that its assessment of the SRMC of runway use is a piece of information that is necessary for the purposes of any review (and a *fortiori* any "accurate" review) of the reasonableness of its proposed runway charges. Yet, so far as the Tribunal can ascertain, BAA never made such an assessment available to the airlines and HMG never encouraged it to do so. In this respect also, therefore, HMG failed to fulfill its obligations to USG under Article 10(5) of the Treaty.

The information provided by BAA with regard to the level of charges

2.2.26 With regard to information in respect of the *level* of user charges at Heathrow during the Arbitration period, USG's essential complaint was that

after the privatization of BAA, BAA ceased to make available to the airlines its forecasts of profitability in the forthcoming charging year to which consultations in respect of charges related. Accordingly and because the precise position before privatization is irrelevant to the declaratory relief which is what USG seeks in respect of its complaints under Article 10(5) of the Treaty, no useful purpose would be served by the Tribunal considering further the details of the information about *level* of charges, i.e. forecast profitability, provided by BAA to the airlines before its privatization.

2.2.27 The Tribunal has already held that the introduction in 1987 of the RPI-X price cap régime did not result in the automatic fulfilment by HMG of its obligations under Article 10(1) and (3) of Bermuda 2 in the intervals between quinquennial reviews. Indeed, the Tribunal has held that in certain respects HMG failed to fulfill its "best efforts" obligation in respect of level of charges: see paragraphs 10.38-10.39 of Chapter 7 above.

2.2.28 Similarly the introduction of the RPI-X régime does not deprive of utility the consultation procedure in the intervals between quinquennial reviews. Consultation obviously continues to be useful in relation to the structure of charges, which is not in itself directly affected by the RPI-X régime, applying as it does only to *average* revenue per passenger. But quite apart from structure, RPI-X establishes only a ceiling to the level of charges and does not guarantee that they will provide for a contribution to no more than the reasonable return on assets referred to in Article 10(1) and (3). One cannot *a priori* exclude the possibility of consultation about level, accompanied by BAA's projections of its revenues, costs and profits, leading to modifications by BAA to its proposals. Such modifications might result from revisions by BAA of its projections or, even without such revisions, from a decision by BAA not to set user charges at as high a level as that proposed - in other words, to set them below the RPI-X ceiling.

2.2.29 The Tribunal has already held that the expression "provide for" where it appears in Article 10(3) of the Treaty implies that the required control of level of user charges is prospective. The consultation contemplated by Article 10(4) is similarly prospective in character ("to enable [users] to express their views before changes are made"). And the provision of information contemplated by Article 10(5) is expressed to be "for the purposes of paragraph 10(4) of this Article".

2.2.30 In these circumstances, it seems to the Tribunal to be inescapable that Article 10(5) requires HMG to use its best efforts to encourage BAA to provide to the U.S. airlines (for the purposes of consultations about the level of user charges at Heathrow proposed for the following year) information about BAA's projections of revenues, costs and profits for that year.

2.2.31 From July 1986 onwards HMG failed to fulfill that obligation. The considerations that led it to refrain from fulfilling it are described at paragraphs 1.5.1-1.5.7 of this Chapter above but, in the judgment of the

Tribunal these considerations did not relieve HMG of its obligations under Article 10(5).

2.2.32 The Tribunal appreciates that, by reason of the considerations in question, efforts by HMG to encourage BAA to make the information in question available to the U.S. airlines for the purposes of the consultation procedure might, in particular since the privatization of BAA, have been unsuccessful. Indeed it may be that since the privatization of BAA, paragraph 5 of Article 10 may not be entirely satisfactory from the point of view of either of the Parties. But the Tribunal must take the paragraph as it finds it and record the infringement set out at paragraph 2.2.31 of this Chapter above.

2.2.33 Lastly, in the present connection, HMG has in a number of places in its pleadings referred to failure *by the U.S. airlines* to provide information *to BAA*. The Tribunal is not a position to judge whether the information in question was necessary to permit an accurate review of the reasonableness of user charges in accordance with the principles set out in Article 10 of the Treaty; if not, Article 10(5) is inapplicable. Secondly, the Tribunal is not in a position to judge whether USG knew or ought to have known that the information in question had not been supplied; only if so, was it obliged to use its best efforts to encourage the U.S. airlines to provide the information to BAA. Thirdly, even if in this respect USG failed to fulfill its obligations under Article 10(5):

(a) there is no claim by HMG against USG in respect of that failure;

(b) there is no evidence to suggest that the failure by HMG to fulfill its obligations under Article 10(5) in the respects identified by the Tribunal was caused or contributed to by failure on the part of USG to fulfill its obligations under Article 10(5).

Accordingly, the Tribunal dismisses as irrelevant HMG's allegations that the U.S. airlines failed to provide information to BAA.

Declaratory relief

2.2.34 The question of precisely what kinds of information HMG is required by Article 10(5) to use its best efforts to encourage BAA to provide to the U.S. airlines for the purposes of the consultation procedure falls within the Second Question referred to the Tribunal (relief and remedies) rather than the First Question. For that reason, and because the question was, quite rightly, barely touched on in the course of the substantive hearing in July 1991, the Tribunal reserves, for consideration in connection with the Second Question, what, if any, definition it should give of the information which Article 10(5) of Bermuda 2 obliges HMG to use its best efforts to encourage BAA to provide to airlines. However, the Tribunal observes that the declaratory relief that it has jurisdiction to give in relation to Article 10(5) will necessarily be confined to such a definition and that therefore there is no substance in HMG's objection that remedial measures under Article 10(5) would effectively be addressed to BAA which is not a party to the Arbitration.

CHAPTER 10

SUMMARY OF CONCLUSIONS

1. The Tribunal's conclusions are summarized below. The summary is to be read in conjunction with the body of the Award. The summary should not be understood to add to, or to subtract from, anything in the body of the Award.

2. The Tribunal rejects HMG's preliminary plea of non-exhaustion of local remedies, as precluding a finding of breach of the Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America (referred to in this Award as "Bermuda 2" (*paragraph 6.46 of Chapter 3*, above).

3. The Tribunal finds that it does not lack jurisdiction in respect of the 1983/84 user charges (*paragraph 2.3 of Chapter 4*, above).

4. In respect of each of the four charging years 1985/86 - 1988/89 HMG failed to fulfil its obligations under Article 10(1) and (3) of Bermuda 2, in that -

(i) it failed to investigate the relationship between the economic costs identified by BAA and the user charges imposed by BAA (*paragraph 11.1.34 of Chapter 6*, above); more specifically and without prejudice to the generality of that finding (see paragraph 11.1.36 of Chapter 6, above)

(ii) HMG failed to monitor whether the operation by BAA of its sharply differentiated peak/off-peak charging system was in practice working inequitably to the detriment of the U.S.-designated airlines, by reason of British Airways having some advantage that was denied to PanAm/TWA, in relation to rescheduling flights out of peak terminal hours (*paragraph 11.2.37 of Chapter 6*, above);

(iii) HMG failed to question BAA's general assertions and specific conclusions in respect of terminal charges nearly as vigorously as it ought to have done *(paragraph 11.6.21 of Chapter 6*, above);

(iv) with regard to parking charges, HMG failed to procure comparisons of e.g. parking charges for typical aircraft/turnround times at peak and off-peak times and compare them with the economic costs by reference to which the charges were said to have been established (*paragraph 11.8.28 of Chapter 6*, above);

(v) HMG failed to investigate the probable effects of adoption by BAA of a properly constructed two-way system of charging for runway and terminal use in order to see whether or not adoption of such a system would have made so little difference in practice to what airlines actually paid overall in runway and terminal charges and to

their use of runways and terminals that adoption of two-way pricing would not have been worth such extra administration as would have been involved (*paragraph 11.10.12 of Chapter 6*, above).

5. HMG failed to fulfil its obligations under Article 10(1) and (3) when it effectively encouraged the introduction in 1985/86 of off-peak landing charge differentials for, and for only, small aircraft and when in 1987/88 and 1988/89 it acquiesced in the maintenance of larger off-peak landing charge differentials for small aircraft than for large (*paragraph 11.5.9 of Chapter 6*, above).

6. HMG failed to fulfil its obligations under Article 10(1) and (3) by reason of its failure to use its best efforts to secure the introduction of separate international and domestic terminal peaks well before their actual introduction in 1988/89 (*paragraph 11.7.46 of Chapter 6*, above).

7. The Tribunal by a majority finds that in respect of the three charging years 1984/85 - 1986/87 HMG failed to fulfil its obligations under Article 10(1) and (3) by reason of its failure to use its best efforts to lower the level of user charges at Heathrow (*paragraph 10.28 of Chapter 7*, above).

8. In respect of the year 1988/89 HMG failed to fulfil its obligations under Article 10(1) and (3) in that:

(i) after the introduction of the RPI-X price-cap régime it failed to establish a mechanism whereby within the ensuing quinquennium it could continue to review the level of Heathrow's profitability and to require BAA to consult with it before taking any measure that could be expected to affect the rate of return at Heathrow and thus HMG's performance of its obligations under Bermuda 2 (*paragraph 10.40 of Chapter 7*, above); and

(ii) specifically, HMG failed to deploy any efforts to ensure that the charges proposed and implemented by BAA for 1988/89 would provide for no more than a reasonable rate of return on assets (*paragraph 10.42 of Chapter 7*, above).

9. In respect of the four years 1985/86 - 1998/89: HMG failed to fulfil its obligations under Article 10(5) in that it failed to use its best efforts to encourage BAA to provide to the airlines

(i) an explanation of the process of reasoning whereby it had used the relevant raw data to arrive at the particular terminal and parking charges proposed for those years (*paragraph 2.2.22 of Chapter 9*, above);

(ii) BAA's assessment of the short run marginal cost of runway usage such as was necessary for the purposes of a review of the reasonableness of proposed runway charges (*paragraph 2.2.25 of Chapter 9*, above).

10. Pursuant to the Tribunal's Decision No. 9 of June 15, 1990, Question 2 of the Tribunal's Terms of Reference (remedy or relief) is reserved for determination by a further award or awards.

Done in The Hague on the 30th day of November 1992

(*Signed*) Fred F. Fielding

(*Signed*) Isi Foighel (President)

(*Signed*) Jeremy Lever

DISSENTING OPINION OF MR. JEREMY LEVER Q.C.

I. The scope of this Opinion

1.1 I have the misfortune to differ from the opinion of Professor Foighel and Mr. Fielding in respect of the matters dealt with in paragraphs 10.25 - 10.28 of Chapter 7 of the Award, as the asterisks to those paragraphs indicate. Rule 26(3) of the Tribunal Rules of Procedure provides that any member of the Tribunal may attach his individual Opinion to the award whether he dissents from the majority or not, or a statement of his dissent and it is pursuant to that Rule that this dissenting Opinion is attached to the Award.

II. The judgment of the majority of the Tribunal

2.1 The judgment of my colleagues is that HMG failed to fulfil its obligations under Article 10(1) and (3) of Bermuda 2 by reason of its failure to take steps to lower the level of charges in 1984/85 - 1986/87. That judgment is expressed to be based on the two following findings:

(i) comparing realized *accounting rates of return* with forecasts and targets, it was not "perfectly clear" that "BAA's rate of return [in the years in question] was unlikely to approach or attain an unreasonable level" (paragraph 10.26 of Chapter 7 of the Award);

(ii) perhaps even more relevant, in the view of the majority, the *accounting rates of return* (CCA) at Heathrow, looked at in isolation, substantially exceeded the accounting rates of return (CCA) of U.K. industries, exclusive of North Sea oil, in the years in question.

III. USG's case as pleaded in the written procedure and as presented in the oral procedure

3.1 In the first instance, I observe that USG's case against HMG was pleaded in the written procedure on a totally different basis from either of the bases set out at paragraph 2.1(i) and (ii) of this Opinion. USG's case was that in controlling the charges imposed by a monopolist, the monopolist's cost of capital should set an upper limit to its rate of return and that, in the case of Heathrow, the rate of return had been of the order of twice BAA's cost of capital for the six years in question. In advancing that case, USG contended that BAA had wrongly included in its capital employed (or, as it was sometimes called its "asset base" or "the rate base") assets in course of construction and had calculated its rates of return in ways that did not disclose its true profitability. BAA's accounting practices had also, according to USG, distorted BAA's rates of return in ways that USG specified (in particular, use of CCA, revaluation of investment properties and adoption of short asset lives). USG further claimed that BAA's debt:equity capital structure might also have unnecessarily raised BAA's cost of capital by inclusion of capitalized monopoly profits. USG's entire case on level of charges and profitability was that the *economic* rate of return, as distinct from the

accounting rate of return (see paragraphs 4.2, 4.3 and 8.18 *et seq*. of Chapter 7 of the Award) at Heathrow, measured against BAA's cost of capital, was unjust and unreasonable and that, by reason of HMG's failure to take into account the relevant considerations referred to above, and to seek to ensure a reduction in the level of charges to no more than the level justified by reference to those considerations, HMG failed to fulfil its obligations under Article 10(1) and (3).

3.2 There is clearly no correspondence between that case and the findings of the majority of the Tribunal set out at paragraph 2.1(i) and (ii) of this Opinion.

3.3 I further observe that no suggestion embodying either of those findings was put to any of HMG's witnesses in the course of the hearing and the Tribunal therefore did not have the benefit of hearing what, if any, answer HMG's witnesses or Counsel might have made to a case formulated against HMG along such lines. Indeed, in the course of the final speech of the Deputy Agent of the United States at the hearing, a member of the Tribunal inquired about USG's written pleadings in relation to *accounting rates of return*. The Deputy Agent stated very candidly that "We don't have any argument in the alternative. When I said that we had addressed the accounting issue, what I meant by that is that we had addressed an economic measure rather than an accounting measure [as] the correct measure."

3.4 Therefore the first ground on which, with the greatest respect to my colleagues, I find it necessary to dissent from their judgment contained in paragraphs 10.26-10.28 of Chapter 7 of the Award is that the bases for that judgment explicitly formed no part of the case against HMG as advanced in the Arbitration so that HMG has had no opportunity to meet such a case, on a highly technical and contentious issue; in my judgment, in an essentially adversary procedure, a tribunal ought not to base itself on such findings.

IV. The finding at paragraphs 10.26 - 10.28 of the Award in respect of 1984/85 and 1985/86

4.1 The second ground on which I find it necessary to dissent from the judgment of the majority of the Tribunal is that in my judgment it does not support the conclusion that the figures that were available to HMG and on which it was entitled to rely when it considered the proposed user charges were such that HMG should have intervened on the ground that the proposed charges "provided for" an excessive rate of return. Thus, for two of the three years in question, the BAA forecasts to which the majority of the Tribunal refers were that the proposed charges would provide for a CCA accounting rate of return of 4.6 per cent, in 1984/85, and 6.2 per cent, in 1985/86.

4.2 At paragraph 3.7 of Chapter 5 of the Award (Questions of Interpretation) the Tribunal concluded that the reference in Article 10(3) of the Treaty to it being permissible for user charges to "provide *for* a reasonable rate of return" indicates that the Treaty is here concerned with the position *ex*

ante (as it is expected to be when the relevant charges are imposed) and not with the position *ex post* (as it turns out to be in the event).

4.3 In my judgment there is nothing in the material before the Tribunal, to which the majority refers, to warrant an inference that HMG should have regarded the forecasts of profitability placed before it by BAA for the years 1984/85 or 1985/86 as unreliably low.

4.4 In relation to 1984/85, there is no evidence as to how the outturn for the preceding year had compared with the forecast for the preceding year which the majority of the Tribunal regard as particularly relevant in relation to 1985/86 and 1986/87.

4.5 In relation to the second of the two years (1985/86), so far as I can ascertain the record disclosed no reason why HMG should have expected that the circumstances that were leading (but were not, at the material time, yet known to have led) to an outturn better than forecast in 1984/85 would be repeated in 1985/86. In particular, I can find no evidence of there having been any reasons for HMG to have supposed that, contrary to what would be my natural assumption, the forecasts given to it by BAA failed themselves to take account of the matters set out at sub-paragraphs (a) and (d) of paragraph 10.26 of Chapter 7 of the Award.

4.6 Before considering the actual forecasts by BAA for the years in question, I must also record my dissent from the test proposed by the majority at paragraph 10.26 of Chapter 7 of the Award that, in order to escape liability, it was *incumbent on HMG* to show that it was *perfectly clear* that BAA's rate of return was unlikely *to approach* or attain an unreasonable level. In my judgment, first, the burden of proof on this issue rested on USG and not on HMG; secondly, use of the expression "perfectly clear" implies, to my mind, an incorrectly heavy standard of proof; thirdly, I cannot see why, even if it was perfectly clear that the rate of return was likely to approach but not to reach an unreasonable level, HMG is to be reproached for not having taken steps to lower the level of charges proposed by BAA.

4.7 In my judgment therefore the question here to be considered is whether, faced with forecasts of 4.6 per cent and 6.2 per cent (see paragraph 10.22 of Chapter 7 of the Award), HMG's "best efforts" obligation should have led it to intervene to get lower charges in the two years in question. I am of the judgment that that question should be answered in the negative.

4.8 In the 1980-83 litigation, which was then fresh in the minds of all concerned, the airlines, with the exception of PanAm, had accepted that an accounting rate of return of up to 6 per cent (CCA) would not be excessive. (With regard to the return at Heathrow in isolation, with which at paragraph 10.26 of the Award, the majority of the Tribunal was not concerned, my conclusions are given later in this Opinion).

V. The finds at paragraph 10.26 of the Award in respect of 1986/87

5.1 In relation to the charging year 1986/87 the majority of the Tribunal bases its conclusion that HMG would have taken steps to lower the level of charges on *inter alia* the following statistics relating to that year:

Financial return implied by target	**BAA's forecast**	**Actual rate of return**
6.25%	7.2%	7.6%

5.2 In so far as the majority of the Tribunal takes the view that those statistics provide evidence that HMG should have taken steps to lower the level of charges for 1986/87, I respectfully disagree. In the preceding year (during which HMG had to take its decision in respect of the charges for 1986/87) the average accounting rate of return for all U.K. industrial and commercial companies was 11 per cent or, if one excludes North Sea oil, 7 per cent. In 1986/87 itself the corresponding figures were 9 per cent and 8 per cent. If one is going to make such comparisons (as the majority of the Tribunal does for the purposes of the comparisons made at paragraphs 10.27 - 10.28 of Chapter 7 of the Award), they show that for the year 1986/87 HMG had no reason to expect the rate of return earned by BAA (whether one takes the forecast figure of 7.2 per cent or the realized figure of 7.6 per cent) to attain an unreasonable level compared with the current industrial averages, excluding North Sea oil of 7 - 8 per cent.

5.3 As contemporary documents confirm, that was the view taken by HMG when it examined BAA's proposals for 1986/87. It examined those proposals at an earlier stage in the charge-setting process than usual and with particular care because 1986/87 was intended to form, and in fact formed, the base year for the RPI-X price-cap régime. As a result of modifications by BAA to its original proposals for 1986/87, user charges at Heathrow were reduced by on average 4 per cent that year.

5.4 HMG expressly considered BAA's response to users in the consultation process leading up to the establishment of user charges for 1986/87. That response contained the following passage:

> "6. Risk-free interest rates in the UK are now about 7% in real terms. The Bank of England's latest calculation of rates of return on net assets for industrial and commercial companies reporting CCA results in 1984 is 11.0%. There have been substantial increases in the first three quarters of 1985. This figure is gained on averages from large companies within each of which the more profitable divisions will be earning higher returns, in the same way that Heathrow earns above the BAA average. The BAA does not therefore consider that 5% represents an adequate return on capital, nor that the projected return on assets figure of 8.9% for Heathrow in 1985/86 and 8.4% in 1986/87 is excessive.

> "7. More fundamentally, consistent with an economic cost based pricing policy, it is relevant to consider the returns achieved on new investment at the proposed charging level. From this viewpoint charges can only be considered excessive in economic terms if they are set at a level which exceeds the marginal cost of meeting growth in demand. None of the Users has addressed this point."

5.5 HMG accepted the validity of BAA's conclusion. That it was right to do so is confirmed by USG's own calculations which, as I explain below, demonstrate that, even at BAA's most profitable airport, Heathrow, the economic rate of return in 1986/87 fell substantially short of BAA's cost of capital that year. Accordingly, there is in my judgment no material on the basis of which it is possible to conclude that HMG's appreciation of the reasonableness of the user charges proposed for 1986/87 was wrong.

VI. The finding at paragraphs 10.27 and 10.28 of the Award in respect of 1984/85 - 1986/87

General considerations

6.1 I pass next to the substance of the second basis on which the majority of the Tribunal has reached the conclusion about what my colleagues regard as the inadequacy of HMG's efforts in respect of the level of user charges for 1984/85 - 1986/87, namely that the accounting rates of return (CCA) *at Heathrow* exceeded the accounting rate of return (CCA) of U.K. industries, excluding North Sea oil.

6.2 In my judgment no useful inferences can be drawn from such a comparison, primarily because, given the circumstances that prevailed in the years in question, it is inappropriate to look at the rate of return at Heathrow in isolation for any purpose relevant to the present Arbitration, let alone for the purpose of comparing the figures with industrial averages. I observe in passing that, for a different reason, USG and its relevant witnesses were equally firmly of the view that comparisons of the accounting rate of return for one company, or, as here, for part of the business of one company, with the accounting rate of return for other companies or industrial averages, were useless for the purposes in hand.

6.3 In my view, in the circumstances that prevailed in the mid-1980s, any relevant comparisons of rates of return, whether with other companies' rates of return or with cost of capital, need to take the Sough East Airports (Heathrow, Gatwick and Stansted) as a whole and not Heathrow alone as their starting point. I base that view on the fact that at the time in question there was a need to expand London's airport capacity in order to relieve congestion at Heathrow. I express no view as to whether, but for that need, it would have been appropriate to look at the profitability of the South East Airports as a whole or of each airport individually. (At paragraph 7.1 *et seq*. below I show that even if one confines one's attention to Heathrow for the years in question, my ultimate conclusion is unaffected.)

6.4 In my judgment, the appropriate test here for the reasonableness or otherwise of charges and profitability is to hypothesise lower charges and lower profitability and to ask whether the consequences of the lower charges and profitability would have been reasonable or unreasonable. If the consequences of a *reduction* in certain charges would have been unreasonable, then one cannot characterize *those charges* and *that level of profitability* as unreasonably high. For reasons that I will now explain, adopted of that approach here necessitates looking at the profitability of the South East Airports as a whole and not at the profitability of Heathrow. In what follows, I am indebted to Professor Kahn, who gave evidence for HMG, for what I regard as his perceptive analysis. That analysis was relevant to USG's comparison of economic rates of return for Heathrow in isolation with BAA's cost of capital but it is also relevant to the different basis on which the majority of the Tribunal has relied in making its relevant finding against HMG.

6.5 The material before the Tribunal amply establishes that throughout the Arbitration period there was a need for very substantial investment by BAA in airport capacity for passengers travelling to and from London. In this connection I note that the route schedules to and from the United Kingdom to which Bermuda 2 refers name London, rather than any particular London airport, as the relevant "point in U.K. Territory" or one of the relevant "points in U.K. Territory" and that Article 10(3) of Bermuda 2 expressly contemplates the provision by the Parties of "appropriate airport ... facilities".

6.6 Moreover, Article 10(1) of Bermuda 2 requires the Parties to use their best efforts to ensure that user charges shall be "equitably apportioned among categories of users"; and I understand that to require equitable apportionment among categories of user at any one "point in [U.K. or U.S.] Territory" and not merely among categories of users at any one of the airports serving such a point.

6.7 By way of final preliminary comment in relation to the need to look at the profitability of the South East Airports and not of Heathrow alone, it is here also relevant to recall that at paragraphs 4.16 *et seq*. of Chapter 6 of the Award the Tribunal has held that the limitation on rate of return must be understood to take precedence over the other aspects of charges that are relevant to whether or not they are just and reasonable. This makes it "particularly necessary", as the Tribunal has expressly recognized (at paragraph 1.7(b) of Chapter 7 of the Award), to try to ensure that the methodology employed in connection with the measurement and appraisal of rates of return is itself in conformity with sound economic principles and does not, in the absence of cogent considerations requiring such a result, lead to condemnation of charges as being too high to be just and reasonable when those charges have been set in accordance with sound economic principles.

6.8 I can now consider what would have been the effects if HMG had taken steps to lower the level of charges at Heathrow in 1984/85 - 1986/87 and if, following the approach of the majority of the Tribunal at paragraph

10.27 of Chapter 7 of the Award, one compares *ex post* airport accounting rates of return with U.K; industrial averages. For reasons that I will explain, I believe that if one is going to make such a comparison (as, indeed, for the purposes of the comparisons that I would regard as relevant) the airport rates of return at which one should look are the averages for the South East Airports and not at those for any one of those airports in isolation. I can consider the effects of the hypothesised enforced reduction in charges only qualitatively since the judgment of the majority of the Tribunal does not indicate the amount by which, in my colleagues' view, HMG should have sought to reduce the level of charges at Heathrow in any of the three years in question.

6.9 A reduction in user charges at Heathrow would either have been accompanied by a corresponding reduction in user charges at Gatwick and Stansted or not. In the latter event, the differentials between user charges at Heathrow on the one hand and at Gatwick and Stansted on the other hand would have been narrowed or eliminated. Indeed if the level of charges at Heathrow had had to be reduced and if the average rate of return for the South East Airports was not to be reduced, then the level of charges at Gatwick and Stansted would have had to be *increased* (i.e. increased more than they were increased in any event by BAA in what the record before the Tribunal demonstrates to have been a conscientious endeavour to establish economically appropriate inter-airport differentials).

6.10 Although, during the period in question, airline users of Heathrow were free and able to switch to Gatwick or Stansted, they did not choose to do so despite the lower charges at those airports. By contrast, airline users of Gatwick and Stansted were not free or able to switch to Heathrow and when, during the Arbitration period, HMG put up for discussion the possibility of changes that would effectively have deprived the existing airline users of Heathrow of the advantage that they enjoyed in this respect, PanAm and TWA strongly resisted the idea, which was in fact not pursued. Thus, with the actual differentials in rates that prevailed as between Heathrow, on the one hand, and Gatwick and Stansted, on the other hand, the U.S.-designated airline users of Heathrow strongly preferred Heathrow to Gatwick or Stansted and any narrowing or elimination of that differential would inevitably have increased the advantage that they evidently perceived that they enjoyed relative to competitors that had to use Gatwick or Stansted.

6.11 The material before the Tribunal amply demonstrated that Gatwick and Stansted were developed to relieve congestion at Heathrow. Indeed in opening USG's case at the hearing the Deputy-Agent for the United States referred to "the fact that Gatwick and Stansted relieve congestion at Heathrow [which] is undoubtedly true."

6.12 Very large capital investment was required for the expansion of capacity at (at the time here under consideration) Gatwick for the purpose just referred to, i.e. a purpose that benefited all airline users of airport capacity at the London "point" and airline users at Heathrow in particular.

6.13 In my judgment therefore it would not have accorded with sound economic principles and it would have contravened the Treaty requirement of equitable apportionment among categories of users if the hypothesised enforced reduction in charges at Heathrow had not been accompanied by a corresponding reduction in charges at Gatwick and at Stansted. This would have reduced the rate of return earned on assets (and new capital investment) at the South East Airports by even more than a reduction confined to Heathrow.

6.14 It was suggested by Professors Brealey and Myers in the evidence that they gave on behalf of USG that a reduction in charges and rates of return at Gatwick and Stansted as well as at Heathrow need not have prejudiced further investment in London airport capacity, since HMG could have made a subsidy available for the required investment. However, in my judgment, Article 10 of Bermuda 2 does not require that a Party should deploy its efforts to reduce user charges to a point at which it will be necessary for it to subsidize the development of required airport capacity at a Treaty "point" within its Territory.

6.15 Moreover, although I do not base my opinion on this since the matter was not pleaded or argued before the Tribunal, I observe that *prima facie* Article 92(1) of the EEC Treaty prohibited HMG from making such subsidies available and that none of the criteria enunciated in Article 92(2) and (3) for exempting, or permitting the exemption of, State aid from the prohibition of Article 92(1) appears to have been satisfied. If that is so, that would provide a further ground for excluding consideration of the possibility of the grant of subsidies by HMG.

6.16 In any event, my conclusion is that since new investment by BAA in London airport capacity was dependent upon the rate of return at the South East Airports, that is the relevant rate of return at which to look in the present context.

The actual accounting rates of return compared with the industrial averages

6.17 The question then arises whether the rate of return earned on assets at the South East Airports appears excessive, still using the methodology adopted by the majority of the Tribunal at paragraph 10.27 of Chapter 7 of the Award.

6.18 For the second and third of the years in question the rate of return at the South East Airports was almost identical with that for U.K. industrial and commercial companies, excluding North Sea oil (7.75 per cent (CCA) for the South East Airports versus 7.5 per cent (CCA) as the industrial average). In the first year the only reason for the difference between the two was that U.K. industry generally had an exceptionally poor year: the rate of return at the South East Airports at 7.6 per cent was *lower than* in either of the two following years; the industrial average excluding North Sea oil was only 5 per

cent, compared with an average of about 8.5 per cent for the next following four years).

6.19 I conclude that a comparison of the rates of return earned by BAA at the South East Airports with U.K. industrial averages confirms the reasonableness of HMG's approval of BAA's user charges at Heathrow for the three years here under consideration.

VIII. USG's case on level of charges in respect of 1984/85 - 1986/87

7.1 Having addressed the reasoning of the majority of the Tribunal at paragraphs 10.26 - 10.28 of Chapter 7 of the Award, I must now, in deference to USG, explain why I do not accept the case that it advanced to the Tribunal on the issue in question.

7.2 USG's case was essentially that the excess of the economic rate of return at Heathrow over the cost of capital was so gross (USG's pleadings provisionally estimated that the economic rate of return was twice the cost of capital) as to make it inconceivable that HMG's efforts in this respect could have been its best efforts.

7.3 It will be recalled that Professor Franks (who gave evidence for HMG) arrived at higher figures for BAA's cost of capital than did Dr. Kolbe (who gave evidence for USG). The differences were attributable in part to Professor Franks's use of a figure of 0.95 for the beta of BAA equity rather than the figure of 0.75 which, ultimately, Dr. Kolbe used. Over the Arbitration period as a whole, this gave rise to a difference of 1.8 percentage points in the two witnesses' figures for cost of capital. I will come back to that and explain why I conclude that one should use a beta of 0.95 as Professor Franks did. The remaining difference between the two witnesses' figures is attributable to differences of opinion on highly technical questions on which reasonable experts could evidently reasonably disagree and I do not think that the Tribunal can say that Professor Franks's conclusions on those questions were wrong.

7.4 With regard to the value of beta, it will be recalled that the difference of view about the appropriate value to use for the purpose in hand arose because, at the time of the October 1987 Stock Exchange crash, which occurred twelve weeks after BAA's equity first began to be traded on the Stock Exchange, the price of BAA shares fell significantly less than the Financial Times Stock Exchange ("FTSE") index for the market as a whole. Neither Party put forward any evidence as to the cause of that phenomenon and in particular as to the extent, if at all, to which it was associated with the recency of the flotation of BAA rather than or as well as BAA stock being perceived to be strongly countercyclical. In any event, it would not have been likely to have affected the estimation of the value of beta for use in computing BAA's cost of capital until some subsequent issue of the London Business School Risk Measurement Service (or some similar publication). Professor Franks's evidence was that the duration of the "crash period" was from

October 19, 1987 until April 1988. It follows that at the time when BAA's user charges for even the last year of the Arbitration period came to be set, a person concerned to regulate those charges could not reasonably have been reproached for failing to take account of the implications, if any, of BAA's share price movements on the estimation of the value of the beta attaching to BAA equity stock.

7.5 This discloses a more fundamental problem about using actual movements in BAA's share price at all to establish a value for beta for use in estimating BAA's cost of capital for the purposes of the present Arbitration: dealings in BAA shares did not start until July 28, 1987, i.e. only 4 months before the proposals for charges for the last year of the Arbitration period 1988/89, were published as part of the annual consultation process. In the absence of any information about BAA's share price for all but a very brief period of relevance for present purposes, the beta imputable to BAA for use in estimating its cost of capital would necessarily have had to be arrived at inferentially. Fortunately it is not necessary to speculate about the likely results of such an inferential process since the process was actually undertaken by a qualified expert, Dr. Ian Cooper, who, at BAA's request advised BAA about its cost of capital in late October (or possibly November) 1987.

7.6 Dr. Cooper's Report described current "best practice" (original quotation marks) in project appraisal and, in so doing, established BAA's cost of capital for use by BAA if it adopted the method of project appraisal described in the Report (essentially, comparison of, on the one hand, expected rate of return from the project with, on the other hand, BAA's cost of capital: Dr. Cooper did not suggest differentiation of cost of capital, project-by-project). Given the nature and purpose of Dr. Cooper's Report, there is no reason to doubt the complete objectivity of his calculations; and no one suggested that they lacked objectivity.

7.7 Dr. Cooper estimated BAA's cost of capital by reference to the behaviour of the shares of companies that he identified as comparable to BAA. The estimated value of BAA's beta implicit in Dr. Cooper's estimate of BAA's cost of capital was 1.0 (as Professor Franks testified in his principal evidence, on which, so far as this point is concerned, neither he nor Dr. Cooper was cross-examined or controverted).

7.8 Dr. Cooper's estimate of 1.0 is to be compared with Professor Franks's estimate of 0.95. Dr. Cooper's estimate does not require adjustment on account of changes in BAA's gearing (debt-to-value ratio) in so far as the estimate is applied to earlier years of the Arbitration period since up to October 1987 the ratio shown by BAA's then most recently published Balance Sheet at 6 per cent was very close to the average for the preceding four years (the first four years of the Arbitration period).

7.9 In these circumstances I conclude that, for the purpose of assessing USG's attack on the sufficiency of HMG's efforts in relation to level of

charges, made on the basis of a comparison of economic rate of return with cost of capital, BAA's cost of capital should be taken at the figures put forward by Professor Franks, using a beta of 0.95 (although, as appears from what is said below, my conclusion for the years 1984/85 - 1986/87 remains unaffected even if one uses Dr. Kolbe's figures for cost of capital).

7.10 Using Table 8.21 and 8.25 in Chapter 7 of the Award and thus taking, in USG's favour, Dr. Kolbe's figures for the economic rate of return, which were disputed by HMG and which were confined to Heathrow, the following picture then emerges:

1. Economic rates of return at Heathrow as per Dr. Kolbe	**1984/85**	**1985/86**	**1986/87**	**3 year single average**
With actual CCA book values	11.3	13.1	4.5	9.6
2. BAA's cost of capital as per Prof. Franks	14.4	16.5	15.4	15.4

7.11 The reason why I have taken Dr. Kolbe's figures with actual CCA book value is because those are the only figures that were available to anyone until the revaluations that took place some years later. The Tribunal has applied a "best efforts" test of asking whether, if a Party's own pocket had been affected, it would have proceeded differently. When, in July 1987, HMG offered the share capital of BAA for sale to the public, it would have been advantageous to it for the full appreciation in the capital values of BAA's assets which (on the evidence submitted to the Tribunal) had by then occurred to have been reflected, in one way or another, in the Offer for Sale. In fact the tangible assets were included in the figures referred to in the Offer for Sale at the valuations put on them by professional valuers as at 1 April 1986 and the figures that I have given above for 1986/87 include those valuations. The subsequent revaluations, in so far as they reflect appreciation in value of assets in 1984/85 - 1986/87 were therefore not reasonably foreseeable by HMG when it considered user charges for the years in question and therefore lines 2 and 3 of Table 8.21 in Chapter 7 of the present Award are simply irrelevant in the present context.

7.12 In the result, in each of the three years under consideration, BAA's cost of capital exceeded its economic rate of return as calculated by Dr. Kolbe for USG, even confining one's attention to Heathrow in isolation. For the three years as a whole, cost of capital averaged 15.4 per cent compared with an average economic rate of return of only 9.6 per cent. Even if, contrary to my conclusion, one uses Dr. Kolbe's figures for cost of capital, the comparison is of an average cost of capital of 12.8 per cent versus the

economic rate of return computed by Dr. Kolbe of 9.6 per cent. My conclusion therefore remains unchanged.

7.13 In my judgment the figures given above provide a complete answer to USG's case, in respect of the three years in question, that a comparison of economic rates of return with cost of capital shows that HMG cannot have used its best efforts to ensure that charges at Heathrow would not provide for an excessive rate of return on assets.

VIII. Conclusion

8.1 For the reasons given above, I regretfully find it necessary to dissent from the conclusion set out at paragraph 24 of Chapter 10 of the Award and, with all respect to my colleagues, to express my opinion that in respect of the years 1984/85, 1985/86 and 1986/87, whether one looks at accounting rates of return and industrial averages or economic rates of return and cost of capital, and whether one looks at Heathrow in isolation or at the South East Airports as a whole, it has not been established that HMG failed to discharge its obligation under Article 10(1) and (3) of Bermuda 2 to use its best efforts to ensure that the user charges should not provide for an unreasonably high return on assets.

Done in The Hague on the 30th day of November 1992

(*Signed*) JEREMY LEVER

APPENDIX I

AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND AND THE GOVERNMENT OF THE UNITED STATES OF AMERICA CONCERNING AIR SERVICES

The Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America;

Resolved to provide safe, adequate and efficient international air transportation responsive to the present and future needs of the public and to the continued development of international commerce;

Desiring the continuing growth of adequate, economical and efficient air transportation by airlines at reasonable charges, without unjust discrimination or unfair or destructive competitive practices;

Resolved to provide a fair and equal opportunity for their designated airlines to compete in the provision of international air services;

Desiring to ensure the highest degree of safety and security in international air transportation;

Seeking to encourage the efficient use of available resources, including petroleum, and to minimize the impact of air services on the environment;

Believing that both scheduled and charter air transportation are important to the consumer interest and are essential elements of a healthy international air transport system;

Reaffirming their adherence to the Convention on International Civil Aviation opened for signature at Chicago on 7 December 1944; and

Desiring to conclude a new agreement complementary to that Convention for the purpose of replacing the Final Act of the Civil Aviation Conference held at Bermuda, from 15 January to 11 February 1946, and the annexed Agreement between the Government of the United Kingdom and the Government of the United States of America relating to Air Services between their Respective Territories, as subsequently amended ("the 1946 Bermuda Agreement");

Have agreed as follows:

ARTICLE 1

Definitions

For the purposes of this Agreement unless otherwise stated, the term:

…

(b) "Agreement" means this Agreement, its Annexes, and any amendments thereto;

(c) "Air service" means scheduled air service or other charter air service or both, as the context requires, performed by aircraft for the public transport of passengers, cargo or mail, separately or in combination, for compensation;

(d) "Airport" means a landing area, terminals and related facilities used by aircraft;

…

(h) "Designated airline" means an airline designated and authorized in accordance with Article 3 of this Agreement;

…

(j) "International air service" means an air service which passes through the air space over the territory of more than one State;

…

(n) "Territory" means the land areas under the sovereignty, jurisdiction, protection, or trusteeship of a Contracting Party, and the territorial waters adjacent thereto; and

(o) "User charge" means a charge made to airlines for the provision for aircraft, their crews and passengers of airport or air navigation property or facilities, including related services and facilities.

…

ARTICLE 10

User Charges

(1) Each Contracting Party shall use its best efforts to ensure that user charges imposed or permitted to be imposed by its competent charging authorities on the designated airlines of the other Contracting Party are just and reasonable. Such charges shall be considered just and reasonable if they are determined and imposed in accordance with the principles set forth in paragraphs (2) and (3) of this Article, and if they are equitably apportioned among categories of users.

(2) Neither Contracting Party shall impose or permit to be imposed on the designated airlines of the other Contracting Party user charges higher than those imposed on its own designated airlines operating similar international air services.

(3) User charges may reflect, but shall not exceed, the full cost to the competent charging authorities of providing appropriate airport and

air navigation facilities and services, and may provide for a reasonable rate of return on assets, after depreciation. In the provision of facilities and services, the competent authorities shall have regard to such factors as efficiency, economy, environmental impact and safety of operation. User charges shall be based on sound economic principles and on the generally accepted accounting practices within the territory of the appropriate Contracting Party.

(4) Each Contracting Party shall encourage consultations between its competent charging authorities and airlines using the services and facilities, where practicable through the airlines' representative organizations. Reasonable notice should be given to users of any proposals for changes in user charges to enable them to express their views before changes are made.

(5) For the purposes of paragraph (4) of this Article, each Contracting Party shall use its best efforts to encourage the competent charging authorities and the airlines to exchange such information as may be necessary to permit an accurate review of the reasonableness of the charges in accordance with the principles set out in this Article.

(6) In the event that agreement is reached between the Contracting Parties that an existing user charge should be revised, the appropriate Contracting Party shall use its best efforts to put the revision into effect promptly.

…

ARTICLE 16

Consultations

Either Contracting Party may at any time request consultations on the implementation, interpretation, application or amendment of this Agreement or compliance with this Agreement. Such consultations shall begin within a period of 60 days from the date the other Contracting Party receives the request, unless otherwise agreed by the Contracting Parties.

ARTICLE 17

Settlement of Disputes

(1) Any dispute arising under this Agreement, other than disputes where self-executing mechanisms are provided in Article 12 (Tariffs) and Annex 2, which is not resolved by a first round of formal consultations, may be referred by agreement of the Contracting Parties for decision to some person or body. If the Contracting Parties do not so agree, the dispute shall at the request of either Contracting Party be submitted to arbitration in accordance with the procedures set forth below.

(2) Arbitration shall be by a tribunal of three arbitrators to be constituted as follows:

(a) within 30 days after the receipt of a request for arbitration, each Contracting Party shall name one arbitrator. Within 60 days after these two arbitrators have been nominated, they shall by agreement appoint a third arbitrator, who shall act as President of the arbitral tribunal;

(b) if either Contracting Party fails to name an arbitrator, or if the third arbitrator is not appointed in accordance with sub-paragraph (a) of this paragraph, either Contracting Party may request the President of the International Court of Justice to appoint the necessary arbitrator or arbitrators within 30 days. If the President is of the same nationality as one of the Parties, the most senior Vice-President who is not disqualified on that ground shall make the appointment.

(3) Except as otherwise agreed by the Contracting Parties, the arbitral tribunal shall determine the limits of its jurisdiction in accordance with this Agreement, and shall establish its own procedure. At the direction of the tribunal or at the request of either of the Contracting Parties, a conference to determine the precise issues to be arbitrated and the specific procedures to be followed shall be held no later than 15 days after the tribunal is fully constituted.

(4) Except as otherwise agreed by the Contracting Parties or prescribed by the tribunal, each Party shall submit a memorandum within 45 days of the time the tribunal is fully constituted. Replies shall be due 60 days later. The tribunal shall hold a hearing at the request of either Party or at its discretion within 15 days after replies are due.

(5) The tribunal shall attempt to render a written decision within 30 days after completion of the hearing or, if no hearing is held, after the date both replies are submitted, whichever is sooner. The decision of the majority of the tribunal shall prevail.

(6) The Contracting parties may submit requests for clarification of the decision with 15 days after it is rendered and any clarification given shall be issued within 15 days of such request.

(7) Each Contracting Party shall, consistent with its national law, give full effect to any decision or award of the arbitral tribunal. In the event that one Contracting Party does not give effect to any decision or award, the other Contracting Party may take such proportionate steps as may be appropriate.

(8) The expenses of the arbitral tribunal, including the fees and expenses of the arbitrators, shall be shared equally by the Contracting Parties. Any expenses incurred by the President of the International Court of

Justice in connection with the procedures of paragraph (2)(b) of this Article shall be considered to be part of the expenses of the arbitral tribunal.

…

ARTICLE 19

Termination

Either Contracting Party may at any time give notice in writing to the other Contracting Party of its decision to terminate this Agreement. Such notice shall be sent simultaneously to the International Civil Aviation Organization. This Agreement shall terminate at midnight (at the place of receipt of the notice) immediately before the first anniversary of the date of receipt of the notice by the other Contracting Party, unless the notice is withdrawn by agreement before the end of this period.

…

ARTICLE 21

Entry into Force

This Agreement shall enter into force on the date of signature.

In witness whereof the undersigned, being duly authorized thereto by their respective Governments, have signed the present Agreement.

Done in duplicate at Bermuda this 23rd day of July, Nineteen Hundred and Seventy-seven.

…

APPENDIX II

US/UK ARBITRATION CONCERNING HEATHROW AIRPORT USER CHARGES

DECISION NO. I OF THE TRIBUNAL (TERMS OF REFERENCE)

THE ARBITRAL TRIBUNAL

Having met in first session at The Hague on 28 and 29 June 1989,
Having considered, on the basis of the written and oral submissions of the Parties, the following matters: –

The present Arbitration arises under the Air Services Agreement between the Government of the United States of America ("the US Government") and the Government of the United Kingdom of Great Britain and Northern Ireland ("the British Government"), as amended on 25 April 1978. That Agreement is usually referred to as "Bermuda 2" and is so referred to in this Decision.

By letter dated 16 December 1988 addressed to the British Ambassador to the United States, the US Department of State requested, pursuant to Article 17 of the Bermuda 2, that there should be referred to arbitration "the continuing dispute between our Governments concerning the user charges imposed by the British Airports Authorities and subsequently by BAA plc on US airlines and of the conduct of the British Government in relation thereto".

As a result of that request, the presently constituted Arbitral Tribunal was duly convened. The present Decision concerns an interlocutory motion by the British Government concerning the Terms of Reference of the Tribunal.

The Contracting Parties have not been able to reach complete agreement about the precise issues to be arbitrated. The following are the terms proposed by the British Government:

1. The tribunal is requested to decide whether, in relation to the charges imposed for the use of London Heathrow Airport upon airlines designated by the Government of the United States of America under Article 3 of the Air Services Agreement, done at Bermuda on 23 July 1977, the Government of the United Kingdom have failed to fulfil their obligations under paragraph (1) of Article 10 of the aid Air Services Agreement in any of the charging periods beginning on or after 1 April 1983.

2. If the answer to the foregoing question is in the affirmative, the tribunal is further requested to decide what, if any, remedy or relief should be awarded.

3. For the efficient management of the proceedings, the tribunal is requested, in the first instance, to render its decision on the above questions only in respect of the charging periods (a) 1 April 1985 to 31 March 1986, and (b) 1 April 1987 to 31 March 1988.

The US Government contends, first, that the references in paragraph 1 of the British Government's proposal, to "paragraph (1) of Article 10 (of Bermuda 2)" should be to Article 10 *simpliciter*. Secondly, the US Government contends that following the reference, in paragraph 1 of the British Government's proposal, to Article 10 of Bermuda 2 there should be inserted the words "having regard to the Memorandum of Understanding between the two Governments on Airport User Charges of April 6, 1983". That Memorandum of Understanding is, in places, abbreviated to "the MOU" and that abbreviation is used in this Decision. Thirdly, the US Government originally contended that, in paragraph 2 of the British Government's proposal, the expression "if any" which precedes the reference to "remedy or relief" should be omitted, although in this regard it modified its position in the course of the oral hearing. Fourthly and lastly the US Government opposes the inclusion, in the Terms of Reference, of paragraph 3 of the British Government's proposal.

(i) Objection 1: the reference to Article 10 of Bermuda 2

According to the motion filed by the British Government under cover of a letter date 12 June 1989, paragraph (2) of Article 10 should not be included in the Arbitration because, as the British Government understands it, the US Government does not complain of violations of that paragraph; and paragraph (3) of Article 10 does not set out the obligations of the Contracting Parties but rather principles in light of which (*inter alia* and in appropriate circumstances) it might be determined whether or not there is or has been a breach of paragraph (1) of Article 10. However, in oral argument it was conceded by the British Government that paragraphs (2) and (3) are incorporated by reference in paragraph (1). Lastly, in the British Government's written observations it contends that there is nothing in the Note sent on 16 December 1988 from the US Government initiating this Arbitration that indicates any dispute concerning paragraphs (4), (5) or (6) of Article 10 which had not been resolved by a first round of consultations and, not having been so resolved, was therefore arbitrable. At the oral hearing the British Government amplified its grounds for confining the Arbitration to, in effect, paragraphs (1) to (3), stating that even if the Note of 16 December 1988 covered disputes about consultation and the provision of information in relation to user charges, the Tribunal should exercise a discretion to exclude such disputes from the Arbitration since the major questions arose under paragraphs (1) - (3), any questions under paragraphs (4) and (5) would be complex and time-consuming and the answers to them would be rendered irrelevant once the main questions had been answered.

The US Government by its Brief of 19 June 1989 maintains that the British Government is factually in error as to the scope of the dispute giving rise to this Arbitration and that as a matter of law the British Government cannot pick and choose the paragraphs of Article 10 that it prefers to arbitrate. In oral argument the US Government stated that the US Government wished to have

its dispute with the British Government resolved fully and finally in a comprehensive and neutral manner and that it was entitled by Article 17(1) of Bermuda 2 to have any and every dispute so resolved; the US Government regarded the inadequacy of the information that had been provided as highly relevant; and it offered proof of the breadth of the complaints that it had made in the past.

In the judgment of the Tribunal it could clearly be most undesirable for part of the actual dispute between the Contracting Parties to be left undetermined by this Arbitration. It is also clearly undesirable for the Tribunal to express at this stage in these proceedings any view about the proper construction of the various provisions of Article 10 or of their applicability or inapplicability to matters that are in dispute since those questions may have to be determined by the Award.

(ii) Objection 2: reference to the MOU

The US Government contends that the MOU was intended to be legally binding, that construed in accordance with established principles of international law it should be treated as binding, that both Contracting Parties and the BAA have treated is as binding and that, by virtue of Article 31(3)(a) of the Vienna Convention, account must be taken of the MOU in interpreting Bermuda 2 and the application of its provisions. According to the US Government, by virtue of the Vienna Convention the MOU forms a part of the law specifically applicable to interpretation of Bermuda 2 and, as such, merits specific mention in the terms of Reference in the same way as it had merited specific mention in the BAA Offer for Sale.

The British Government in turn submits that: the MOU is not the source of independent obligations which could be the subject of arbitration under Article 17 of Bermuda 2; the extent to which, the circumstances in which and purposes for which regard should be had to the MOU may be in issue in the Arbitration; and the absence of reference to the MOU in no way precludes the Tribunal having regard to the MOU in interpreting Bermuda 2 where it considers it appropriate. According to the British Government, the MOU no more deserves specific mention in the Terms of Reference than anything else relevant to the interpretation of Bermuda 2, such as, for example, subsequent practice.

In the judgment of the Tribunal inclusion of reference to the MOU in the Terms of Reference will not prejudice any issue in the Arbitration and by reason of its particular status it is appropriate to mention the MOU in the Terms of Reference.

(iii) Objection 3: remedy or relief "if any"

The original difference between the Parties here was rather technical. Both accepted that the Tribunal has the power in appropriate circumstances to include remedies or relief or both; and both accepted that the circumstances

might be such as to make it inappropriate to do so. The US Government however feared that inclusion of the words might suggest that it agrees in this case that the Tribunal might appropriately not grant relief after finding a violation of Bermuda 2 whereas the British Government believes that the words should be included to make it clear that a finding of a breach would not *necessarily entail* the grant of remedies or relief.

In the course of oral argument the US Government indicated that if the inclusion of the words "if any" would in no way prejudice the US Government contending in the Arbitration that the normal consequence of breach of an international agreement is grant of a remedy, it had no objection to the words in the Terms of Reference.

It is the judgment of the Tribunal that the inclusion of the words would in no way so prejudice the US Government.

(iv) Objection 4: adjudication of two "sample" years in the first instance

The British Government urges the Tribunal to conduct the Arbitration so as initially to adjudicate only two years, namely those ended 31 March 1986 to 31 March 1988 as "sample" years in the first instance since in its view there is a real chance that the decision of the Tribunal in relation to one or two years will set a framework within which a settlement of the complete dispute can be reached and, if so, that that would be much more economical of time and expense than looking at the whole period since 1 April 1983 in the first instance.

The US Government submits that the Tribunal should reserve judgment on whether any procedural device, such as that suggested by the British Government, is necessary. In the view of the US Government, it would be wholly inappropriate at this stage in the proceedings to give such a procedural direction, which would deprive the US Government of its right to present its claim in a full and fair manner.

In the judgment of the Tribunal there could be a risk that a limitation to "sample" years would impair a Party's right to present and prove its case in the way that it believes to be appropriate and would actually add to the time and expense of the Arbitration. At the same time the Tribunal accepts that it will be free to give procedural directions at a later stage as an aid to the efficient administration of the Arbitration. The Tribunal finds that it would be inappropriate to include in the Terms of Reference any procedural direction such as that suggested in paragraph 3 of the British Government's draft Terms.

DECIDES that -

based upon the foregoing considerations and determinations, the Terms of Reference should read as follows:

"1. The Tribunal is requested to decide whether, in relation to the charges imposed for the use of London Heathrow Airport upon airlines designated

by the Government of the United States of America under Article 3 of the Air Services Agreement, done at Bermuda on 23 July 1977, the Government of the United Kingdom have failed to fulfil their obligations under Article 10 of the said Air Services Agreement, interpreted having regard to *inter alia* the Memorandum of Understanding between the two Governments on Airport User Charges of April 6, 1983, in any of the charging periods beginning on or after 1 April 1983.

"2. If the answer to the foregoing question is in the affirmative, the Tribunal is further requested to decide what, if any, remedy or relief should be awarded."

Done at The Hague this twenty-ninth day of June 1989:

(*Signed*) Isi Foighel, President

(*Signed*) Fred F. Fielding, Esq.

(*Signed*) Jeremy Lever Q.C.

APPENDIX III

US/UK ARBITRATION CONCERNING HEATHROW AIRPORT USER CHARGES

THE TRIBUNAL'S RULES OF PROCEDURE

as agreed upon between the parties and accepted by the Tribunal at its first session on 29 June 1989,

and as amended by Decisions No.7, No.14 and No.15 of the Tribunal

and as supplemented according to the Tribunal's Minute of 7 May 1991

Edited by the Registrar
28 January 1992

RULE 1
INCAPACITY OR RESIGNATION OF ARBITRATORS

(1) If an arbitrator becomes incapacitated or unable to perform the duties of his office, he shall as soon as possible notify the other members of the Tribunal and the Registrar.

(2) An arbitrator may resign by submitting his resignation to the other members of the Tribunal and the Registrar.

RULE 2
PROCEDURE DURING A VACANCY ON THE TRIBUNAL

(1) The Registrar shall forthwith notify the parties of the death, incapacity or resignation of an arbitrator.

(2) Upon the notification by the Registrar of a vacancy on the Tribunal, the proceeding shall be or remain suspended until the vacancy has been filled.

RULE 3

F1LLING VACANCIES ON THE TRIBUNAL

A vacancy resulting from the death, incapacity or resignation of an arbitrator shall be promptly filled by the same method by which his appointment had been made, and within the time periods specified by Article 17 of the parties' Agreement Concerning Air Services.

RULE 4

RESUMPTION OF PROCEEDING AFTER FILING A VACANCY

As soon as a vacancy on the Tribunal has been filled, the proceeding shall continue from the point it had reached at the time the vacancy occurred. The newly appointed arbitrator may, however, require that the oral procedure be recommenced, if this had already been started.

RULE 5

SESSIONS OF THE TRIBUNAL

(1) The Tribunal shall hold its first session within 60 days after its constitution or such other period as the parties may agree. The dates of that session shall be fixed by the President of the Tribunal after consultation with its members and the parties.

(2) The dates of subsequent sessions shall be determined by the Tribunal, after consultation with the parties.

(3) The Registrar shall notify the members of the Tribunal and the parties of the dates and place of the sessions of the Tribunal in good time.

RULE 6

SITTINGS OF THE TRIBUNAL

(1) The President of the Tribunal shall conduct its hearings and preside at its deliberations.

(2) The President of the Tribunal shall fix the date and hour of its sittings.

RULE 7

DELIBERATIONS OF THE TRIBUNAL

(1) The deliberations of the Tribunal shall take place in private and remain secret.

(2) Only members of the Tribunal shall take part in its deliberations. The Registrar may also be present. No other person shall be admitted unless the Tribunal decides otherwise.

RULE 8

DECISIONS OF THE TRIBUNAL

(1) Decisions of the Tribunal shall be taken by a majority of the votes of all its members. Abstention shall count as a negative vote.

(2) Except as otherwise provided by these Rules or decided by the Tribunal, it may take any decision by correspondence or telephone discussion among its members, provided that all of them are consulted. Decisions so taken shall be confirmed in writing by the President of the Tribunal and communicated to the Registrar and the parties.

RULE 9

REPRESENTATION OF THE PARTIES

(1) Each party may be represented or assisted by agents, deputy agents, counsel or advocates whose names and authority shall be notified by that party to the Registrar, who shall promptly inform the Tribunal and the other party.

(2) For the purposes of these Rules, the expression "party" includes, where the context so admits, an agent, deputy agent, counsel or advocate authorized to represent that party.

RULE 10

PROCEDURAL ORDERS

The Tribunal shall make the orders required for the conduct of the proceeding.

RULE 11

PRELIMINARY PROCEDURAL CONSULTATION

(1) As early as possible after the constitution of a Tribunal, its President shall endeavour to ascertain the views of the parties regarding questions of procedure. For this purpose he may request the parties to meet him. He shall, in particular, seek their views on the following matters:

(a) the number of the pleadings and the time limits within which they are to be filed;

(b) the number of copies desired by each party of instruments filed by the other;

(c) dispensing with the written or the oral procedure;

(d) the manner in which the record of hearings shall be kept.

(2) In the conduct of the proceeding the Tribunal shall apply any agreement between the parties on procedural matters.

RULE 12

PRE-HEARING CONFERENCE

(1) At the discretion of the President of the Tribunal, a pre-hearing conference between the Tribunal and the parties may be held to arrange for an exchange of information and the stipulation of uncontested facts in order to expedite the proceeding.

(2) At the request of the parties, a pre-hearing conference between the Tribunal and the parties, duly represented by their authorized representatives, may be held to consider the issues in dispute with a view to reaching an amicable settlement.

RULE 13

CORRECTION OF ERRORS

(1) An accidental error in any instrument or supporting document may, with the consent of the other party or by leave of the Tribunal, be corrected at any time before the award is rendered.

(2) Within 30 days after a decision or award is rendered, the Tribunal, upon the request of a party or upon its own motion, may after notice to the parties rectify any clerical, arithmetical, or similar error in the decision or award.

Note by the Registrar: As for the time period applicable to requests for clarification of the decision pursuant to Article 17 (6) of Bermuda 2, reference may be made to the Registrar's note at Rule 26 below.

RULE 14

TIME LIMITS

(1) Where required, time limits shall be fixed by the Tribunal by assigning dates for the completion of the various steps in the proceeding. The Tribunal may delegate this power to its President.

(2) The Tribunal may extend any time limit that it has fixed. If the Tribunal is not in session, this power shall be exercised by its President.

RULE 15

NORMAL PROCEDURES

Except if the parties otherwise agree, the proceeding shall comprise two distinct phases: a written procedure followed by an oral one.

RULE 16

THE ORAL PROCEDURE

(1) The oral procedure shall consist of the hearing by the Tribunal of the parties, their agents, deputy agents, counsel and advocates, and of witnesses and experts.

(2) The Tribunal shall decide, with the consent of the parties, which other persons besides the parties, their agents, deputy agents, counsel and advocates, witnesses and experts during their testimony, and officers of the Tribunal may attend the hearings.

(3) The members of the Tribunal may, during the hearings, put questions to the parties, their agents, deputy agents, counsel and advocates, and ask them for explanations.

RULE 17

MARSHALLING OF EVIDENCE

Without prejudice to the rules concerning the production of documents, each party shall, within time limits fixed by the Tribunal, communicate to the Registrar for transmission to the Tribunal and the other party, precise information regarding the evidence which it intends to produce and that which it intends to request the Tribunal to call for, together with an indication of the points to which such evidence will be directed.

RULE 18

EVIDENCE: GENERAL PRINCIPLES

(1) The Tribunal shall be the judge of the admissibility of any evidence adduced and of its probative value.

(2) The Tribunal may, if it deems it necessary at any stage of the proceeding:

(a) call upon the parties to produce documents, witnesses and experts; and

(b) visit any place connected with the dispute or conduct inquiries there.

(3) The parties shall cooperate with the Tribunal in the production of the evidence and in other measures provided for in paragraph (2). The Tribunal shall take formal note of the failure of a party to comply with its obligations under this paragraph and of any reasons given for such failure.

(4) The Tribunal may, at the request of either of the parties, call upon the other party to provide further information on, or clarification of, any factual matter in an memorandum submitted by that other party.

RULE 19

EXAMINATION OF WITNESSES AND EXPERTS

(1) Witnesses and experts shall be examined before the Tribunal by the parties under the control of its President. Questions may also be put to them by any member of the Tribunal.

(2) Each witness shall make the following declaration before giving his evidence:

> "I solemnly declare upon my honour and conscience that I shall speak the truth, the whole truth and nothing but the truth."

(3) Each expert shall make the following declaration before making his statement:

> "I solemnly declare upon my honour and conscience that my statement will be in accordance with my sincere belief."

RULE 20

WITNESSES AND EXPERT'S : SPECIAL RULES

Notwithstanding Rule 19 the Tribunal may:

(a) admit evidence given by a witness or expert in a written deposition; and

(b) with the consent of both parties, arrange for the examination of a witness or expert otherwise than before the Tribunal itself. The Tribunal shall define the subject of the examination, the time limit, the procedure to be followed and other particulars. The parties may participate in the examination.

RULE 21

VISITS AND INQUIRIES

If the Tribunal considers it necessary to visit any place connected with the dispute or to conduct an inquiry there, it shall make an order to this effect. The order shall define the scope of the visit or the subject of the inquiry, the time limit, the procedure to be followed and other particulars. The parties may participate in any visit or inquiry.

RULE 22

CLOSURE OF THE PROCEEDING

(1) When the presentation of the case by the parties is completed, the proceeding shall be declared closed.

(2) Exceptionally, the Tribunal may, before the award has been rendered, reopen the proceeding on the ground that new evidence is forthcoming of such

a nature as to constitute a decisive factor, or that there is a vital need for clarification on certain specific points.

RULE 23

PROVISIONAL MEASURES

(1) At any time during the proceeding a party may request that provisional measures for the preservation of its rights be recommended by the Tribunal. The request shall specify the rights to be preserved, the measures the recommendation of which is requested, and the circumstances that require such measures.

(2) The Tribunal shall give priority to the consideration of a request made pursuant to paragraph (1).

(3) The Tribunal may also recommend provisional measures on its own initiative or recommend measures other than those specified in a request. It may at any time modify or revoke its recommendations.

(4) The Tribunal shall only recommend provisional measures, or modify or revoke its recommendations, after giving each party an opportunity of presenting its observations.

RULE 24

SETTLEMENT AND DISCONTINUANCE

(1) If, before the award is rendered, the parties agree on a settlement of the dispute or otherwise to discontinue the proceeding, the Tribunal shall, at their written request, in an order take note of the discontinuance of the proceeding.

(2) If the parties file with the Registrar the full and signed text of their settlement and in writing request the Tribunal to embody such settlement in an award, the Tribunal may record the settlement in the form of its award.

RULE 25

DISCONTINUANCE AT REQUEST OF A PARTY

If a party requests the discontinuance of the proceeding, the Tribunal shall in an order fix a time limit within which the other party may state whether it opposes the discontinuance. If no objection is made in writing within the time limit, the other party shall be deemed to have acquiesced in the discontinuance and the Tribunal shall in an order take note of the discontinuance of the proceeding. If objection is made, the proceeding shall continue.

RULE 26

THE AWARD

(1) The award shall be in writing and shall contain:

(a) a precise designation of each party;

(b) a description of the method of constitution of the Tribunal;

(c) the name of each member of the Tribunal, and an identification of the appointing authority of each;

(d) the names of the agents, deputy agents, counsel and advocates of the parties;

(e) the dates and place of the sittings of the Tribunal;

(f) a summary of the proceeding;

(g) a statement of the facts as found by the Tribunal;

(h) the submissions of the parties; and

(i) the decision of the Tribunal on every question submitted to it, together with the reasons upon which the decision is based.

(2) The award shall be signed by the members of the Tribunal who voted for it; the date of each signature shall be indicated.

(3) Any member of the Tribunal may attach his individual opinion to the award, whether he dissents from the majority or not, or a statement of his dissent.

Note by the Registrar: As appears from the Minute of the proceedings of the Tribunal dated 7 May 1991: "The Parties have agreed that in the circumstances of the present Arbitration Article 17(5) of Bermuda 2* can reasonably be interpreted to allow the Tribunal to attempt to render a written decision on the first of the questions referred to the Tribunal within 6 months after completion of the hearing that is due to commence on 2 July 1991. The Parties have further agreed that in the circumstances of the present Arbitration they should be free to request clarification of that written decision within 8 weeks after that decision has been rendered and that the Tribunal should issue such a clarification within 8 weeks of any such request. It is acknowledged that neither Party will raise any objection to use of those time limits in connexion with the written decision to be rendered following on the hearing that is due to commence on 2 July 1991."

*Due to a writing error the Minute referred to Article 17(6) of Bermuda 2 instead of Article 17(5). On behalf of the Registry the error has been corrected in letter GBA 1073 of 19 November 1991.

RULE 26A*

MORE THAN ONE AWARD

(1) Nothing in these rules shall be understood as excluding the power of the Tribunal, after having consulted with the parties, to limit its initial award to one or more specific issues only, reserving its decision with respect to any remaining issues in dispute for a further award or further awards.

(2) If the Tribunal decides so to limit an award:

(a) the declaration contemplated by Rule 22(1) shall indicate the issues with respect to which the proceeding is closed;

(b) notwithstanding Rule 26(1), such award shall contain only such of the facts and submissions as are in the opinion of the Tribunal relevant to the issue or issues addressed and shall give a decision only on the issue or issues to which the award is limited.

* Rule 26A has been inserted by Decision No. 14.

RULE 27

RENDERING OF THE AWARD

(1) Upon signature by the last arbitrator to sign, the Registrar shall promptly:

(a) authenticate the original text of the award together with any individual opinions and statements of dissent; and

(b) dispatch a certified copy of the award (including individual opinions and statements of dissent) to each party, indicating the date of dispatch on the original text and on all copies.

(2) The award shall be deemed to have been rendered on the date on which the certified copies were dispatched.

(3) The Registrar shall, upon request, make available to a party additional certified copies of the award.

RULE 28*

WITNESS STATEMENTS

Not later than ten weeks prior to the hearing, each party shall provide to the Registrar and the other party (a) written notice of the name, address and relevant biographical data regarding each witness it intends to call at the hearing and, in the case of an expert witness, a *curriculum vitae* or the witness and (b) a written statement of the testimony of each witness. Written statements filed pursuant to this rule shall support or address positions taken by a party in its Memorial or Reply and may be in question and answer form. If, after examining a witness statement of the other party, a party wishes to

call additional witnesses to rebut positions taken or information provided therein, it shall, not later than fourteen days prior to the hearing, provide to the Registrar and the other party (a) written notice of the name, address and relevant biographical data regarding each rebuttal witness it intends to call and (b) in the case of an expert witness, a *curriculum vitae* of the witness and a written summary of the testimony of the witness.

* Rule 28 has been amended by Decision No. 7.

RULE 28A*

FILING AND EXCHANGE OF EVIDENCE

(1) Each party within 10 days after the filing of its initial memorandum, its reply or its rejoinder shall provide to the Registrar (5 copies) and to the other party (9 copies) bound volumes containing:-

(a) the documentary evidence; and

(b) the relevant portion of each legal precedent, text book or other authority; upon which it intends to rely at the hearing in support of positions taken in each such pleading.

(2) Any witness testimony upon which a party relies in support of its case shall be filed in accordance with the procedure described in Rule 28 of the Tribunal's Rules of Procedure.

(3) Each party, not less than 21 days before the date fixed for any oral hearing, shall provide to the Registrar (5 copies) and to the other party (9 copies) bound volumes containing the relevant portion of each legal precedent, text book or other authority upon which it proposes to rely at that oral hearing and which has not been provided pursuant to (1) above.

(4) Where the material in (1)(b) or (3) above forms part only of the precedent, text book or other authority relied upon, the party relying thereon shall make the whole available upon the request of the other party or the Tribunal. A party shall comply with any request made pursuant to this paragraph by supplying a copy of the requested authority to the agent of the other party at his usual address by the quickest practicable means available but no request shall be made by a party without that party first making a reasonably diligent search of its own.

(5) The Tribunal may, upon the application of a party, waive the time limits set out in Rule 28 or in this rule, provided that the requisite filing shall be done as soon as practicable upon the application being granted.

(6) The date for filing any document under these rules shall be the date on which it is despatched by a party to the Tribunal and to the other party. High quality commercial air courier service or other rapid means of shipment shall be used.

* Rule 28A has been inserted by Decision No. 7.

RULE 29

NOTICE OF MOTIONS

Not later than two weeks prior to the hearing, each party shall endeavour to provide the Registrar and the other party with a written copy of any motion it wishes the Tribunal to consider.

RULE 30*

SUPPLEMENTARY DECISION

(1) Within eight weeks after the date on which the award was rendered, either party may request a supplementary decision on the award. Such a request shall be addressed in writing to the Registrar. The request shall state in detail any questions which, in the opinion of the requesting party, the Tribunal omitted to decide in the award.

(2) Upon receipt of the request, the Registrar shall forthwith transmit to the other party and to the members of the Tribunal a copy of the request and of any accompanying documentation.

(3) The President of the Tribunal shall consult its other members on whether it is necessary for the Tribunal to meet in order to consider the request. The Tribunal shall fix a time limit for the parties to file their observations on the request and shall determine the further procedure for the consideration of the request.

(4) Rules 26-27 shall apply, *mutadis mutandis*, to any decision of the Tribunal pursuant to this Rule.

*Rule 30 has been amended by Decision No. 15.

APPENDIX IV

MEMORANDUM OF UNDERSTANDING BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND ON AIRPORT USER CHARGES (6 APRIL 1983)

1. [USG] and [HMG] have been in dispute about the pricing policies of [BAA], the policies of HMG in relation thereto, and in particular the charges imposed by the BAA at London (Heathrow) Airport from 1976 to date. The present dispute has arisen under Articles 10 and 11 of [Bermuda 2]. The dispute is reflected, *inter alia*, in the Diplomatic Notes of 7 April, 19 June, 27 July, 16 September and 19 October 1981 from the USG, and of 30 April, 27 July, 10 August and 28 September 1981 from HMG; in papers presented during consultations and in the [Memoranda] of Consultations resulting therefrom dated 7 October and 13 November 1981.

2. Her Majesty's Secretary of State for Trade (the Secretary of State), the BAA and a number of airlines of the United States and other countries have also been involved in legal proceedings in the High Court in England. On 22 February 1983 the parties to those proceedings concluded a Memorandum of Understanding and Settlement Agreement ("the Settlement") to take effect when a Memorandum of Understanding has been entered into between HMG and the USG. This document constitutes that Memorandum between the two Governments.

3. HMG maintains that it has complied with its obligations under Articles 10 and 11 of Bermuda 2 with regard to user charges imposed by the BAA. The USG maintains that HMG has been in breach of those obligations in relation to user charges imposed by the BAA from 1976 to date. Nevertheless, while differences remain between the USG and HMG concerning those user charges, the USG and HMG share the hope that the policies of HMG relating to the imposition of user charges in the United Kingdom will no longer be the subject of dispute between them.

4. As a result of discussions between the two Governments, the following understandings are recorded:

(a) Without prejudice to the right of either Government to contend that from 1976 to 31 March 1983 the other Government has been in breach of its obligations under Articles 10 and 11 of Bermuda 2 and the right of either Government to contend that it has fully complied with such obligations, the USG and HMG acknowledge that their disputes with respect to user charges from 1976 to 31 March 1983 have been set aside. Accordingly, neither Government will proceed to an arbitration under Bermuda 2 concerning the fulfillment by the other Government of its obligations with respect to user charges

under Articles 10 and 11 of Bermuda 2 in respect of the period up to and including 31 March 1983. In the event a dispute arises concerning fulfillment by either Government of its obligations with respect to user charges after 31 March 1983, both Governments may refer to and rely on their contentions to date concerning user charges and the history of this dispute, including the materials referred to in paragraph 1 above.

(b) Borrowing is often required by sound financial practice, and, therefore, within the framework of and subject to the duties and powers applicable, the Secretary of State in exercising his statutory powers over the borrowings of the BAA recognizes that it may be necessary to seek external financing. If the BAA incurs major capital expenditure, such as the capital investments currently planned, there will be occasions when the BAA's after-tax cash flow, including user charges, is insufficient to cover the BAA's requirements for capital expenditure in a given year, and in such circumstances it would be necessary and appropriate for the BAA to fund all or part of its capital expenditure programme from other sources as permitted by existing legislation or as may be permitted by future legislation.

(c) In formulating financial targets with the BAA, HMG acknowledges the need to secure efficient use of the public resources employed by the BAA, and looks for no more than a reasonable rate of return on investment. In computing revenues that contribute to the rate of return on assets, no distinction will be made as to the sources of revenue, including duty-free sales and other commercial revenues.

(d) In using its best efforts, HMG expects the charges determined and imposed by the competent charging authorities at the airports served by U.S. carriers to be just and reasonable, and equitably apportioned among categories of users and in accordance with the principles set forth in Article 10 of Bermuda 2. In particular, the Secretary of State expects the competent charging authorities to ensure that the charges more closely reflect actual differences in the full costs of supplying airport services and facilities, are based on sound economic principles and on the generally accepted accounting practices within the United Kingdom, and are reasonably related to and do not exceed the full costs, including depreciation and a reasonable rate of return, of supplying the services and facilities concerned.

5. Both Governments acknowledge in principle that an acceptable system of peak charges reflecting airport costs might be constructed in appropriate circumstances. Further, both Governments welcome the arrangements agreed upon by the BAA and the airlines for a collaborative review of peak charges. The USG has expressed a number of concerns about the BAA's peak pricing practices. In particular, the USG believes that (1) all traffic should bear at least some capital costs; (2) all traffic should bear its share of operating costs;

(3) peak periods, where established at any airport, should encompass all periods of comparable activity at that airport; and (4) no peak charge should be assessed with respect to any service or facility unless a charge is also assessed for such service or facility during off-peak periods. HMG sees force in the last three of these views and will commend them to the BAA, as well as drawing all the USG concerns to the attention of the BAA so that they may be taken into account in their collaborative review of peak pricing.

6. The undersigned, being duly authorized by their respective Governments, hereby confirm that the foregoing correctly represents the understandings of the two Governments in this matter and that these understandings will take effect if on or before 12 April 1983 Action 1980 A No. 4127 and 1980 P No. 4245 are discontinued as contemplated by the Settlement.

Done at Washington this sixth day of April, 1983, in duplicate.