

**Airline response: Discussion paper on the regulatory
treatment of issues associated with airport capacity
expansion**

July 2014

Introduction

This submission sets out airlines' views on the CAA's June discussion paper on the regulatory treatment associated with airport capacity expansion.

Airlines welcome the initial assessment published in the CAA's paper, and have worked across the airline communities at Heathrow and Gatwick to provide a consideration of these proposals. As such this response is submitted jointly from the ACC at Gatwick, the LACC at Heathrow and endorsed by BATA and IATA.

Executive summary

While there is no formal role for the CAA in the Airports Commission decision making process, the CAA will clearly have a role in determining a fair price path and regulatory regime for the successful option, once decided. Moreover, it has a primary duty to protect the passenger interest and therefore needs to ensure that the process being carried out will lead to that duty being met.

The CAA's discussion paper is therefore helpful in setting out a number of the regulatory issues that need to be considered in relation to any new airport capacity at Heathrow or Gatwick. It is important there is a clear understanding of the CAA's objectives for economic regulation. It is also important that there is a clear framework for when it will regulate, and the conditions under which regulation may change.

Perceived financing risks are likely to vary significantly between projects, according to the commercial viability of the scheme chosen. Airlines do not consider that airports would face real financing issues if a commercially viable option is selected, because the project would be attractive to airlines and passengers, to investors, and therefore to the CAA, significantly limiting risk of all kinds.

However, if a scheme is chosen that is not commercially viable, only a contribution by Government, if permitted under State Aid rules, could reduce the risks. In that case, airlines consider that regulatory intervention, however innovative, is unlikely to reduce demand, regulation or financing risk sufficiently. The most that could be achieved would be to transfer risk, or to reduce one type of risk by increasing another type of risk.

Long term profit guarantees or advance payments are especially damaging because they increase demand risks, they reduce the airport's incentive to build in an efficient way to meet consumer needs and they can generate distorting inter-generational cross-subsidies. Such regulatory intervention would be disproportionate and damaging. Airlines support the principle proposed by the CAA that the party best able to manage a risk is allocated that risk. The CAA has no duty to facilitate inefficient investment, but does have a clear primary duty to further the interests of passengers.

There are a number of areas where airlines are aligned with the CAA's thinking, but the airlines believe that there are some areas which require further consideration by the CAA. In particular:

- Airlines are concerned that, under current plans, there is no firm view by the CAA on how it will carry out cost scrutiny in order to meet its primary duty to passengers. Airlines believe this warrants urgent consideration given the high level of detail already submitted to the Airports Commission.
- Airlines believe that funding for additional capacity should begin only once new capacity enters into use. This is both in the best interest of passengers and moreover is what would happen in a competitive market. This will require careful thought to the appropriate regulatory mechanism for additional capacity and is at odds with the CAA's decision to allow GAL to collect R2 funding during Q6.
- It is important to note that the existence of a plan to build capacity, or even building works, does not change the conditions in the market unless there has been a flow through to the economic conditions facing airports and airlines. The CAA therefore needs to consider further how and when it will carry out any further market power assessments.

The CAA has only allowed a four week consultation on its proposals. Airlines believe that this consultation period was too short to reasonably address, in detail, all the critical issues raised in the discussion paper. In particular we would expect an open dialogue with the CAA on the following areas over the coming months as our thinking evolves:

- The design of an appropriate regulatory mechanism for the addition of additional capacity. Airlines believe international examples such as Dublin and Amsterdam airports should be considered.
- The identification and appropriate allocation of risk. To ensure economic efficiency and fairness.
- Financing issues and cost of capital

Chapter 2

The CAA's role

It is important there is a clear understanding of the CAA's objectives for economic regulation. It is also important that there is a clear framework for when it will regulate, and the conditions under which regulation may change.

The airlines note that the CAA has a set of statutory duties, which have only recently been set. The existence of the capacity expansion question does not change the CAA's duties.

The CAA has set out its view on the role of regulation, and in particular four ways in which it will deliver this. Each of these is worth comment.

1. 'delivering, as far as possible, an outcome that broadly approximates to that of a competitive market in long run'

We support this statement, and believe it is important that the CAA assess any regulatory solutions against competitive outcomes.

2. 'ensuring consumers' interests are promoted through the efficient provision of good quality, reliable and sustainable services'

The airlines support this statement, in particular its recognition that consumers value efficient provision and not simply the provision of capacity at any cost.

3. 'creating regulatory frameworks that avoid adding undue uncertainty and risk to the business environment, as this could increase the costs of investment which would be to the detriment of users of air transport services'

The airlines support this statement; it is important that the CAA does not create extra risk.

4. 'being a critical enabler of infrastructure investment'

The airlines do not support this statement. There is no mention in the CAA's statutory duties of any requirement to support investment. The airlines are particularly concerned as this statement could create a real risk that the CAA finds itself in a position where it supports new capacity *because* it is new capacity, rather than because it is in the interests of passengers. Instead new capacity must be addressed through its value to consumers, and whether they are willing to pay for any new capacity.

Airport market power

There are a range of issues that affect whether or not an airport has market power, one of which is capacity.

The airlines agree that it is too early for the CAA to 'hypothesise' about how competitive constraints may change. In our view there must be 'facts on the ground' for the CAA to come to a view on competitive constraints. Without changes in underlying economic conditions we do not see how the CAA can declare that there has been a Material Change in Circumstance (MCC) at either Heathrow or Gatwick, as it is the underlying economic conditions that drive the market position of the airports. By

‘underlying economic conditions’ we mean the commercial drivers/incentives for both the airport and airlines and also the wider factors that affect market power such as switching costs etc.

The airlines believe it is unlikely that economic conditions at either airport will change until at least there is new capacity in place. However, it is clear that addition of new capacity of itself does not create MCC, but it can potentially be a factor that would need to be taken into account along with the other factors set out by the CAA.

It is important to note that the existence of a plan to build capacity, or even building works, does not change the conditions in the market unless there has been a flow through to the economic conditions facing airports and airlines.

The CAA has set out the main factors (in 2.12) that would go in to a Significant Market Power test, reflecting the previous work that the CAA has carried out on airport market power. The airlines do not see a need for a separate set of criteria to assess the implication of new capacity but rather the CAA should use its existing guidelines to undertake any future market power assessments.

The CAA consultation also discusses the role of critical loss analysis in any future market power assessment. The airlines agree broadly with the CAA’s high level analysis (in 2.14 to 2.18) of the likely impact of changes in airport charges on airport revenues.

While the CAA then says that the critical loss analysis may not provide a definitive answer due to the outcomes of its analysis the airlines do think this is an important piece of evidence that the CAA should put appropriate weight on. This does not seem to be due to any flaw in critical loss analysis or for any other robust reason. We are concerned that the CAA is of the view that new capacity requires some different form of analysis from the assessments it has done to date, without explaining the logic to support this assertion.

Do you consider that new runway capacity in the south-east of England would change the competitive conditions in the south-east of England? If so, what are the likely changes in those conditions? Would this be affected if any new capacity was released in a staged manner?

The airlines have not carried out any analysis yet to determine whether new runway capacity would change conditions or whether this assessment can even be carried out. However, our initial assessment is that this analysis cannot be carried out at this stage, as there have been no changes in the underlying economic conditions that determine the market position of Heathrow and Gatwick.

Further, new capacity is at least ten years away, so any analysis today would require significant speculation on the future structure and level of demand at the South East airports and development in underlying economic conditions.

The airlines note that the CAA’s high level analysis of the critical loss factor implies that changes in charges would not have a significant effect on demand at any one airport. However, the CAA then goes on to imply that the critical loss assessment ‘would not provide a definitive answer as to how market power may change’. While we agree that it is unlikely to be definitive, we do not support the CAA implying that because the critical loss assessment is unlikely to point to a change in market power an alternative approach is needed.

What do you consider are the implications for economic regulation if an existing airport operator faces terminal competition? What factors (if any) would need to be re-considered?

The airlines think it too early to speculate on these changes and are unclear of the benefit of doing so now. The airlines note that terminal competition has been considered in some detail in earlier regulatory reviews. It would also require changes to the current regulatory regime.

Chapter 3

The airlines welcome the CAA's discussion of the timing of any new market power assessment, although we do not necessarily agree with its analysis.

The CAA has rightly focussed on the potential triggers for a Material Change in Circumstances. However, it presents a very mechanistic approach, which outlines potential changes in circumstances linked to a series of construction events. However, the economic circumstances of the market are not necessarily driven in such a simple way by construction event. It is particularly unclear how any of the preparatory activities for the delivery of new capacity will necessarily change the competitive position of London airports. We do not think any of the events set out by the CAA constitute a MCC.

The airlines believe the CAA needs to carry out further work to assess the economic circumstances that are likely to bring about any change in market power, and to consider when these may occur.

Further, the airlines believe that it is impossible to determine ex-ante when there is a MCC, as a MCC is an outcome of changes in the behaviour of market participants, not an automatic change following a construction event.

The timing of any Market Power Assessment

The airlines are concerned at any suggestion that a Market Power Assessment can be carried out ahead of a Material Change in Circumstance. For the CAA to carry out such an assessment without a change in the 'facts on the ground' it would have to rely on untested theory, rather than evidence. We do not think it good practice to assess market power on the basis of theory rather than evidence.

If investors have specific questions for the CAA to answer these, however these would need to be set out in the context of the uncertainty around the issues.

What do you consider are the risks/benefits of the CAA undertaking a market power determination in advance of a material change in circumstance? Do these risks/benefits change over time?

The main risks relate to the lack of evidence if an assessment of market power is carried out ahead of any change in the market. This would severely limit the credibility of the assessment and leave it open to challenge, creating longer term uncertainty.

Do you consider that there are particular milestones that, if passed, suggest that the CAA should undertake a market power determination in advance of a material change in circumstance?

No. We can see no justification for a market power assessment ahead of a material change in circumstances.

If the CAA does not undertake a market power determination in advance of a material change in circumstance would it be helpful for the CAA to publish relevant information? If so, what information do you consider would be useful for the CAA to release?

The airlines can see benefits in the CAA publishing information on the main factors in a market power assessment, effectively a summary of the factors relevant to its earlier market power assessments. This would simply be a summary of the current position.

The airlines note that while it is legitimate to seek to reduce forward looking investor risk where this arises from information gaps etc. However, it is not an objective in its own right, as reducing investor risk could involve increasing returns to investors at the expense of consumers.

If the CAA did release information before any new capacity was available, as there was a high level uncertainty with that information, would you find that information useful?

It is important that the CAA provides a clear factual basis for any analysis by CAA of market power issues.

The airlines are concerned that where information is subject to a high level of uncertainty it can become potentially misleading.

For example; the consultation document mentions the prospect of releasing materials on scenario analysis and catchment areas. Drawing conclusions from scenario analysis can be highly speculative and complex to assess given changes in other conditions. When not properly undertaken catchment area analysis can also lead to misleading conclusions. While some airports may be operating in partially overlapping catchment areas, they may still offer unique different products in different markets. Even in cases where there may be some overlap between the product offers and markets, the extent to which it is sufficient to replicate competition is complex consideration which will not be addressed through an assessment of only catchment areas.

Chapter 4: Risk, regulation and financing

Risk allocation is a more significant consideration given the size and duration of the investment than for smaller incremental projects and it is therefore worth addressing explicitly to ensure appropriate incentives are provided to deliver a runway in passenger interests.

Do you consider that risk should be allocated to those parties who are best able to manage it?

Yes, this is a fundamental principle. Misallocation of risk will create inappropriate incentives to developers and would be likely to undermine the CAA's primary duty to further passenger interests. Risks should be allocated so as to maximize the total project value, taking into account each party's ability to influence, anticipate, respond to and absorb the risk. We explore this further in the remaining questions in section 4.

How the CAA's duties should guide risk allocation

When allocating risk, the CAA needs to be driven predominantly by its primary duty to further the interests of passengers, while taking account of other relevant secondary duties and promoting competition where appropriate. As discussed further in Chapter 9, the weighting of these considerations should reflect the wording of the Statutory duties..

In light of the primary duty to further the interests of passengers, it is fundamental that risks to passengers are optimised and that any risk allocated to them is balanced by a clear and commensurate benefit. If this cannot be achieved, the onus must be placed on the airport to redesign its proposed approach.

Airlines agree that promoting competition could imply toleration of increased risks to the airport, as this is what would happen in a competitive market. To look at it another way, placing risks on passengers (such as long term cost and demand risks) is likely to give the airport a perverse incentive to take excessive risks, such as expanding too rapidly or expensively or not catering to the needs of airlines and passengers, in order to improve their own market position and thereby strengthen market power.

The requirement to "have regard to" the need for an airport to finance its activities must be seen in the context of pursuing the primary objective to passengers and cannot therefore imply a cap on airport risk unless:

- There is some other mechanism to ensure that the risks will be properly managed; and
- risks are reduced by the cap and not simply transferred.

For example; one way to cap risks to airports would be to support a phased development approach to delivering the runway and associated investments (such as terminals and stands), so that outputs and benefits are delivered earlier and costs expended later. This would reduce the "lumpiness" of investment and the airport would then bear the risk only of the next development stage. As there would be no regulatory commitment to fund the whole project, a back-up option would need to be put in place – for example, by allowing another developer to take the project forward.

The requirement to have regard to the need to promote efficiency and economy must mean that the CAA gives careful consideration to the efficiency of the proposal. This is currently the weakest area of RAB based regulation. Allocation of greater cost risk to the airport would undoubtedly help by providing the airport with meaningful incentives to manage costs. Chapter 7 explains why there is a need for more cost scrutiny by CAA and the appointment of an independent cost surveyor.

The CAA must also have regard to the need to secure that all reasonable demand is met. This means that the CAA must take a view on passenger demand and whether the projections of the Government and airport developer are “reasonable”. Demand risk needs to be allocated first to the airport, as the party best able to manage this. This would create strong incentives for the airport to have realistic traffic forecasts and to take account of the effect of airport costs and other economic factors on demand. The airport could, for example, reduce demand risks by reducing costs and/or by making sure that the development was likely to attract airlines, passengers and freight. This allocation of demand risk would therefore provide stronger incentives on the airport to meet passenger needs.

Demand: there are two types of demand risk, long and short term risk. Under standard RAB regulation, the airports take on short-term traffic risk through the quinquennium (although this process is evolving at Gatwick through a series of contracts and Commitments). In addition, airlines offset much of the demand risk in practice, by discounting prices when demand is weak so as to fill their aircraft at marginal revenues. The rate of WACC should reward only this residual risk. Once the period is over, the risk is re-set to zero as traffic forecasts for the next period are taken into account in determining allowable revenue. However, the longer term demand risk in relation to runway projects is key as this is how the business cases are determined to be viable. There is therefore a significant risk for airlines and their passengers over the medium to long term if the traffic forecasts used by the scheme proposers have been inflated or based on unrealistic assumptions. Airlines and passengers should not be exposed to this risk.

The CAA also needs to have regard to the need to target regulation only where it is needed. This means that any change from the default commercial position, where the developer bears all the commercial risk of development, should further passenger interests and be proportionate and clearly targeted.

If risk is perceived as too high, do you consider that the CAA should look to try and address those risks?

Not necessarily. An airport with market power may perceive or claim that the risks are too high to proceed with a project as a means of securing greater shareholder reward or by making it easier to profit from the project. In fact, they would have a commercial incentive to exaggerate the risks to the CAA. An airport operating in a competitive market would have stronger commercial incentives to reduce risks themselves (especially by developing a robust business case) and would also have to balance the risk of proceeding against the risk of not proceeding.

Airlines agree that the CAA should examine the scope for addressing risks, with a view to minimizing them where possible. However, addressing risk inappropriately could skew commercial incentives and cause serious long term harm to passenger interests. The CAA should therefore not intervene automatically.

Airlines do not necessarily accept that there is an issue with financing risk if a strong business case is selected. However, if a business case is selected which is based on unrealistic traffic or revenue scenarios this will create a risk in the ability to raise finance. What is clear is that there is no role for passengers or the CAA to underwrite business cases that are not viable in their own right by providing overgenerous or guaranteed returns to shareholders.

Risks caused directly by the form of regulation used (for example by the length of a control period, by the uncertainties in calculating WACC and by the existing demand risk transfer mechanisms) should be addressed because the CAA must have regard to the need for proportionate and well targeted regulation. The CAA should therefore be prepared to adapt its regulatory approach to ensure best outcome for consumers.

Any action by the CAA must stem from its statutory duties, and as reducing risk is not mentioned directly, this cannot be an objective. There should therefore be no presumption that the CAA should intervene, especially for commercial risks.

Do you consider that the CAA's approach to mitigate, attribute and remunerate risk is appropriate? Do stakeholders consider that there are other options?

There are two clear principles that should apply to the management of risk:

- Risk should always be allocated first to the party best able to manage it, as this will create the strongest incentives to reduce and mitigate the risk efficiently; and
- If risk is best re-assigned, it should not be without appropriate benefit where necessary.

These two principles seem to underlie the CAA's discussion on attribution and remuneration, but it would be helpful if they were spelt out explicitly.

Therefore we agree with the CAA's view that risk cannot be transferred from airports to airlines without clear benefit. Such benefit should be distributed in a way that does not create inefficiency or competitive distortions (inter-temporal or otherwise). In competitive markets, it should be noted that customers do not bear development risks unless they choose to do a commercial deal with the supplier. If a developer proceeds without working with customers, they may fail to produce a competitive product or service and the customer can use alternative suppliers. The starting point should be that the airport carries the commercial, cost and development risks. If risk is transferred to airlines, it would need to be demonstrated that airport WACC had been reduced accordingly..

The CAA should also take account of the fact that transferring risk to airlines may in fact result in a less efficient outcome for passengers. For example, reducing airport risks by allowing pre-funding could increase total costs to passengers if airline cost of capital is higher than airport cost of capital. The preliminary assessment of risk allocation in Appendix D confuses matters by separating passenger and airline interests and making assumptions about whether and how airlines transfer risk to passengers. The CAA's "rebuttable position" is that airline and passenger interests are generally aligned because of competition in the air transport market. It would be simpler to examine only the airport and its direct customers, the airlines. Equally, Appendix D does not consider the scope for Government and CAA to bear some of the risks.

In the current 5 year RAB based approach, long term cost, demand and financing risks are allocated to airlines and passengers, giving the airport poor incentives to plan for long term capex and opex cost efficiencies and exposing customers to risks they cannot reasonably manage. We also consider that the rate of WACC is too high given this risk allocation. Reducing long term risk reduces normal commercial incentives to invest efficiently and over-rewarding capital gives a perverse incentive to over-invest. It is therefore unlikely that allocating long term cost and demand risks to airlines and passengers is an efficient way to develop the airport.

Are the risks that the CAA has identified, the key risks that you are concerned about? Are some of these risks more important than others?

Airlines agree broadly with the main risks identified by the CAA, ie:

- Demand risk;
- Construction risk;
- Cost risk;
- Financing risk;
- Regulatory risk; and
- Political risk

However, in addition to the above risks, development risk and operation & maintenance risks should also be considered.

Airlines also agree that risks change over the life of a project. In addition, the magnitude of the risks are likely to vary according to the particular scheme, so it is difficult to make generalisations about the relative importance of risks in developing runways, except to say that cost risks are likely to be high for all options.

It seems unlikely that regulatory risk could ever be the greatest risk – given the CAA’s clear primary duty to act in the interests of passengers and the new right to appeal licence decisions if necessary. However, as explained further below, political risk can be a major source of uncertainty that could increase all the other types of risk.

Do you consider the CAA’s proposed risk mitigation strategies are appropriate? What are the costs and benefits of these strategies? Is there anything else the CAA could do to help manage risk?

Airlines agree that it might be possible to address regulatory risks. The current paper and forthcoming consultation should help to provide more regulatory certainty by setting out key principles, timetables and exploring possible alternatives, as the CAA has started to do. For example, through discussion of:

- The need for projects to demonstrate clear passenger benefits and to be robust to changes in some of the key assumptions – and how this would be assessed;
- The key principles of risk allocation;
- Exploring the potential advantages and drawbacks of longer regulatory cycles

- Setting out principles of cost scrutiny and how the CAA would decide whether costs should be accepted into the RAB;
- Considering the benefits of moving to a more formulaic approach to WACC
- Examining the potential for separate regulatory treatment of the costs associated with the new runway and associated development;
- Examining and shortlisting possible alternative models eg a special purpose vehicle.

A risk matrix showing the risk allocation, mitigation and effects for each risk could be developed to help allocate risks transparently and efficiently, using the following format (with example included for illustration):

Risk Category	Specific risk	Party allocated risk	Mitigation	Effect on airport	Effect on risk holder	Effect on pax
Construction	Cost/time overrun within contractor's control	Contractor is best able to manage risk.	Fixed price contract with competitive tendering	Contract price reflects risks. Creditworthiness of contractor is important. Clear contract necessary.	Will not win earn a return unless manages risk well	Insulated

And so on. Once the best risk allocation is determined, the regulatory approach can be designed to allocate the risks accordingly, or to reflect agreed adjustments.

Do you consider that the Government has a role in the mitigation of risk, particularly political risk?

Yes. There is a strong case for Government to manage the political risks, given that these are of much greater magnitude than the political risks faced by most companies. There have been many failures of the political process to address runway capacity effectively over the years. The consequences of a failure to manage political risks are all too evident and impossible for industry to manage.

It is clear from previous examples where this has happened at Heathrow and Stansted, where passengers are still funding elements of costs of additional runway proposals that were never realised, that there needs to be a better way to manage this risk during this process. Airlines believe that the Government is best placed to underwrite political risk in the period until planning permission is granted. Government action can have significant financial implications at all stages. Policy risks arise because Government can change aviation policy, standards, regulations or taxes at any time and is also responsible for providing surface access links to airports. Government action can therefore stop the development or undermine the net benefits. These risks arise to some extent in all businesses, but to a much greater degree than most in infrastructure. Therefore there is a need for Government to play a positive role by creating an enabling environment that reduces political risks. The national policy statement should facilitate this, for example by making clear political commitments, by coordinating surface access inputs and by addressing force majeure events.

Transferring the risk to users merely because that is all the CAA can do would be unacceptable and clearly contrary to passenger interests. This would exacerbate the problem by making the party least able to influence the politics bearing an uncontrollable cost without receiving anything in return.

The Government should accept the need to manage political risks because it is the country as a whole – and not industry – that will receive the greatest benefits from expansion. The direct national benefits stem from securing:

- A more extensive and efficient network of international links to the rest of the world;
- Greater productivity and economic prosperity; and
- Increased tax revenues.

Do you consider there would be difficulties for an airport operator in raising the necessary finance to undertake airport capacity expansion? If so, what are these difficulties?

There could be difficulties if the proposed development was not commercially viable once it opens. We do not consider that financing the runway is the key issue, since financiers will be looking to the long term commercial viability of the project and many investors seek long term investments with the prospect of sustained income streams.

The key issue is whether and how the costs can be recovered and therefore whether the development meets the commercial needs of airlines and passengers. If there is not a good business case, the project is likely to be difficult to fund, but not otherwise. As explained in Chapter 9, the CAA's duty to have regard to the need for airports to finance their activities is secondary to the absolute obligation to further passenger interests and equal to the secondary duty to promote efficiency. Therefore the CAA does not have an obligation to ensure a project can be funded if it is not viable.

Do you consider that Government involvement would assist an airport operator gaining the necessary finance for capacity expansion?

If Government selects a runway that does not have an adequate commercial case, it would be for political reasons. In that case, State support would be needed and would be justified where it meets EU guidelines on State aid.

The Government has helped to secure other national infrastructure projects, for example by providing guarantees that lower WACC. The aviation environment is different and the EU State Aid rules must be respected, but the scope for this might need to be explored depending on the option chosen.

Do you consider that the risks associated with undertaking a runway expansion project are significantly different from the ongoing (day-to-day) risks faced by an airport operator?

The cost of a new runway is a relatively small part of the overall costs of the shortlisted projects and we do not believe that in construction terms this is more risky than other development. Most of the development cost is in the associated infrastructure of terminals, stands, apron, car parks etc, which

are part of the normal development programme at both airports. While the political risks are clearly significant for a runway, all airport expansion projects bring political risks, whether it is a terminal or runway development, or even the lifting of a movement cap. There is therefore nothing inherently different about the runway expansion programme

Clearly the scale is larger and the development timeframe is longer, but Heathrow has already made very large long term investments in new terminal capacity and investment at Gatwick, while smaller, is also significant in total. Moreover, additional capacity is built and funded at airports around the world so international investors will understand the risks involved.

Do you consider that economic regulation (RAB based or other) is important to the financing the investment in new runway capacity, by either lowering the cost of capital or increasing the availability of funds?

Economic regulation should provide a clear framework to the investor on how the funds will be repaid over time (provided the investment is delivered efficiently).

The approach to economic regulation has been very stable, having been in place for almost thirty years since privatization. Relatively small adjustments have been made in an evolutionary way, clearly targeted to prevent airports exploiting some obvious loopholes. The basic approach has survived several fundamental reviews including the introduction of a whole new legislative framework which was intended to clarify the CAA's duties and make them more accountable, enabling airports to appeal perverse decisions if necessary.

The approach will need to continue to evolve to ensure that passenger interests are protected properly, as discussed below. In the light of the legislative framework and this long track record, we consider that economic regulation creates a very stable environment for investors – always assuming that the selected project offers clear net benefits to passengers and is delivered efficiently by the airport.

What form of regulation do you consider most appropriate for expanding runway capacity? Do you consider that using two RABs or LBC and a RAB would be appropriate? Are there any other approaches that the CAA should consider? What are the costs and benefits associated with these approaches?

It is too early to state a position on this. Airlines are interested in exploring alternative approaches, such as a separate RAB or special purpose vehicle.

The approach to regulation would need to be adapted to take account of the need to allocate risks in a way that creates the best incentives and produces the best outcomes for passengers. Equally it would be premature to conclude for either airport that a RAB based approach is not appropriate.

Given the short timeline for responses to this consultation and importance of the issues being considered, we expect to be able to return to the CAA with further thoughts on this ahead of the publication of the Autumn policy statement.

While airlines are starting to consider the appropriate regulatory mechanism for the funding of additional runway capacity, there are a number of principles we believe need to be taken into account in the development of such a mechanism to ensure it is the interest of our passengers.

These are:

- There should be no pre-funding or revenue advancement – airport capacity should only be paid for once in use, so that the airport has an incentive to start delivering benefits early and to defer costs where possible.
- Only efficient costs should be passed through. It is not in passengers interests to reward airport shareholders for inefficient or poorly timed expenditure.
- There should be no ‘gold plating’– investments need to take account of airline and passenger needs, with sound business cases showing clear passenger benefits.
- Inter-generational equity needs to be addressed – this is a long term investment with multi-generational benefits. Temporal cross subsidies are likely to distort competition to the long term detriment of passengers.

Equally, we would not expect the CAA to settle on one type of regulatory structure at this stage, but to set out an approach that could accommodate different options (eg RAB based, SPV, hybrid ownership structure, longer control periods etc). As discussed in answer to 4.5 above, the regulatory structure should be designed only after the best risk allocation and incentive structure is assessed.

Do you consider that the case studies provide insight into how the CAA should regulate going forward? Is there merit in the CAA considering special purpose vehicles or only allowing the pass through of efficient costs (or additions to the RAB) in a staged manner?

There is merit in considering alternative approaches such as these and we would like to draw attention to the following points..

Airlines would not support cross subsidies from users of one airport to the development costs of another airport, as happened for the initial development of Stansted airport. The experience of Stansted shows that the cross subsidies incentivized the airport to build far too expensively and the growth stimulated by the subsidies fell away when the subsidies were stopped. In any case, this would not now be possible given today’s competition law framework, state aid rules and the separate ownership of airports.

Despite the £300m revenue deferral in the Terminal 5 project, the planning delays were not anticipated in the CAA’s regulatory settlement and the result was that an adjustment had to be made to prevent the airport being remunerated twice for the same expenditure. This was complicated and controversial at the time.

Airlines do not agree with the CAA’s conclusions (para 4.48) that in greenfield sites where long term risks are transferred to users, adjustments made when demand fails to materialize has not in practice left users worse off. If the developer carried demand risks, it is quite likely that either more realistic demand forecasts would have been used, or development would be adjusted to mitigate

demand risks (eg with a phased approach or optional later expansions). In which case, project costs might have been lower or deferred and prices would be lower.

Do you consider there are any other case studies that could provide useful insights?

Yes. Examples at some other airports better reflect the pricing profiles that would be found in competitive markets. Airport development at both Amsterdam (investments larger than €100m) and Dublin Airport (all investments) adjust the depreciation profiles. In both cases, depreciation was back-end loaded, rather than using a straight line approach as in London. In the Dublin approach, an “annuity” is calculated so that the sum of depreciation and capital return is the same over time. At Amsterdam, a steady cost per unit is calculated over time to smooth user charges taking account of the rate of utilisation of the asset.

The current approach to AICC and depreciation is designed to provide early returns to the airport so as to reduce financing risks, but for a large project, this has quite serious adverse effects on users, with a large spike in charges when there is most capacity to fill and providing the airport with reduced long term incentives to make sure the project is a success commercially. This approach is likely to exacerbate demand risks.

An approach that mitigates the impact on user charges and delays returns should reduce demand risks and allow for a more normal commercial profile, with returns rising over time as the full value of the investment is achieved. Giving the airport an incentive to ensure the development is fit for the long term is also likely to be beneficial to passengers.

Therefore airlines are interested in exploring further the Dublin and Amsterdam approaches involving back-end loading of depreciation as this seems to offer benefits to passengers.

Do you consider that there is a role for Government in providing financial assistance for any capacity development?

See answer to 4.8 above. Government (ie Highways Agency/Network Rail) should also pay for surface access links.

It is quite clear that projects that would be required even without the new runway should be wholly Government funded. For example, the M4 will need to be widened by 2030 whether or not Heathrow gets a new runway.

How do you consider the CAA should take into account any Government financial assistance? Are there any potential concerns/benefits with the approaches that the CAA has outlined?

Government funded capex should not be allowed into the RAB.

To the extent that it lowered risk, we would naturally expect this to be reflected in the WACC calculation.

What do you consider are the costs and benefits of extending the duration of a price control (or elements contained within it)?

A longer control period could give the airport greater confidence of returns if a different approach to depreciation is used (see 4.13 above) and a longer term strategic interest in the success of the project.

If this lowers regulatory risk and gives stronger incentives for the airport developer to manage cost and demand risks, it is worth considering. To avoid the need for re-openers or mini interim reviews, indexation could be considered for factors clearly beyond the airport's control (eg the level of corporation tax or the market rate for risk-free debt). Indexation should not apply to traffic levels.

Longer periods do, however, increase the scope for regulatory gaming by the airport operator and could be detrimental to passengers if risk is merely transferred from the airport to others. It is likely that existing safeguards, such as service quality standards, Capex triggers, or a "core and development approach" (as at LHR) would therefore need to be strengthened.

What do you consider would be the appropriate duration of a price control (or the elements contained within it)?

Airlines have yet to take a view on this. We would prefer to start with a more structured approach to assessing risks before designing particular approaches to regulation, as discussed above.

Chapter 5

Do you consider that the generation that is demanding a particular piece of infrastructure should pay for it?

Yes. In other words, each user should pay their own costs and not expect a subsidy from other users. Otherwise the demand is unsustainable and should not be catered for.

How do you consider that the costs of a large project such as runway expansion could be spread across different generations, that is, between existing users (airlines and passengers) and new runway users (airlines and passengers)?

There should be no pre-funding of airport investments, so users should pay for new infrastructure only once the assets come into use.

Pre-funding makes users who are not benefitting from the new infrastructure pay for it- this is fundamentally unfair and anti-consumer. Prefunding may also distort incentives for driving cost efficiency. While prefunding can smooth costs, other better approaches can and have been used to smooth the impact on user charges.

A better approach would be to alter the depreciation profile so that returns reflected the usage of the new runway, which largely removes inter-generational distortions. A more back-end loaded approach has been applied at both Dublin and Amsterdam, as discussed above. While this approach would delay returns compared with the current approach, it does offer several advantages to airports as well as to passengers:

- It can reduce or remove altogether the inter-generational issue;
- The airport has a stronger incentive to make sure the investment is suitable for the long term;
- Total airport returns rise or remain steadily rather than falling;

The resulting airport charges are smoother and the early peak is reduced when new capacity is plentiful. This reduces demand risks.

Do inter-generational issues suggest that there should be a role for Government in providing financial assistance to the airport operator undertaking any capacity development?

Yes, that would be one way to assist, provided it is in line with EU State aid rules.

Do you consider that airline business model should be taken into account when considering the potential allocation of airport expansion costs to airlines?

No. In any case, these are merging to some extent making precise definitions difficult and liable to change.

What do you consider are the costs and benefits from adopting a regulatory approach that involves managing costs via assets in the course of construction?

See questions 5.1 and 5.2 above. An AICC approach creates a situation in which users pay for the cost of facilities they don't use. Such an approach also distorts airport incentives (and allows them to benefit from delays)

What do you consider are the costs and benefits from adopting a regulatory approach that involves managing costs via assets in operation?

This approach ensures that users pay for the assets they use. This should not undermine the airport's ability to secure funding (compared to an AICC approach) so long as there is a clear regulatory approach that explains how costs will be paid for by users over time.

What do you consider are the costs and benefits from adopting a regulatory approach that involves the profiling of revenue?

This should be considered on a case by case basis and agreed with airlines. We have suggested that depreciation profiling is used over the life of the project rather than short term smoothing between control periods. Inter-generational issues should be avoided where possible. In any case, no profiling of revenues prior to the assets coming in to use should be used.

Airlines would prefer unsmooth pricing if the alternative is inefficient regulatory interventions that create the problems discussed above. Smooth pricing does not justify remunerating AICC.

Are there any additional regulatory approaches that you think the CAA should consider? What are the costs and benefits of these approaches?

We would expect to return to the CAA with further thoughts on this.

Chapter 6: High level options for the recovery of costs

What do you consider are the costs and benefits associated with the four high level approaches to cost recovery that the CAA outlined? Are there alternative high-level options that the CAA should be considering?

The CAA's workshop in May set out some emerging thoughts on how it could ensure that the costs passed through to passengers of the chosen capacity solution could be scrutinised. No agreement on process or timing was reached, although it was agreed that a reliance on ex-post scrutiny on its own would neither be effective or attractive.

On the basis that the current Civil Aviation Act remains unchanged, the overarching rationale for CAA intervention must be to meet its primary duty to protect the passenger interest. Airlines believe that, in order to meet this primary duty, the CAA needs to ensure that the costs that will ultimately be passed through to passengers are efficient and represent good value for money.

Out of the options put forward by the CAA, therefore, only option 3 would allow it to meet its primary duty as it is clear that no collection of funding can begin until there has been some cost scrutiny. It is likely that this will need to be supplemented by ex-post scrutiny, as is currently the case, as this will keep an incentive on the scheme provider to ensure costs are effectively and efficiently managed through the construction and delivery process.

However, the schemes under consideration have already submitted a high level of information around the design and costs. It is not clear how much detailed cost scrutiny will be carried out by the Airports Commission and the airlines are therefore concerned that, under current plans, if the CAA were to scrutinise the costs after a decision is made by the Commission, next summer, this could be too late to influence the design and overall costs. Furthermore it could introduce a degree of regulatory risk.

Moreover, airlines have had no detailed view of the costs being fed into the Airports Commission process and under the current plans would have no sight of these until the October consultation from the Airports Commission. The airlines believe this is therefore an area that warrants urgent further consideration by both the CAA and Airports Commission.

Airlines believe the CAA and Airports Commission should consider whether changes are needed to the current process to ensure proper scrutiny, on behalf of passengers, can take place. This could be done by either:

- A recognition in the final decision by the Airports Commission that their recommendation is not wedded to a specific cost and that further cost and scheme scrutiny work is required; or,
- The CAA could lead a process to provide an initial level of scrutiny of all schemes before the decision of the Commission in summer 2015. This could be completed by a mini form of constructive engagement and could provide an initial level of challenge to the costs set forward by indicating a range of efficient costs that may be allowed.

Chapter 7: Cost recovery – principles and in practice

Airlines disagree with the CAA's view that there should be any recovery of costs during Q6. It is not clear why passengers should be funding something that should be carried out at the risk of shareholders, as is the case with the Heathrow Hub proposal.

Airlines' view is that airports should only be able to reclaim the costs of additional capacity once that capacity has come into use.

The comments made on the questions in this chapter are without prejudice to this position.

Do you consider the principles that the CAA has outlined for assessing costs that may arise in Q6 are reasonable? Are there any additional principles (or criteria) that the CAA should consider?

Airlines broadly agree with the principles for set out by the CAA for the potential recovery of airport expansion costs. However:

- It is not clear what the CAA means by incentivisation but airlines agree that it is important to have the right incentives in place throughout the process depending on level of market power. For example in the event that an airport made unreasonable demands, it would be helpful to have a back-up option, such as allowing another developer to take the project forward. Therefore the CAA cannot rely on incentivisation where there is significant market power. We think the correct allocation of risk to those most able to manage it would help create some of the right incentives for efficient delivery of capacity.
- Airlines believe that the CAA has mis-judged the balance of risk. Given its primary duty is to further the interests of passengers, rather than airport shareholders, the obvious risk is that shareholders are over-rewarded, at the expense of passengers, in allowing returns on capacity expansion costs.

Do you consider that the CAA's Constructive Engagement (CE) operating principles should be continued and extended to cover airport expansion costs? Do you consider that extending the role of CE is consistent with a light touch regulatory approach?

Although this chapter refers to costs in Q6 airlines have assumed that this question refers to all costs in relation to airport capacity expansion and not just those which may be incurred during the Q6 period.

Constructive Engagement can be a useful process to provide scrutiny and transparency over costs and plans and has been relatively successfully implanted through the CAA's price control reviews. However, if it is to be meaningful there needs to be a formal mandate and governance around the process so scheme operators are required to share all relevant information in relation to the business case. It should also be noted that Constructive Engagement, whilst a helpful input, should not be a substitute for any other scrutiny by the CAA or Airports Commission.

Airlines believe that scrutiny of costs is needed before the costs of the schemes are finalised and the amount that can be passed through to passengers is agreed. Constructive engagement could be one way to do this if there is a mandate and appropriate forum for the scheme operators to share information with airlines, as representatives of passengers.

If CE is to take place it will be most useful if it relates to the full business case rather than just the capital costs. It is difficult to scrutinise one element of the business plan without a good understanding of the overall case.

It should be noted that if CE is to happen before a scheme is recommended by Davies then an individual airline's participation in CE should not be seen as endorsement of a particular proposal.

Even with the existence of an extended role of CE, a robust economic regulation is still necessary.

Do you consider that Constructive Engagement should be used as part of the cost development process? When should it occur?

Although this chapter refers to costs in Q6 airlines have assumed that this question refers to all costs in relation to airport capacity expansion and not just those which may be incurred during the Q6 period.

As outlined in response to the points in Chapter 6. Airlines believe the CAA and Airports Commission should consider whether changes are needed to the current process to ensure proper scrutiny, on behalf of passengers, can take place. It is crucial this scrutiny happens before costs are finalised.

This could be done by either:

- A recognition in the final decision by the Airports Commission that their recommendation is not wedded to a specific cost and that further cost and scheme scrutiny work is required; or,
- The CAA could lead a process to provide an initial level of scrutiny of all schemes before the decision of the Commission in summer 2015. This could be completed by a shortened form of constructive engagement and could provide an initial level of challenge to the costs set forward by indicating a range of efficient costs that may be allowed.

CE is a transparent way for cost scrutiny to occur and allows airlines to represent the views of their passengers. However, if a process of CE is going to be introduced to the AC process, either before or after a decision, it needs to be set out now when it would occur so as not to introduce regulatory risk.

Do you consider that the Government or Airports Commission should ensure that Constructive Engagement occurs as part of any assessment process (particularly if any costs are not going to be subject to a detailed review by the CAA)?

Although this chapter refers to costs in Q6 airlines have assumed that this question refers to all costs in relation to airport capacity expansion and not just those which may be incurred during the Q6 period.

As outlined in response to the questions in Chapter 6, airlines are concerned that the current process could lead to costs of the schemes not being properly scrutinised before they are finalised. A form of Constructive Engagement before a decision is made by the Airports Commission could be one way to overcome this risk and enable the CAA to meet its primary duty.

If Constructive Engagement is to occur, the airlines believe that, given its experience in leading a similar process for the Q6 process, the CAA is best placed to run this process and it should be given a mandate by the Airports Commission to do so.

If Constructive Engagement does not occur before a recommendation is made by the Airports Commission, the CAA needs to urgently consider how proper cost scrutiny can occur to enable it to meet its primary duty to passengers.

Do you consider that the Constructive Engagement mandate outlined by the CAA provide sufficient guidance? If not, what additional information would be needed?

It is not clear what mandate is being consulted on in this question as there is no mandate published in the discussion paper.

If this refers to the mandates that were used in Q6 then airlines believe this would require further review before they could be used for this purpose. During the price control review process, airlines had difficulty in being able to receive all the relevant information from airports that was necessary to properly scrutinise their business plans. This limits the effectiveness of CE.

There also needs to be consideration of how CE could work with the Heathrow Hub proposal; as this is being proposed independently and not by a regulated airport.

Do you consider that the cost recovery triggers outlined by the CAA are reasonable? Are there any other triggers the CAA should consider?

Airlines believe it is only appropriate for runway costs to be recovered once any additional capacity is operational. We therefore believe that trigger 4 is the most appropriate.

As set in in the response to chapter 4 airlines do not believe that pre-funding or revenue advancement are economically efficient or in the interest of passengers.

It does not seem appropriate for it to start before this as there remains a risk that the Government of the day will not accept the results of the Commission and/or that planning permission may not be granted or may be appealed. It is clear from previous examples where this has happened at Heathrow and Stansted, where passengers are still funding elements of costs of additional runway proposals that were never realised, that there needs to be a better way to manage this risk during this process.

Having a trigger once capacity has come into use also provides an incentive for the airport to manage costs and risk during the construction process as this will be at their own risk. Moreover it is in line with user pays principle and therefore broadly what would happen in a non-regulated market.

Do you consider that the options outlined by the CAA on the recovery of costs before there is certainty on whether or not capacity expansion will occur (and where it will be located) are appropriate?

Airlines disagree with the CAA's view that there should be any recovery of costs before a decision by the Airports Commission. It is not clear why passengers should be funding something that should be carried out at the risk of shareholders, as is the case with the Heathrow Hub proposal. Otherwise

there is a risk that passengers could be rewarding shareholders for a proposal they may never see the benefit of.

Airlines' view is that airports should only be able to reclaim the costs of additional capacity once that capacity has come into use .

Why might each of these options identified by the CAA work/not work? What do you consider are the most appropriate options for the recovery of costs?

Airlines disagree with the CAA's view that there should be any recovery of costs before a runway has come into use we therefore do not believe there should be any collection of costs during Q6 before decision by the Airports Commission. We therefore do not agree with any of the proposed mechanisms for recovery of costs during Q6.

Do you consider that there are alternative options for the recovery of costs that the CAA has not highlighted which would be useful for it to consider?

Airlines disagree with the CAA's view that there should be any recovery of costs before a decision by the Airports Commission. It is not clear why passengers should be funding something that should be carried out at the risk of shareholders.

Airlines' view is that airports should only be able to reclaim the costs of additional capacity once that capacity has come into use.

Chapter 8: Slot allocation

We recognise that slot allocation is likely to play an important role in which airlines provide services following the introduction of new capacity. However, the CAA should not assume that any changes can be made to slot rules to allow it to better achieve its objectives. In other words it should work on the basis that there will be no meaningful changes to slot rules under both EU regulation and the World Slot Guidelines.

What do you consider would be the effect of changes, as outlined by the CAA, to the Slot Regulation?

Airlines think it is unlikely that any changes to the slot regulation will have a significant impact on the issues being considered by the CAA in this consultation.

Do you consider that the Slot Regulation pose challenges to the financing of any capacity expansion?

The slot regulation limits the ability for pre-financing to work efficiently, as upfront payments cannot be reflected in new slot allocations. This further strengthens the arguments against pre-financing, as airlines that pay the pre-financing costs cannot receive any future benefit from expanded capacity.

Do you consider that the current slot allocation process impacts on their potential willingness to pay for any capacity expansion?

This depends on whether a pre-financing model is used. Under pre-financing the slot allocation process creates a potential for new entrants to benefit from pre-financing paid for by other airlines. Without pre-financing, there should be a much better match between willingness to pay and airline costs, assuming that the airport charge structure is relatively efficient.

Do you think that the CAA or the airport operator(s) or both should find some ways to link financing of new capacity and benefits of new slots? If so, how do you consider that such a mechanism could work?

This is a complicated question and there would need to be a proper consultation on this. However, this presupposes that pre-financing occurs. In the view of airlines it makes no sense to try and develop a mechanism to address the weaknesses of pre-financing, when there is no need for pre-financing itself.

Chapter 9: The CAA's Statutory Duties

The CAA's statutory duties, outlined in the Act, should provide the framework for all interventions. While there is no formal role for the CAA in the Airports Commission decision making process, the CAA will clearly have a role in determining a fair price path and regulatory regime (if any) for the successful option, once decided. Moreover, it has a wider primary duty to protect the passenger interest and therefore needs to ensure that the process being carried out will lead to that duty being met.

Airlines believe that the role and objectives of the CAA in the Airports Commission process need to be defined and set out clearly, to reduce any later accusations of regulatory risk. It is clear that the overarching rationale for CAA intervention must be to meet its primary duty to the passenger.

Airlines can see no rationale for changing the primary duty of the CAA. If, for example, infrastructure and investment were prioritised over the passenger, it could lead to sub-optimal and inefficient investments being made. This has been the case in respect to previous capacity proposals at Stansted and international examples include Montreal.

In order to ensure that its duty to the passenger is considered in the outcome of the Airports Commission process, and whichever option is eventually decided upon, there are a number of key areas where airlines believe the CAA has a critical role. Further information on these have been set out in this response:

- How it will allow the costs of additional capacity to be recovered from passengers and airlines. This includes both the timing and overall cap on this recovery.
- How it will determine whether the costs that will be passed through are efficient – in line with its current assessment of costs through the regulatory process.
- How it best believes the balance of risks between airports and users should be managed in delivering any additional capacity.

When allocating risk, the CAA needs to be driven predominantly by its primary duty to further the interests of passengers. Other duties in the licence should guide the CAA's activities but cannot have more weight put on them than the primary duty:

- The duty to promote competition is not a stand-alone or unqualified duty, but promoting competition must be done "where appropriate" as a means of satisfying the CAA's primary duty to further the interests of passengers.
- The paper also refers to the CAA's duties to secure that licence holders can finance their activities and the duty to promote efficiency. These are not duties as such, but matters for the CAA to "have regard" to when performing the duty to further passenger interests and promote competition where appropriate. They guide the CAA in the interpretation of its primary duty, but are not objectives in themselves.

These distinctions are important when allocating risk, because it makes it clear that passenger interests should not be compromised or balanced off against airport interests.

The CAA will also need to “have regard to” other matters set out in legislation when allocating risk, including the principle that regulation should be targeted only at cases where action is needed, and the need to secure that all reasonable demand is met.¹

In light of the primary duty to further the interests of passengers, it is fundamental that risks to passengers are minimized and that any risk allocated to them is balanced by a clear and commensurate benefit. If this cannot be achieved, the onus must be placed on the airport to redesign its proposed approach.

The requirement to “have regard to” the need for an airport to finance its activities is must be seen in the context of pursuing the primary objective to passengers and cannot therefore imply a cap on airport risk unless:

- There is some other mechanism to ensure that the risks will be properly managed; and
- That risks are reduced by the cap and not transferred

For example, one way to cap risks to airports would be to support a phased development approach, so that outputs and benefits are delivered earlier and costs expended later. The airport would then bear the risk only of the next development stage. .

The requirement to have regard to the need to promote efficiency and economy must mean that the CAA gives careful consideration to the efficiency of the proposal. This is currently the weakest area of RAB based regulation. Allocation of greater cost risk to the airport would undoubtedly help by providing the airport with meaningful incentives to manage costs.

The CAA must also have regard to the need to secure that all reasonable demand is met. This means that the CAA must take a view on passenger demand and whether the projections of the Government and airport developer are “reasonable”. Demand risk needs to be allocated to the airport, as the party best able to manage this. This would create strong incentives for the airport to have realistic traffic forecasts and to take account of the effect of airport costs and other economic factors on demand. The airport could, for example, reduce demand risks by reducing costs and/or by making sure that the development was likely to attract airlines, passengers and freight. This allocation of demand risk would therefore provide stronger incentives on the airport to meet passenger needs.

The CAA also needs to have regard to the need to target regulation only where it is needed. This means that any change from the default commercial position, where the developer bears all the commercial risk of development, should further passenger interests and be proportionate and clearly targeted.

Do you consider that any part of the Act presents barriers to investment, including with respect to any potential capacity expansion?

¹ This and the four preceding paras may not be needed if the argument is set out in Chapter 9 and a cross reference is included. The text is included to show the flow of the argument and to check consistency across chapters in the drafting.

Airlines do not believe there are any barriers to investment, for sound business cases, presented by the current act. It is therefore difficult to see the case for any changes to the Act for airport capacity expansion or any changes in the current primary duty.