Supporting the Airline Community

London (Heathrow) Airline Consultative Committee

Response to CAA Consultation (CAP 1510) on Economic Regulation of the new runway and capacity expansion at Heathrow Airport: CAA priorities and timetable

Final 14 March

Exec Summary

- Strongly support enhancing the CAA's role in the capacity enhancement process ensuring regular, active and comprehensive engagement which delivers affordable benefits for both current and future consumers
- Airlines believe that HAL's primary consideration should be to develop an expansion scheme that is affordable – for consumers and airlines – and then from that position determine what financeability arrangements should be. HAL should not make a judgment on financeability first and then establish the level of affordability as this will constrain development of affordable schemes
- The CAA must actively ensure that HAL delivers a scheme which is affordable with the CAA, including having the capability for early intervention when measures affecting affordability and financeability are no longer sustainable.
- Note that airlines support the case for expansion at Heathrow but this support is conditional on flat or reduced charges being delivered and if not, then there is a risk that the NPS and the DCO submission will not be able to be supported
- Believe that CAA must actively monitor progress against all 4 priorities in both the project and policy framework as the capacity expansion process develops
- Acknowledge the continued need for joint agreement between airlines and HAL in the local governance framework which is now close to being finalised. Nonwithstanding this airlines will welcome the continued and regular participation by the CAA in all relevant fora.

Introduction

1 The Heathrow airline community welcomes the opportunity to respond to the CAA consultation on Economic Regulation of the new runway and capacity expansion at Heathrow Airport: CAA priorities and timetable.

2 The remainder of this response will cover comments on the 4 priorities outlined in CAP1510 and highlight suggestions which we hope will be of value to the CAA. We understand that the CAA will develop its thinking further based on a series of workshops to review specific measures associated with the regulatory treatment of the costs and financing of the constructions programme. We belief that this is the appropriate mechanism to develop the relevant proposals in more detail acknowledging the complexity of some of the issues, the need for efficient financing and developing an affordable business plan which covers the whole of HAL's operations. We also welcome the development of the CAA's capacity to develop its own financial model of HAL's business. This will ensure a more independent approach in future decision making and will enhance transparency around the evolution of the regulatory framework.

Priority 1 scheme design

3 We welcome the CAA's indication that HAL must develop a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines on potential options, cost and value for money. However the role of the CAA must go further than *monitoring* and *assessing* but also <u>ensure</u> that outcomes are aligned with affordability objectives. The early engagement of the IFS will become essential as some aspects of the planning and strategic brief pertain to expertise which do not reside within the airline community {action secure Jason's input}

4 HAL needs to show evidence of how it has dealt with input it has received from the airline community, including development of options and provide a justification as to the measures adopted. As the HAL process has not yet been applied to any component, we look forward to the first application, for example, in the decision around runway length

5 We recommend that the decision making process needs to be evaluated after 100 days from the December immersion session with an assessment of what has been agreed or not and provide the justification for decisions taken. We believe that this process should become a standard and will provide the evidence required to support the DCO process.

6 Whilst acknowledging the important role of Consumer Challenge Board as per its terms of reference, the role of the airlines is to challenge the cost of the components within the scope of the Strategic Brief and to assess the overall affordability of the Master Plan. In this context the airlines are the representative of the passenger and are subject to the "rebuttable" proposition test.

7 Airlines have acknowledged the receipt from HAL of the Ready Reckoner. This will provide a useful supplement to highlight the impact of charges arising from various development scenarios. However we have some queries regarding its use and the assumptions which underpin the model's working and application. Specifically we have no analysis of how the capex process is delivered, the phasing, the nature of the spend, profile etc. In addition, we also have no analysis of how the passenger numbers are derived.

8 The development of the CAA's own modelling capacity is welcomed and will support a more interventionist approach should measures affecting affordability and financeability become no longer sustainable for consumers. It is important that the CAA can take its own view rather than solely relying on HAL's own modelling.

Priority 2 robust cost estimates

9 Taking account of the fact that engagement by airlines has only just commenced following HAL's briefing session in Jan 17, the level of maturity associated with the scheme proposal and its cost base is very low. The coming months will enable a greater understanding of the cost estimates. However even using HAL's own Gateway Management process, substantial uncertainties on expansion development and costs will continue to exist for a considerable time due to the necessity for HAL to comply with the NPS and DCO frameworks. In addition there will be new project requirements, including all of the risks associated with a complex project, which may emerge in the future as master planning proceeds. This will require a different approach to cost estimating which needs to take account of the following factors:

- Incorporating the lessons learnt during Q6 from certain projects which have not performed well
- The recommendations from the CAA commissioned CEPA studies, in particular:
    - The scope for CAA to revisit regulatory approach and the incentives within it
    - A role for CAA and all airport stakeholders to consider the best delivery model for the new runway.
- The procurement issues identified by the CAA which warrant a far greater degree of scrutiny including contract strategies and risk allocation
- The urgent need for better benchmarking processes for the airport sector
- As stated earlier, a more substantial role for the IFS at the earliest stages of the project definition phase. Some of the key lessons from the introduction of the IFS function in Q6 are:
    - Governance & decision making are given specific attention to ensure that a robust process and organisation are in place.
    - The focus areas should include the Brief and Business Case (incorporating a drive for investment appraisal and management)

- There should be a clear focus on the development of a realistic time-plan that sits alongside the cost plan
    - There should be a focus on the identification, allocation and mitigation of risk from the beginning.
    - The importance of developing options to a budget rather than developing options and assessing costs
    - Change management will be critical from the commencement of the project. This concept needs to be applied to the content of an agreed Brief and then to the evolving masterplan.

10 As outlined in our response to priority 4 below airlines need to understand the cost of the long-term HAL business plan for the whole airport including expansion and will not be able to form a view of the costs of expansion in isolation.

Priority 3 efficient financing, affordability and financeability

11 Issues identified by the CAA in this part of CAP 1510 remain complex and require considerable effort to secure the best results for consumers. Airlines believe the following points and issues need to be considered:

- Airlines believe that HAL's primary consideration should be to develop an expansion scheme that is affordable – for consumers and airlines – and then from that position determine what financeability arrangements should be. HAL should not make a judgment on financeability first and then establish the level of affordability as this will constrain development of affordable schemes.
- CAA needs to elaborate further especially on the allocation of risks. We have identified several including:
    - Need more tailored approach to individual investments. Alternative models could be investigated and we should avoid over dependence on the current model
    - Volume risk needs to become more symmetric
    - Gearing and notional capital structures must be related to an "efficient" cost of capital. Particular attention will be paid to the process, methods and justifications associated with the determination of the WACC including the taxation element.

12 CAA should not assume that HAL are the sole delivery agent or operator but the regulatory framework should be designed for most efficient delivery or operation mechanism

13 We welcome the CAA's comment regarding the low likely hood of reaching commercial agreements (refer to annex) but the link between <u>prefunding</u> (where AICC is treated as a last resort) and <u>financeability</u> needs to be much stronger. A more comprehensive approach is required and we would welcome a greater level of ambition being pursued by the CAA. Airlines also acknowledge that there may be constraints to the level of innovation which are possible but two key factors are critical:

- Maintaining the continuous focus on a flat or reduced charge outcome

- Ensuring that phasing, scoping and sweating of existing assets remains paramount and that these are considered and used first before adding new scope to the expansion plans

14 Some ideas related to incentivisation and risk allocation requiring a combination of ex-ante and ex-post controls developments in the regulatory framework are outlined in Annex 1. These concepts may be useful in helping the CAA develop its thinking.

Priority 4 H7 and Expansion is affordable and financeable

15 We welcome the CAA's emphasis on the development of coordinated proposals for both existing operations and the expansion programme. This is important not just for business planning purposes but maintaining the level of resilience and efficient operation at the airport for the 750 million consumers who will use the airport before new capacity becomes available. In this context we would like to highlight the following:

16 Q6+1, H7 and Expansion are now all linked and will become apparent in HAL's initial business plan expected in Nov 17 with the first publication of HAL's proposed price path. Consequently it will remain very difficult to assess expansion plans with any certainty at this stage in the process. As identified earlier there are too many unknown elements at this stage and airlines remain very concerned at being seen as the "risk takers of last resort" by HAL

17 Tests to be applied from the airline perspective are

- Ensuring an efficient consultation process
- Developing a project plan and key milestones which ensure that airlines sign-off project deliverables at key development milestones
- Ensuring a regular review of an efficient spend by the IFS
- Realisation of flat or reduced charges as project maturity develops

18 The prioritisation of all projects in the H7 portfolio will require CAA engagement ensuring real choices are made and that expansion remain within the affordability envelope

19 There is a need to monitor and effectively manage the extended HAL supply chain which already includes 14 different consultancy companies for expansion alone

Conclusion

20 Note that airlines support the case for expansion at Heathrow but this support is conditional on flat or reduced charges being delivered and if not, then there is a risk that the NPS and the DCO submission will not be supported

21 Airlines believe that HAL's primary consideration should be to develop an expansion scheme that is affordable – for consumers and airlines – and then from that position determine what financeability arrangements should be. HAL should not make a judgment on financeability first and then establish the level of affordability as this will constrain development of affordable schemes

22 The airline community will strongly support enhancing the CAA's role in the capacity enhancement process ensuring regular, active and comprehensive engagement which delivers affordable benefits for both current and future consumers

23 We understand that the CAA will develop its thinking further based on a series of workshops to review specific measures associated with the regulatory treatment of the costs and financing of the constructions programme. We belief that this is the appropriate mechanism to develop the relevant proposals in more detail acknowledging the complexity of some of the issues, the need for efficient financing and an affordable business plan which covers the whole of HAL's operations.

24 We welcome the CAA's active monitoring of progress against all 4 priorities in the expansion project and to assess emerging outcomes based the affordability of the scheme with flat or reducing charges in mind. In this regard the future policy framework must be flexible enough to acknowledge that considerable uncertainty will continue to exist until a level of maturity has been reached in both the NPS and DCO processes, both of which are outside the direct control of the stakeholders.

ANNEX ON PRIORITY ISSUE 3

Summary of key points:

- Incentives and risk allocation

    - Tailored approach to individual investments is needed to incentivize efficient and timely delivery of the expansion project.
    - Allocation of the increased costs from changes in project scope need to consider which entities are best placed to manage and carry the relevant risk.
    - Volume risk within a regulatory period and over the life time of investments needs to be considered – the current regulatory framework is inadequate and subject to regulatory gaming.

- Support efficient financing and long term investor and consumer confidence
    - Evolutions in the RAB framework should be centered on consumer interest by driving operational efficiency, improving risk allocation, delivering the right investment efficiently, the phasing of regulatory depreciation, avoiding distortions in the airline market and ensuring efficiency gains are passed on to consumers.
    - The regulatory framework should be designed for the most efficient delivery mechanism and not simply tailored to HAL – including ensuring most efficient

- The cost of capital, financeability and affordability
    - The approach to allocation of risks will drive the cost of capital - not the existence of risks.
    - There are measures the UK Government can undertake to reduce the perception as well as acceptance of risks from this airport investment.
    - Two options for an airport development plan needs to be developed based on:
        1. No prefunding/AICC –decreasing charges trajectory until assets come into use, subsequently charges are at levels no more than current charges in real terms
        2. Charges remaining at levels no more than at current level in real terms.

Overarching comments:

- Airlines are concerned that the CAA is tasking a lot of the preparatory/technical work to be developed by HAL. However, our understanding is that such preparatory work will be undertaken by independent experts as part of the planning processes (Category B) – accountable to the governance structure that includes an “approval type” role from the airline community.
- Governance arrangements on how to deal with specific elements of Category C costs may need to also be developed and interact with or be incorporated into the regulatory framework. There will need to be detailed consideration on how to treat activities of different risk categories.

Comments on specific sections:

How to best develop incentives and allocate risks

Incentivizing efficient and timely delivery:

- This is complex and as stated by CAA it will require a combination of ex-ante and ex-post controls.
- To start with, options need to be developed on how to deliver on different activities. This will require identification of uncertainty ranges as well as costing options on how to deal with them (For example: Option 1: guaranteed via contractor; Option 2: risk carried by HAL; Option 3: risk passed on to consumers etc.). This needs to be done not just by phase of project but also by activity. This will require detailed consideration, measure by measure, and may require there to be a dynamic interaction between the governance structure and regulatory framework – in effect with the governance structure being incorporated into the regulatory framework.

Dealing with substantial changes in project scope:

- Increases in costs related to changes in statutory or planning requirements should be carried by government or project proponents. These actors are best placed to influence and manage such risks. However, we accept that it may be appropriate to deviate from this practice if other actors can also influence or manage this risk or if the capacity of government or project proponent to carry the risk is more costly. This would need to be informed by robust analysis.

- The regulatory framework needs to also address what happens when additional costs are incurred as a result of actions or decisions on project scope taken by the project proponent. For example, HAL has indicated that its intention is to apply for DCO based on a broader project definition then what will eventually be constructed. Securing DCO permission with a broader scope may be associated with higher costs compared to one with more limited scope. How will the costs incurred for securing planning consent for the broader project scope (beyond what will be needed) be treated. Similarly, how would the regulatory framework treat cases if the project proponent undertakes investments (without airline community consent) that fall within the DCO but have been temporarily put on hold or abandoned due to decisions taken by project proponent?

Dealing with costs that may need to be incurred before consent is granted

- Governance arrangements for Cat B may be applied as an interim solution until Cat C governance is developed as to whether such costs are allowed. But the point of entry of these costs should be that of other costs (which is when the assets come into use or alternatively based on a deviated/modified approach but only if found to be in the consumer interest to do so).

Allocation of volume risk:

- Two types of risks need to be considered:
  1. Volume risk within a regulatory period
  2. Volume risk over the life of the assets.

- On volume risk within a regulatory period: Generally it is appropriate that the volume risk is with HAL. However, to date, it can be argued that HAL has gamed this approach to its advantage and to a certain extent at the expense of consumers.

- On volume risk over life of the assets: The current regulatory framework does not adequately address these issues by default passing on these risks to consumers.

- Furthermore, a key issue in the context of expansion is going to be the “ramp-up” rate once the capacity becomes available. Options on how to deal with this uncertainty need to be considered.

- The references to bilateral commercial contracts as a lever for managing aggregate demand (volume) risk raise significant concerns. Airlines offer services to meet underlying demand for travel. The ability for individual carriers to underwrite overall travel demand (volume) risk is limited by the contestability of the airline market as well as aggregate demand dynamics. Therefore, airlines are not better placed to carry such risks, compared to other potential investors. Furthermore, the possibility to mix the use of commercial contracts with other risk management instruments may lead to risks transferred differently across airlines operating in the same market. This could lead to distortions in airline markets and could compromise short and long term market efficiency.

Regulatory arrangements to support efficient financing and long term investor and consumer confidence:

RAB:

- It is welcome that the CAA is looking at ways to introduce evolutions to the RAB model that would better serve consumers’ interest. Any such evolutions should ensure that they:
    - Improve risk allocation – thereby reducing project cost from a consumer perspective
    - Identification of needed investments and their delivery in an efficient way – thereby reducing cost to consumers as they would not need to pay for unneeded investments and avoid rewarding inefficient delivery.
    - Improve performance in delivering operational efficiency – thereby reducing cost to consumers
    - Not create distortions in the airline market – thereby allowing market dynamics to determine consumer preferences
    - Ensure airport efficiency gains are passed on to airlines– thereby reducing costs to consumers

Other commitments to support long-term investor and consumer confidence:

- Detailed work is needed on what elements may be fixed and which could be flexible. These issues are not separate from the approached discussed above under incentives, allocation of risk, RAB etc. Rather it can be considered as another dimension that would need to be considered for determining the regulatory framework.

Alternative delivery mechanisms:

- Regulatory framework should be designed for the most efficient delivery mechanism and not simply tailored to HAL. CAA should set the regulatory framework in the interest of consumers and if subsequently that would mean HAL having to co-develop or seed development of runway/terminals to other developers so be it. The key to ensuring this works would be to create an easy mechanism for allowing such a "transition" to happen.

The cost of capital, financeability and affordability

Estimating cost of capital:

- The CAA claims that the "financing and construction of the capacity expansion will change the risk profile of HAL…" But then it goes on to say "The extent of these risks and the way they are allocated between HAL and airlines/consumers will need to be considered in assessing the appropriate cost of equity." While the CAA recognizes that allocation of risk is a key consideration it seems to under emphasize the importance of this aspect. It is the allocation of these risks that will drive the cost of capital not the existence of the risks themselves.
- There are measures the UK government (perhaps beyond the CAA and in conjunction with UK Treasury and/or Department for Transport) can undertake to reduce the perception as well as acceptance of risks from this airport investment. For example, acceptance of airport expansion issued debt may being allowed to be used as safe assets in financial regulatory compliance. Or other innovative risk mitigation strategies may also need to be considered.

Financeability

- Two options for an airport development plan needs to be developed based on:
  1. No prefunding –decreasing charges trajectory until assets come into use, subsequently charges are at levels no more than current charges in real terms
  2. Charges remaining at level no more than at current level in real terms.

- The assessment of financeability should not be tailored to HAL but rather assessed from an overall project viability basis. Key financeability levers need to be incorporated into the financeability analysis, including:
  - Phasing – what are the phasing options and how does varying when costs are incurred impact financeability?
  - Scoping – what are the options for scoping the project and how do they influence financeability?
  - Efficiency gains – how do different intensity of operational efficiency improvements contribute to overall financeability?
  - Sweating of assets – what can be the replacement trajectory for existing assets?
  - Other levers influencing financeability – increase aircraft improvements and identification of other options
  - Cost of capital/capital structure

Affordability and Assets in the course of construction (AICC, prefunding etc.)

- The AICC concept (prefunding) should merge with section on financeability. Only when other more attractive levers (such as phasing, scoping, sweating existing assets etc.) to address financeability issues have been exhausted would AICC need to be considered alongside other options.

- We welcome a practical approach through which to consider this issue. However, we are deeply concerned with the conceptual views expressed by the CAA on arguments in support of why AICC/prefunding would imply lower financing/project costs. We do not see this as an accurate depictions. We are of the firm view that such an approach will be against consumer interest. It would lead to worse risk allocation outcomes and result in higher costs to consumers (when time value of money of consumers is considered). Furthermore, it would lead to inequitable inter-generational outcomes as consumers that do not benefit from the investment will have to incur higher costs. In addition, we do not see advancement of revenue in any form, reflective of what is observed under normal competitive market conditions.