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Response to the CAA's Consultation on the Economic regulation of capacity expansion at Heathrow: policy update and conclusion

CAA CAP 1658

6 July 2018

Introduction

The Airline Operator's Committee (AOC) and the London Airlines' Consultative Committee (LACC) welcome this opportunity to submit this joint response to the CAA's consultation on regulating capacity expansion at Heathrow (CAP 1658).

Our response below, follows in so far as its possible, the structure of the CAA's own CAP 1658 document. However, we do have the following general comments that we would also like to make.

i. the airline community has always supported the CAA's s16 work on Heathrow expansion. We believe that it has been a valuable aid in helping move the programme forward and were concerned that it has come to an end. We are pleased to see that the CAA (together with the DfT) have responded to our concerns and requests to continue the s16 approach so positively. We have some comments on CAP 1656 and the proposed Terms of Reference, which we will send separately, but are grateful for the CAAs response and broadly supportive of its proposed approach;

ii. we have been encouraged by the CAA's approach in modelling affordability. We believe that in building and sharing the model that the CAA will use to test affordability and financeability, the CAA has aided a further degree of transparency and regulatory certainty to the process. The airlines are now able (subject to the extent and quality of the data supplied by Heathrow Airport Limited - HAL) to test affordability using the same model as the CAA. We believe that this is a major step forward. We also wish to thank the CAA for the open and constructive way it went about building and testing its assumptions for the model runs in 1658. We believe that this is a template for future engagement and strongly encourage the CAA to continue with such an approach;

iii. the CAA appears to have misunderstood the airlines' position on affordability. In para 1.1 the CAA states that in CAP 1610, the CAA noted *'…the support given by HAL, the airlines and the SoS for making sure that airport charges are maintained <u>as close as practicable</u> to current levels'* (our emphasis). As we pointed out in our response to CAP 1610, this is not the airlines position. For the avoidance of doubt, the airline community believes, and has said consistently, that expansion at Heathrow Airport must be delivered with no increase in charges in real terms from todays prices.

The CAA also appears to wrongly characterise the airline position. CAP 1658 states *'… airlines will need to accept that our assessment of cost efficiency and the consumer interest may not always align with a cost profile that produces the lowest possible charges, since developing passenger facilities of an appropriate quality, and ensuring a resilient airport are also important objectives for consumers.'*[1]

This could be read that the CAA interpret the airlines position as wanting the lowest possible cost (and therefore by implication the lowest possible quality) expansion at Heathrow. This is an incorrect assumption. Airlines are acutely aware of what their passengers want and will pay for and are skilled in delivering it for them. What we want is the right type of capacity, delivered at the right time and done so affordably. Consequently and to a degree we agree with the CAA. Expansion might not be delivered at the price for a low quality low price expansion, but, we have every right (as do our passengers both current and future) to expect that the right type of expansion should be delivered at the lowest possible cost.

Chapter 1: Approach to affordability and financeability

We agree with the CAA that airlines and our passengers (both current and future) should expect to see no more than efficient costs reflected in airport charges. However, we have some concerns about how this is to come about. We note that the CAA expect HAL to *'seek to win the confidence of stakeholders by thoroughly exploring all reasonable approaches to delivery.'*[2]In our view this will be insufficient for a number of reasons, including:

i. efficient costs are not just about efficient delivery, but also about efficient design, planning and requirements capture;
ii. the airline community requires transparency from HAL, so that we can explore appropriate options and designs to ensure the right capacity is being built for our passengers at an efficient price; and
iii. ultimately affordability is an issue for the CAA. It is the CAA that sets the price cap for HAL at Heathrow Airport (which we note HAL always charge up to). Therefore while HAL may deliver a proposal for an efficient scheme, it may still be unaffordable if the CAA choose to allow an increase in prices in real terms.

In terms of financeability, we cautiously support the CAA's proposals to adopt a twin track approach. We remain of the view that the CAA should conduct its assessment using financial structures that would be adopted by a notionally efficient company. It has always been the

[1] Para 1.17, CAP 1658
[2] para 1.19, ibid

CAA's policy that HAL's financial structure (and for example its gearing) is a choice for HAL. HAL's shareholders have chosen to gear HAL more highly than the CAA assume on a notional basis, and have reaped the reward for doing so. The CAA have always been clear that HAL would need to bear any costs of doing so too.

Consequently, if HAL have chosen a financial and capital structure that has earned them extra returns in the past, but that given the scale of borrowing required for expansion, would make raising finance more expensive, then we believe that any additional costs that arise from HAL's choice of financial structure are costs that should be borne by HAL. Its shareholders took the decision to adopt their financial structure in full knowledge of the CAA's policy at the time, and so should bear any costs of such a decision, as they have reaped the additional returns.

Furthermore, we believe that if the CAA were not to take this approach then it would not be fulfilling its statutory duties to promote the interests of passengers.

A stable and profitable airport operator at Heathrow is vital for the success of the airline community at Heathrow, and so we agree with the CAA that HAL should retain access to cost efficient and efficient investment grade financing, and that it is financially resilient. It is not clear however, how the CAA's policy will develop in this regard, and how they will achieve this in their regulation of HAL.

The airline community note that HAL has proposed another alternative definition of affordability. We make no comment on this proposed definition, but rather make two comments:

i. the vast majority of the benefits of expansion come not from the construction phase but from airlines using the new capacity to fly to augment their schedules and fly to new destinations. Consequently, in order for the expansion business case to work, what matters is whether airlines can afford to use the capacity; and
ii. the airlines have been very clear that their support for expansion is conditional on it being affordable, and that is affordable by their definition.

Consequently, whilst other bodies may wish to propose alternative definitions of affordable, the only definition that matters in ensuring a positive business case for expansion is the airline definition.

Chapter 2: Initial Assessment of affordability and financeability

The airline community were pleased to engage with the CAA to help the CAA develop its modelling approach. We are grateful to the CAA for sharing their model with us, and for engaging so openly and constructively. We would certainly welcome further engagement with the CAA as all parties continue to model affordability.

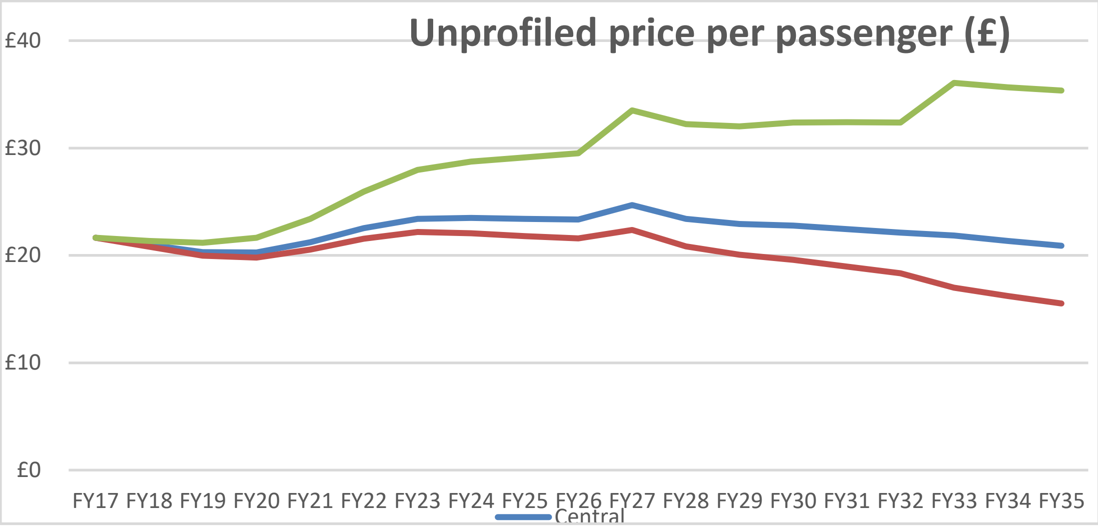
We recognise the scenarios tested by the CAA, and having examined the model that the CAA have shared with us, agree that those results are consistent with the assumptions stated when applied to the model.

We were keen to add to the stock of knowledge on affordability modelling, and so have modelled three scenarios ourselves. In order to make our scenarios as comparable to the CAA's as possible we have adopted CAA assumptions and HAL assumptions where we can. For the avoidance of doubt our use of any number (for example our assumptions on the capex costs or the WACC) does not imply an acceptance of those numbers. Rather they are being used simply to aid comparison.

We model three scenarios: a central case which we believe, at present to represent the most likely outcome given the immaturity of the data; an upside scenario where costs are lower and passenger growth faster than in the central case; and a downside scenario where costs are higher and passenger growth lower. The assumptions for each scenario are shown in the table below.

Inputs	Central	Upside	Downside
Passengers	2%pa growth until 3rd runway opens, then 3% pa for 5yrs after runway open (HAL initial uptake). Dropping back to 2%pa trend	2.5%pa until 3rd runway opens, then 3.5%pa after the runway opens for five years, then returning to 2.5%pa	1.5%pa growth until 3rd runway opens, then 2.5%pa after the runway opens for five years, then return to 1.5%pa
Capex	HAL Westerly option	Central case -5% (as recommended by IFS)	Central case +45% (as recommended by IFS)
WACC (Internal)	4.57% Vanilla as per CAA modelling	H7&H8 - 4.57% (vanilla), H9 onwards - 4.3% vanilla (as per CAA modelling)	H7&H8 - 4.57 vanilla H9 onwards - 5.47% vanilla
Opex	Variable opex grows in line with passenger volumes; £200m uplift for new terminal Further variable opex growth in line with passenger volumes. Assume 1%pa efficiency frontier reduction	As per Central case but 2%pa efficiency frontier reductions	As per Central case but no efficiency frontier gains
Revenue	1% growth	Grows 1% New terminal 2% for 5 years Returns 1% growth	1% growth No growth post new runway

Applying these assumptions to the CAAs model produces the following results:



Our initial modelling shows that there is no scenario that currently complies with a strict interpretation of the airlines' definition of affordability. We note that in our upside scenario for the second half of our assessment period, prices would seem to be consistent with an affordable solution. We also note that our central case, whilst not affordable, does not seem to be dramatically unaffordable.

However, the results of our downside scenario shows that the current expansion plan could be significantly unaffordable.

The results of the CAA's modelling led them to suggest that '*there are credible assumptions that could lead to a path of prices that is* *__broadly__* *affordable.*'[3] (our emphasis). Our interpretation of the modelling is slightly different to the CAAs.

We believe that whilst there are currently no scenarios that deliver an affordable solution at Heathrow, we are encouraged that under some assumptions, with some hard work on costs and regulatory interventions it may be possible to deliver an affordable price path. However, we also caution that there are equally plausible assumptions that would deliver a price path that is extremely unaffordable.

We appreciate that at this stage the data supplied by HAL is necessarily high level and immature, and that the CAA is yet to conduct any thorough analysis of the future WACC for HAL. Consequently, the numbers are subject to change, and what they really show us is the range of possible outcomes with regards to affordability at this stage.

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[3] para 2.12, CAP 1658

The airline community restates its commitment to working collaboratively with HAL and the CAA to find a solution that delivers an affordable expansion at Heathrow.

Chapter 3: Evolutions to the Regulatory Framework

We have stated in our previous responses to the CAA, and continue to believe that the introduction of as much competition as possible into the expansion programme will ensure a more efficient design and delivery process and generate benefits for our passengers. Indeed we have engaged constructively with the CAA and with HAL to try to bring more competition into the process.

Consequently, we support the CAA's position that they are *'seeking to support and encourage the timely introduction of more competitive arrangements in the interests of consumers.'*[4] We are pleased that the CAA supports our position, and also wishes to promote the interests of our passengers.

However, it is worth noting that the Civil Aviation Act (2012) places competition among the first objectives of the existing regulatory regime. Greater emphasis should be placed on this aspect. The CAA and UK Government should:

- Ensure a directly competitive process for the third runway expansion as a major infrastructure project affecting the entire UK economy; and
- closely consider and evaluate models of inter-terminal competition or other proposals with demonstrable benefits for consumers under which more than one operator is able to deliver services at Heathrow Airport.

However, we note that the CAA's position thus far has been to encourage HAL to think about engaging with stakeholders on alternative delivery arrangements. We also note that the CAA has not, as yet, set any expectations regarding the process or about the intensity with which HAL should engage, what the CAA regards as successful engagement, and what sanctions the CAA will impose if engagement is not sufficiently intense and successful.

Consequently, we are disappointed to have to also note that engagement on these issues has been disappointingly slow. The timetable for expansion is a tight one, and we are told by HAL that early Category C costs need to be born now to ensure that programme delivery stays on schedule. However, we note that it was not until the end of April this year that HAL proposed principles to guide engagement (rather than any actual engagement).

[4] para 3.4, CAP 1658

Whilst we are encouraged by the beginnings of such an engagement, we are concerned with the lack of pace in the process demonstrated thus far. We are concerned that unless the CAA sets a clearer and firmer framework, that engagement will not happen with sufficient pace, intensity or the potential for successful outcome. Therefore we would ask the CAA to set out, as a matter of urgency:

- what it considers to be the necessary level of intensity of engagement HAL should demonstrate with airlines, but also with alternative suppliers and delivery mechanisms including any options for a more competitive framework;
- what the CAA considers to demonstrate successful engagement; and
- what sanctions the CAA will impose if they consider that HAL has not engaged with sufficient intensity or success.

The airline community is keen to engage with both HAL and the CAA in examining both the role for alternative suppliers and competition within the expansion programme, but also alternative delivery mechanisms. To this end, we previously proposed exploring a 'Buildco' delivery solution. We are very encouraged that the CAA also believes that there is merit in exploring this further.

We are keen to engage with both the CAA and HAL to explore this option. We have already had an initial high level discussion with HAL. Clearly there is a lot of detail to consider in order to test whether any Buildco solution is viable and would deliver tangible benefits.

Whilst some of this work will need to take place between HAL and the airline community, ultimately any regulatory option would need to be approved by the CAA. The CAA, as the industry regulator and the Government's expert has expertise in economic regulation, and is better placed than the airlines or HAL to understand both what would work in a regulatory context, and what the experience of other regulators in other sectors has been when they considered such issues (e.g. OFWAT and Thames Tideway). Consequently, the airline community is keen that the CAA should engage proactively in exploring the possibility of adopting a Buildco type approach.

Finally, we note that the CAA is proposing to supplement its thinking on a licence condition on HAL to operate, maintain and develop Heathrow Airport in an efficient and timely manner with guidance. We remain open to the concept of a licence condition and guidance, but until we see the detail of the CAA's proposals find it difficult to comment on:

- the need for such a condition;

- whether the CAA is proposing the right split between what is in the licence (i.e. an obligation for HAL) and what is 'under' the licence (i.e. guidance to be considered); and
- whether the CAA's proposals would set in place unintended consequences that would be against our passengers' interests.

Chapter 4: Cost of capital and incentives

The airline community fully supports the CAA examining a wide range of regulatory options to ensure that it regulates HAL in the right way to ensure that we see the expansion of capacity that we want, of the right type at the right time, and in an affordable way.

The CAA's RORE analysis is interesting and we would like to see it developed further, although at this stage we are not sure quite what type of ex ante regulation the CAA would favour. For example, does the CAA have a relatively simple fixed price arrangement with modest incentives approach in mind, or would it seek to develop a menu based approach to regulation as OFWAT and OFGEM have used?

One issue that is clear is that the cost of construction needs to be realistic, efficient and affordable, and that the incentive regime should not incentivise adding cost. So for example if the true cost of a project is 100, the licensee should not be able to say it will cost 200 (an inefficient cost) so it can mitigate downside risk and ensure outperformance. In short the governance process needs to ensure that the price set as the fixed price is the efficient one and the one set by the CAA.

As such the airline community strongly recommends that the CAA works with us, and HAL to ensure that there is sufficient strength and transparency in the governance process to ensure the efficient fixed price is the one that is set ex ante. This would need to cover whether scheme design was the most efficient for the level of service and resilience required, design costs, construction costs, on costs and so on.

The CAA will also need to consider whether transferring construction risk more fully to HAL than under the current regime would generate a higher WACC and overall higher levels of charges for our passengers.

We also note that in at least one of its options, the CAA talks of including an ex post efficiency review. We note that the CAA has talked extensively in recent consultations about ensuring only efficient costs enter the RAB, and we fully support this objective. In our view however, it is vital that the CAA generates a clear and objective measure of what an efficient cost is, and develops an objective and transparent approach to the ex post assessment of capital spend.

In our view, the generation of a strict ex post efficiency test would be a powerful incentive to ensure that capex is spent efficiently.

Consequently, whilst we support the CAA looking at new approaches, we wonder if the better approach would be to strengthen the governance process for capex spend (especially during the project need and design stages), and to institute a much stronger and objective ex post efficiency testing regime. We feel that these adaptations are likely (if properly and rigorously enforced by the CAA) to deliver better outcomes, and be more transparent and better understood than complex ex ante incentives.

Chapter 5: Interim arrangements to apply after the end of the Q6 price control

The airline community is broadly supportive of the CAA's desire to align the regulatory and expansion timelines. Consequently, we are broadly supportive of the proposal to provide an interim settlement, and thus delay the start of the H7 settlement by a further two years. We also agree with the CAA that to conduct a full price control review for these two years, would defeat the object of an extension, and therefore that the CAA should *'…adopt a proportionate and targeted approach, consistent with the interests of consumers.'*[5]

Whilst we support the CAA's approach in effectively extending the Q6 control, there are three broad issues that we believe that the CAA needs to consider and act upon. These are:

i. the actual price that is set and the arrangements for 'truing up';
ii. clarity on the second (final year) of the proposed interim arrangements; and
iii. clarity on what would happen if the regulatory and expansion timelines slipped out of alignment.

Looking at the first of these – we agree with the CAA that a pragmatic approach should be taken and that the CAA should, as it proposed, restrict itself to a review of passenger forecasts, opex and commercial revenue forecasts, together with a limited adjustment to the WACC for new debt costs and corporation tax.

However, rather than applying a price path of RPI-1.5%, and truing up after, the airline community has a strong preference that the CAA should just set the price path that comes out

[5] Para 5.10, CAP 1658

from the recalculation of the elements that it suggests. This both reduces complexity (by removing the need to 'true up' at the end of the control), in other words if the CAA has to do the calculation to work out what the 'real' control price is, why not just apply it from Day 1 and do away with the need to true up. In addition, such an approach would improve transparency.

Furthermore, the airline community believes that such an approach would be better suited to passenger needs. The demands of our passengers mean that airlines have a strong preference for cash now rather than in the future. By applying the reductions it suggests in real time, the CAA would be bringing forward the tangible opportunity for airlines to invest in new products and services for their passengers (for example through new routes and products or product development), rather than allowing the shareholders of a regulated monopoly to benefit. Such an approach would be a tangible way for the CAA to promote the interests of passengers.

Our second issue is that the CAA is not clear on what their proposal is for the second year of the interim arrangement. We are clear that the proposal for year 1 is RPI-1.5%, with a commitment to true up in the future, but for year two the CAA state *'…by testing for financeability for 2021 to determine whether an RPI-1.5% price reduction is appropriate for the second year of the interim price control[6]'*. It is thus unclear what price path the CAA is proposing for year two.

The airline community believes it is extremely unlikely that HAL would experience financeability issues that would outweigh the benefits of regulatory uncertainty, which could not be seen some way off. We also do not believe that the issues that arise could not be dealt with at the end of the control, or if they were so severe as to demand emergency intervention, through a re-opener.

Consequently, the airline community strongly recommends that the CAA sets a price control for both years of the proposed interim price control to provide regulatory certainty.

Finally, our third issue is around the uncertainty of the expansion timetable. Under the CAA's proposal, the longer the interim control is in place, the longer airlines and their passengers pay more than they should, and HAL's shareholders benefit. Given the uncertainty of the expansion timetable, we believe that the CAA should confirm that it will not seek to further extend their proposed interim arrangements beyond the two years proposed.

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[6] para 5.32, CAP 1658

We believe that there are other regulatory arrangements that are better suited to dealing with the uncertainty of the expansion timetable than the CAA's open ended interim proposal. Such arrangements might be based on, for example, the approach of the CAR (the Commission for Aviation Regulation – the Irish regulator) to their price control for Dublin Airport expansion.

In short, the airline community agrees that the CAA should adopt a pragmatic approach, and therefore will support interim arrangements that:

i. are based on the actual price from the adjustments to the building blocks that the CAA suggests, rather than a truing up process;
ii. are certain, and therefore set the price path for both years, rather than one; and
iii. is limited only to the two years proposed.

In terms of the CAA's proposed timetable, we are not certain that either timeline option is appropriate. Our requirements in this process are that:

i. HAL produce a meaningful Initial Business Plans;
ii. there is adequate time for us to scrutinise that and their Final Business Plan;
iii. the CAA has adequate time to form its views;
iv. that we have adequate time to scrutinise, evaluate and challenge the CAA's thinking and proposals.

Given the current lack of maturity of HAL's expansion plans, we are not certain that a robust initial business plan could be produced by July 2019. Similarly, we are not clear why the CAA would make its decision earlier than November 2021.

Chapter 6: Early category C costs

The airline community notes the CAA's proposals on early Category C spend by HAL. We have a number of concerns with the CAA's proposals and approach in this regard.

We agree with the CAA that HAL has yet to provide any evidence that early category C costs are required, that the risk cannot be borne by HAL, or that there is a positive business case for airlines and passengers paying such costs. Consequently, at this stage, where the need for such costs is unproven, and indeed whether HAL can produce an expansion proposal that is affordable and can gain airline support, there seems little point in developing a governance framework for costs which may never be incurred.

The airlines have consistently argued that early category C costs should only be remunerated after DCO consent. This is because until that point, the benefits to our passengers of incurring such costs (and ignoring for simplicity the issues of intertemporal inequality) are purely theoretical. Whilst there may be benefits to HAL's shareholders of having early Category C costs remunerated before DCO consent, there are, in our view, no benefits to our passengers or the airlines of incurring and paying for these costs if DCO consent is not granted.

Whilst the CAA's proposals are brief there are a number of issues that arise from them that need clarifying:

i. as HAL have not yet told the airlines what they will build and for how much, how can the airlines reasonably determine whether they support HAL's case for expansion?

ii. That being the case, what does the CAA propose if the airlines reject HAL's proposals for early Category C costs?

iii. in 6.23b the CAA propose to use an expert to assess the negotiation process. Who will this be? What skills will they have? Why will airlines only see a Summary Report? What measures will the CAA use to determine the efficiency of such costs?

iv. We note (6.23c) that the CAA will ask HAL to show its cost are efficient. How will this be done, and will the process be transparent?

v. Will the CAA address the fact that HAL's compensation schemes are significantly in excess of recent compensation schemes, and were developed without consultation with airlines?

vi. We note that the CAA has not addressed the questions the airlines raised in their response to CAP 1610 about whether the CAA's previous policy statements created a conflict of interest when deciding on early category C costs. Can the CAA explain how it will handle any actual and/or perceived conflict?

We are also concerned that the CAA appears to be stepping away from the standard regulatory norms for adding expenditure to HAL's RAB. This being that expenditure is added to the RAB if all parties are agreed, it was consulted on before being developed and the expenditure has been efficient. In contrast to this the CAA appears to be suggesting that the two tests are now that HAL is able to demonstrate that early category C costs are in the interests of consumers and invested efficiently. The CAA and HAL are already aware that the airline community has concerns regarding HAL's unilateral approach to engaging with passengers on their needs from expansion without including airline representatives in this work. For example, the Passenger Insight Community set up by HAL which airlines asked to even have observer status on, but which HAL stated was commercially confidential and so airlines could not take any part – but simply wait for quarterly updates of what HAL wants to share from its research.

We are also concerned that the CAA proposes to use a third party (Arcadis) to take a view on the extent to which the early Category C costs incurred by HAL are in the interests of passengers. If the CAA is to include this criteria, it should be in addition to the test of consultation on early Category C costs with the airlines. The airline community should also involve in considering if the costs incurred are in the interests of consumers (including transparent access to any HAL information supporting their case that it is).

The airline community also believes that there are issues to be considered with respect to timings. We strongly object to the new process for early Category C expenditure being proposed by the CAA, and urge the CAA to be clear that any new process would only apply up to DCO decision and not beyond. Secondly, it seems clear to us that the desire for early Category C is being driven by a particular date for runway opening. It is not clear to us what the costs of delay are, or indeed whether where HAL's programme is currently at is consistent with such a date. Consequently, any decision on early Category C should be taken at the last responsible moment, and only if there is clear evidence that such a decision needs to be made and it is in our passengers' interests. This should include the costs of any delay.

Finally, the airline community is concerned with what appears to be a lack of transparency in the CAA's process. Whilst we understand that there may be at least one commercially sensitive compensation negotiation, we are concerned that the CAA will be making decisions on early Category C costs in a way that is not transparent, and seems to involve just the CAA, its expert and HAL. This does not seem like good governance to us, and is not conducive to the collaborative and consensual approach to expansion that we have been seeking to build. Consequently, we support the recommendations on enhancing the governance process that are being made in their submission by IAG.

In addition, the airline community proposes that the CAA publishes objective criteria on which it will base its decision on efficient early category C costs. We also propose that the airlines should be able to appoint an independent representative who would attend any discussions and decision making meetings on early Category C costs, to ensure that airline and passenger interests are fully and fairly represented.

The airline representative would be contractually obliged not to reveal the detail of the discussions to the airlines, but would be responsible for assuring them that their views were fairly and properly represented and considered and that the costs agreed by the CAA were indeed efficient and in our passengers' (both current and future) interests.

Chapter 7: Surface Access

The CAA states that *'we do not consider it is in consumers' interests for them to pay for surface access schemes, or enhancements and upgrades to schemes that are not required for expansion. We also agree with respondents' strong support for the user pays principle'*[7] The airline community strongly supports this statement and endorses and supports the CAA position here.

The airline community also acknowledges that as part of an overall package to try to get DCO consent, or as a condition of such a consent that HAL may need to invest in certain surface access schemes. We agree with the CAA however, that HAL and indeed the CAA's policy framework on surface access must ensure that *'relevant legal and planning obligations are met at lowest overall cost.'*[8]

We also agree with the CAA that where expansion requires an investment in a surface access scheme with another promoter which will also benefit non-airport users, then the airport's contribution should be in line with the user pays principle, and that the other promoter should have an obligation to promote the use of the new asset by non-airport users to ensure efficient use.

We note that the CAA expects that any surface access costs would be subject to financeability, efficiency and affordability tests. However, it is not clear exactly what tests the CAA would expect to apply, or indeed how they would interact. For example what would happen if a sum was efficient but not financeable?

Yours sincerely

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[7] para 7.12, CAP 1658
[8] para 7.17, ibid