

Consultation on Core Elements of the Regulatory Framework to Support Capacity Expansion at Heathrow

Introduction

1. This submission is made by International Consolidated Airlines Group SA (IAG) in response to the CAA's consultation of July 2017 on core elements of the regulatory framework to support capacity expansion at Heathrow (CAP1541). It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling and Aer Lingus.
2. This submission will set out the key issues regarding capacity expansion at LHR, before going on to address a number of other points arising from CAP1541.
3. We have first detailed our views on an **alternative delivery mechanisms**, because we believe these would have a significant and beneficial impact and so represent by far the best approach to capacity expansion of the scale proposed.
4. In regard to **other points arising from CAP1541**, we have addressed only those issues where IAG's views and those of the CAA differ, or when the CAA has introduced a new concept which requires comment. For ease of reference, this part of the submission will broadly follow the same structure as CAP1541.
5. References, unless otherwise stated, are to CAP1541.

Executive Summary

6. The regulation of an expanded LHR provides a generational opportunity to introduce competition in the development, provision and operation of passenger facilities. The introduction of competition would provide an enduring benefit to all airport consumers in South East England. In so doing, it would potentially allow the CAA to take a less intrusive approach to – or even to step away from - some areas, which are currently subject to economic regulation.
7. Competition would provide better facilities at a more economic cost and in a timely manner, a better customer outcome. Truly commercial infrastructure could be taken out of current regulatory frameworks, while investors in those facilities (including HAL's shareholders) could potentially earn higher returns than currently permitted.
8. The introduction of competition would be facilitated by a split RAB, divided into utility assets and commercial assets, allowing third parties to develop and operate

competitive commercial facilities in competition with HAL. IAG urges the CAA to consider three immediate practical steps towards facilitating a future split:

- a. to conduct a full and transparent audit of the existing RAB;
 - b. to continue to force HAL to publish in detail and benchmark the costings for its own proposals; and
 - c. to encourage existing HAL shareholders to consider third party proposals through future regulation of the allowed cost of equity.
9. Such diversification in the provision of equity funding should encourage not only better outcomes for customers but also a greater range of equity funding. Currently, equity funding is entirely concentrated amongst a small number of equity providers (HAL's shareholders) who are not 'growth' investors; rather, they are 'yield-seekers' (predominantly pension funds and sovereign wealth funds) and who potentially act as a regressive influence on the financeability of the entire project.
10. Opening up the development and sources of equity clearly must not prejudice HAL's existing and future debt providers; rather, it should act to benefit them. Debt providers would have the choice of financing utility-type assets (runways and taxiways) or commercial assets (terminal buildings). Instead of the currently proposed 'one-size, one-master-plan-fits-all, no-choice' financing, this approach would open up a greater diversity of financing, with greater transparency and consequently lower risk. Greater diversity and lower risk would translate into lower costs of capital, particularly if debt providers see risk-taking developers and airlines investing alongside them.
11. Affordability of the project must be supported by continued Section 16 reporting on costs and benchmarking with, in light of the size and timescales of the proposed expansion, rigorous ex-ante analysis of capital expenditure plans.
12. An expanded LHR with competitive development, provision and operation of passenger facilities, at an affordable cost with split sources of funding delivered in a timely manner is a 'win-win' outcome for consumers, airlines, facility providers and their shareholders.

Alternative Delivery Mechanisms

13. **Summary.** IAG strongly believes in the potential for third-party investment in selected parts of the LHR expansion project – and that this would deliver better facilities for customers, at a lower cost, and in a timelier manner, than would a monopolistic HAL-only development. This could be facilitated by a splitting of the

existing RAB into ‘utility’ assets (runways, taxiways and related infrastructure) and ‘commercial’ assets (terminals and related infrastructure). Third parties could then develop competitive commercial proposals for customers, jointly with HAL or potentially in limited areas as a competitor to HAL, potentially backed by JV vehicles.

14. Truly commercial parts of the airport could be taken out of today’s regulated frameworks, and investors in those facilities (including HAL’s shareholders) could potentially earn higher returns than currently allowed - provided customers are not compromised in the form of higher charges. While it would be premature to imagine at this stage what form these commercial arrangements might take, IAG urges the CAA to consider three immediate practical steps:
 - a. to conduct a full and transparent audit of the existing RAB;
 - b. to continue to force HAL to publish in detail and benchmark the costings for its own proposals; and
 - c. to encourage existing HAL shareholders to consider third party proposals through future regulation of the allowed cost of equity.
15. In this way, interested third parties could start to develop firm investment proposals.
16. **Importance of competition in the provision of terminal facilities.** We strongly endorse the CAA’s openness to alternative delivery mechanisms and the promotion of competition at LHR. We believe that competition would work best in the area of development, provision and operation of terminal facilities.
17. The aim of introducing competition would be to promote the delivery of better facilities for the customer, delivered at a more efficient cost, and in a timelier manner than would be the case under a single monopolistic developer. This approach already works at other major hubs around the world. Ideally, terminals or terminal complexes would develop long-term competing expansion plans, and would compete for airline customers on service and cost. A good recent example of this would be the Irish Government’s consideration of having a third party provider own/develop a third terminal at DUB, rather than DAA.
18. **Importance of competition and diversification in the provision of equity funding.** Such diversification would encourage not only better outcomes for customers, but also a greater diversity of equity funding. Currently, equity funding is entirely concentrated amongst a small number of equity providers (HAL’s shareholders) who are not ‘growth’ investors; rather, they are ‘yield-seekers’ (predominantly pension funds and sovereign wealth funds) and who potentially act as a regressive influence on the financeability of the entire project.

19. As ‘yield-seekers’ they are naturally prone to be focused on regulatory outcomes which suit themselves, pushing the regulator to lock in a continuous utility-like dividend stream from a pre-determined master-plan, rather than acting as developers for an asset which is planning a 75% capacity expansion. Although there are utility-type assets within Heathrow (the runways and taxiways), the terminal facilities for airlines and their customers should be treated as commercial developments. Broadening the investor base away from pension funds to include developers and airlines would act to invigorate and discipline the whole project.
20. **Importance of funding diversity to cost of capital.** Opening up the development and sources of equity clearly must not prejudice HAL’s existing and future debt providers; rather, it should act to benefit them. Debt providers would have the choice of financing utility-type assets (runways and taxiways) or commercial assets (terminal buildings). Instead of a ‘one-size, one-master-plan-fits-all, no-choice’ financing currently proposed, this should open up a greater diversity of financing, with more transparency and consequently lower risk. Greater diversity and lower risk should translate into lower cost of capital, particularly if debt providers see risk-taking developers and airlines investing alongside them.
21. **The expansion project offers the opportunity to move away from monopolistic financing, to the benefit of customers.** The ‘whole business securitisation’ approach followed in the past may have had the benefit of simplicity from a debt provider’s point of view, but it has had the pernicious side-effect of reinforcing the position of an unresponsive monopoly provider.
22. While debt providers may have been comforted by the apparent simplicity of the current funding structure, it has in fact had the consequence of raising long-term underlying risk to the debt providers. A monopolistic HAL has historically failed to engage with its customers, with one result that it has so far failed to deliver an affordable expansion plan. The regulator ought never to have permitted this monopolistic financing approach and, we believe, now has an opportunity to open up LHR to a more healthy and diverse set of investors.
23. **How alternative delivery mechanisms could be structured.** We believe that the regulator should be open to splitting the Regulated Asset Base between its natural ‘utility’ and ‘commercial’ components, and then adopting different regulatory approaches to each. The ‘utility’ RAB would consist of the runways, taxiways and associated infrastructure. Given the operational nature of all airports, the ‘utility’ RAB needs to be in the hands of one owner, and to have been built and to be operated according to one central plan. Given its natural monopoly, it must remain fully regulated. On the other hand, the ‘commercial’ components, consisting of

terminals and their related infrastructure, could be regulated in a less intrusive manner, if there is clear potential for competition between different facilities.

24. This competition, at the very least, should take the form of long term rival expansion potential and options to build differentiated facilities. If construction costs are sufficiently efficient, competition could also take the form of medium term potential to encourage marginal airline switching between competing facilities.
25. **Ensuring competition between different commercial facilities.** The key to competition should be the introduction of a proportion of equity ownership, other than HAL's, in at least one of the commercial components. In addition, each component should have the potential to expand in a material way. Finally, this expansion potential should ideally have the capability to generate a degree of surplus capacity, to allow airlines the potential to switch between different terminals in the medium term.
26. Obviously, to enable any surplus capacity to exist, facilities need to be capable of being delivered in a cost-effective and timely manner; indeed, we would expect the potential for competition to play a significant part in ensuring cost discipline in construction and operation.
27. **How commercial facilities might be split.** As noted above, the key to ensuring competition in the delivery of commercial facilities must be the introduction of external equity capital into the funding of at least part of the commercial facilities. The commercial facilities (terminals and related infrastructure) at LHR naturally split into two 'campuses': west and east; the latter encompassing T4 to the south.
28. Although there are connections of many kinds across the two campuses, the core of the hub operations at LHR is based in the west, in T5. At the very least, IAG would strongly support the introduction of third party equity into the western campus and its expansion. This could take the form of a joint venture between HAL and third parties, with control resting with the third parties.
29. IAG is currently spread across both the west and east campuses but, with timely and cost-effective expansion plans in the west, would look to relocate all of its operations there over time, to the benefit of customers in the form of shorter and easier connections between flights, and a more efficient hub operation. This would make space for other airlines in the east, who could over time expand and customise those facilities to suit their existing predominantly point to point models - or expand their own hub facilities, if they so choose.
30. **The importance of splitting the RAB early in the expansion process.** It is also the west that offers the most cost-effective early expansion potential, after the opening

of R3, in the form of a potential westwards extension of T5. Given the very significant expense involved in the construction of R3, it will be vital that customers are not further overwhelmed by even more expensive terminal construction costs in the early stage of expansion, after the opening of R3. In principle, both east and west campuses could be opened up to competitive ownership, but at the very least terminal developments in the west should be opened up to competitive and commercial funding first.

31. **How the splitting process could start.** IAG urges the CAA to audit and publish, as soon as practicable, the current detailed make-up of the Heathrow RAB, together with detailed costings of the expansion plan, which it has already required HAL to provide as part of the Section 16 process. This would enable all interested parties to propose commercial structures, with knowledge of the current economic make-up of LHR, and to be able to project for what different components might be worth at key investment milestones in the future.
32. IAG strongly believes that, in any case, a full and transparent audit of the RAB is long overdue and should be a key element of cost benchmarking for expansion. We have been unable, for example, despite detailed requests to HAL over many months, to ascertain the current RAB value of T5. Without such basic transparency, it has been difficult to evaluate the economic case for expansion, let alone the potential for commercial agreements.
33. **The role of the CAA in fostering constructive engagement.** IAG strongly supports the CAA's expectation that: *"HAL will actively consider the full range of mechanisms and delivery arrangements to promote efficiency, including those brought to it by third parties and proposals for joint delivery of assets"*.¹ IAG encourages the CAA to move beyond simple expectations, and instead further clarify its potential approach to setting the allowable returns on equity in the building block formula.
34. As discussed above, an opening-up of the expansion project to properly qualified third parties with proposals which would clearly be in customers' interests should act to reduce risk and consequently lower the cost of capital. Any failure on HAL's part to consider credible JV proposals from third parties must be taken by the CAA as strong evidence that HAL regards a 'go-it-alone' approach as the lowest risk strategy - at which point it should be made clear that this strategy should, all other things being equal, argue for the setting of a lower cost of equity than would otherwise be the case.

¹ Paragraph 2.22

35. Putting it the other way, were HAL's shareholders to consider a more co-operative, commercial approach, open to competition and to third party partners, then a more lightly-regulated set of assets would open the possibility of higher equity returns in the long-run than would otherwise be the case in a heavily-regulated environment - provided those returns are not at the expense of the customer in the form of real-term price increases from today's levels.
36. **The importance of continuing to set strong expectations around the appropriate level of aeronautical charges.** While IAG would encourage the CAA to actively use cost of equity incentives in the way described above, this would have to be balanced by a firm reiteration of the CAA's position that the overall result should never be aimed at prejudicing the customer in the form of raising prices in real terms. If peak charges are to remain flat in real terms, but the cost of equity is less rigid, then a rational HAL shareholder would naturally look to build the best possible facilities for the customer at the most efficient cost, and in the timeliest manner, knowing that they will potentially be rewarded more for doing this, than for persisting with the monopolistic, highly-regulated approach.
37. **How HAL shareholders can benefit overall.** The CAA's Q6 cost of equity settlement was made without regard to the value of growth embedded in the potential R3 expansion: indeed, HAL argued that it should receive a higher cost of equity as a result of there being limited growth potential for the existing (pre-expansion) asset. In the CAA's judgement, HAL's shareholders are already receiving a fair return on the existing assets. Any potential to expand the airport therefore creates a new stream of value for shareholders. HAL's existing shareholders stand to make a considerable value gain from their current, static start point, even if they do not participate in 100% of the equity expansion.
38. With the help of airlines, LHR is set to expand passenger capacity and therefore potential value by more than 70% over the life of the project: even if part of that upside is shared with new partners - and especially if those partners can themselves help to reduce the financial and commercial risk of the project - then a rational HAL shareholder should view a JV approach for part of the expansion as a significant overall value-creation opportunity.

Other Points arising from CAP1541

39. **The January 2017 Consultation: Stakeholders' Responses.** The CAA argues that dis-benefits to consumers have arisen as a result of capacity constraints in the SE

airports' market. We do not entirely disagree; however, note that while the CAA has a primary duty to protect consumers, current high prices and poor service quality are an outcome of the extant regulatory regime, within which HAL has been able to profitably operate.

40. We agree with GAL, in that airport competition (in as far as it is possible) should be a priority for the CAA.² Such competition should extend across financing, planning, development, construction and operation of both new and existing capacity. With this in mind, as the CAA (rightly) considers that competition will increase as constraints diminish, it clear that (at this crucial stage) the CAA must not arbitrarily constrain possibilities at LHR.³
41. HAL is already arguing for a higher WACC; however, given its unique access to new SE capacity and the significant enthusiasm demonstrated by financial markets, there is no substantive argument for a higher risk allocation; indeed, the contrary argument is more compelling.⁴ If, as is widely accepted, there is a chronic shortage of capacity in the SE airports market, then the current market leader, absent competition for new market share and backed by regulator-guaranteed returns, would seem to be a most attractive investment – and as such, does not require returns much in excess of risk-free rates.
42. A key point is that under the current regulatory system, if unchecked by the CAA, HAL's shareholders stand to not only benefit from returns in the form of dividends, but also growth, which the CAA proposed will be funded by its customers. While it is not difficult to understand why HAL is in favour such '*well established approaches*', the CAA need not be reminded of its primary duty to passengers, or of the close alignment of airlines' interests and those of passengers.⁵
43. In the real/commercial/competitive world, investors face a choice: either they take benefits in dividends or, if they trust management and believe it is in their interests, then they reinvest capital into growth.⁶ This is a very different scenario to that proposed by the CAA, in which not only would HAL's shareholders enjoy ongoing dividends, but their customers would pay for HAL's growth.
44. If HAL is to undergo significant growth, then this must be financed by its shareholders. Competitive organisations only pursue growth strategies, with a view

² Ibid 1.6

³ Ibid 1.1 & 1.7

⁴ Ibid 1.11

⁵ Ibid 1.13

⁶ Broadly analogous to running yield or growth strategies.

to realising scale economies and thus, reducing unit costs and capturing market share. It would be perverse to imagine that (in a competitive market, all else being equal) an organisation could concurrently increase both prices and market share; yet, this is what HAL envisages. At the very least, the CAA must prevent HAL from increasing unit prices.

45. As the CAA points out, both ex-post and ex-ante scrutiny of CAPEX are required.⁷ In particular, rigorous ex-ante scrutiny (through an IFS) is absolutely crucial for investment of this scale – and will require much more detailed plans and costings than have so far been provided by HAL. That said; associated difficulties (not least in quantifying uncertain investment) will necessitate complimentary use of ex-post scrutiny, combined with some mechanism to return excess revenues from capital efficiency and/or over-forecast to customers.⁸

46. Whilst HAL unsurprisingly defends its procurement practices, the fact remains that it has not published a suitable Procurement Code of Practice and is thus, in breach of its licence.⁹ Despite our repeated correspondence on this topic – and its description of HAL’s approach as *‘lightweight’*, the CAA has failed to respond meaningfully to IAG.¹⁰

47. **Regulatory Framework.** It is unreasonable to expect airlines to endorse a regulatory approach such as RAB, without knowing of what the RAB is comprised. IAG has corresponded with the CAA on this topic, but has not received a meaningful response.¹¹ In our understanding, the RAB should be the depreciated NBV of assets, approved by the CAA; however, the CAA (somewhat mysteriously) describes it as *‘the value invested by HAL’*.¹² If the CAA is going to assign a different definition to the RAB than that which is generally understood, then it needs to explain and justify its interpretation.

48. We agree with the CAA, inasmuch as a RAB-based approach (however derived) does not preclude *‘commercially delivered alternative delivery arrangements’*.¹³ It must however not forget (or somehow reduce its regulatory rigour) that airlines are strongly incentivised to opt for least-worst outcomes. So the simple fact that

⁷ Paragraph 1.14

⁸ We have discussed potential risk-sharing mechanisms with the CAA.

⁹ Paragraph 1.15

¹⁰ For example, letter IAG (Ian Clayton) to CAA (Richard Moriarty) of 17th May 2017

¹¹ For example, email IAG (Ian Clayton) to CAA (Andrew Walker) of 19th May 2017

¹² Paragraph 2.6

¹³ Ibid 2.2

something may be commercially agreed makes it neither competitive nor commercial.

49. We also agree that straight-line depreciation would be an inappropriate mechanism for the financing of such long-term investment and that it would be unreasonable to expect current passengers to finance capacity used by future passengers. HAL predictably argues for remuneration of assets in the course of construction; however, again, this isn't the way competitive markets work. It would be analogous to an airline applying a surcharge to its airfares, in order to finance future deliveries of aircraft, whilst at the same time expecting its load factors to increase!
50. The benefits of capacity expansion in the SE airports market are so clear to financial markets, that no further incentivisation is necessary – let alone, one so generous as HAL proposes.¹⁴ So a much more appropriate mechanism (as suggested by the CAA) would be unitised depreciation, which we understand to mean that every passenger would contribute equally (in NPV terms) to all capacity (current and new), over its life-time. This approach is common in competitive sectors (highways, for example) and would have the added advantage of meeting the CAA's ambitions, in terms of balancing affordability and financeability.
51. We accept that the CAA *'[cannot use] existing powers to force delivery of all or part of the capacity expansion by a party other than HAL'*, in that it cannot force a third party to deliver infrastructure at LHR.¹⁵ If that is the CAA's meaning, we agree; however, in our view the CAA is perfectly able to force HAL to allow a third party to participate in a competitive process – and to grant a licence to that third party, should it transpire that it has delivered the best option to further passengers' interests. Indeed, in our view, the CAA could take no other approach.¹⁶
52. We consequently reiterate the support set out in previous submissions for alternative delivery mechanisms – that is, alternative suppliers, for financing, planning, development, construction and operation. The CAA will have noted the £6.1bn reduction in HAL cost forecasts, which followed an extended period of intransigence and a much shorter time, since an alternative developer published plans costing £6.1bn less than HAL's. Moreover, as the CAA sets criteria, we consider this to be in the interests of stakeholders: passengers, airlines and HAL's shareholders, who would benefit from diversity in funding.¹⁷ Of course, HAL's

¹⁴ Ibid 2.10 & 2.13

¹⁵ Ibid 2.20

¹⁶ Civil Aviation Act 2012, Section 9 (3) & (4)

¹⁷ Paragraph 2.21

management may take a different view, but it is a matter for the CAA to choose the optimal regulatory approach.

53. The CAA makes an interesting point about the boundary of the single-till.¹⁸
54. HAL recently lost a High Court case against ORR, which essentially gives Crossrail access to the Heathrow rail spur at marginal cost. The spur is currently in the single-till – and so its costs, as well as the revenues from the Heathrow Express (HEX), are taken into account in setting airport charges. It seems then that with a competitor paying lower infrastructure costs than apply to HEX, the latter will lose revenue but costs will remain unchanged and so the difference will be made up in airport charges.
55. Consequently, it would be in passengers' interests for HAL to divest HEX. It may be the case that the attainable price for HEX would be lower than its RAB-value (assuming this is known) and doubtless HAL would protest; however, there is meaningful precedent. In 2008, HAL divested WDF for £545m – a figure that significantly exceeded its then RAB-value, but, with CAA support, the RAB was reduced only by the RAB-value. In this way, HAL's shareholders effectively pocketed a significant windfall, which was used to help write down Ferrovial's debt from the acquisition of BAA plc. The sale price/RAB-value differential was driven, in part at least, by HAL providing WDF with a 12-year concession at the time of the sale and thus, significantly increasing its value to potential buyers.¹⁹
56. We note that HEX was constructed to support ambitions of increasing the proportion of passengers using public transport to access LHR. With the imminent arrival of Crossrail, the best outcome for passengers would be for HAL to divest HEX to a rail operator and to instead focus on its core business of running and expanding an airport.
57. In our view, it would be contrary to its primary duty, were the CAA to allow HAL to retain an asset no longer needed to further passengers' interests – and entirely unfair, were it to change its previous policy of decrementing the RAB by the RAB-value of an asset, simply because on this occasion it may not suit HAL.
58. **Incentives.** In our view, the incentives bearing on HAL (and its financiers) to deliver are so strong as to render any perceived requirement to provide additional inducement entirely misplaced; however, the CAA describes '*an element of balance*'

¹⁸ Ibid 2.30

¹⁹ <http://news.bbc.co.uk/1/hi/business/7287156.stm>

and ‘the risks [HAL] faces [and that this] may need to be taken into account in setting the cost of capital.’²⁰

59. In terms of HAL’s current Service Quality Rebate and Bonus Scheme (SQRB), we repeat previous arguments that in providing HAL with a bonus for delivering what customers have already paid for, the CAA is overly concerned with ensuring HAL’s shareholders achieve a regulated return, at the expense of passengers’ interests. In competitive markets, suppliers provide outputs for customers at a price covering costs, including the WACC. This in turn provides investors with a fair return for the risk they bear, part of which will be the risk that customers will be dissatisfied and so will not buy their outputs, either by switching suppliers or demanding rebates.
60. HAL’s customers cannot switch suppliers, so it is right that when they don’t get what they’ve paid for, there should be rebates. It is demonstrably wrong that when they do get what they’ve paid for, they should have to pay for it again – and to dress this up as somehow providing appropriate incentives and/or applying a symmetrical approach entirely misses the point.
61. We note that *‘at recent price controls, the CAA’s use of ex-post efficiency assessments has not resulted in significant disallowed expenditure...’²¹* There can be little doubt that HAL has also taken account of the CAA’s lack of rigour, as suggested by the £6.1m reduction in CAPEX forecast. In spite of HAL’s obvious informational advantages, the CAA has (for some time now) appointed an IFS and must take a firmer approach to ex-post CAPEX assessment.
62. Indeed this lack of rigour from the CAA that is likely perceived by HAL as part of wider pattern of decisions and policy. Examples include:
- a. expansion Category B costs risk share, wherein the CAA’s proposal would reimburse HAL 105% of its costs of securing a successful DCO, whilst imposing 85% of costs for a failed DCO onto consumers – costs and risks which are entirely beyond the control of those stakeholders, whilst insulating HAL from the effects of something over which it has significantly more control;
 - b. expansion Category B costs, wherein the CAA’s proposal exempts the first £10m of annual Category B costs from any efficiency scrutiny by the IPCR; and

²⁰ Paragraph 3.4

²¹ Ibid 3.9

- c. expansion Category C costs: consideration of allowing expansion Category C costs facilitates pre-funding of expansion by airlines, before planning permission is secured and so again insulating HAL from any risk and passing that onto airlines and consumers.
63. The CAA has consistently provided HAL with financial incentives (where none is needed), has consistently failed to challenge and sanction HAL (when it has been appropriate) and has repeatedly passed the risks and costs of the monopoly (which is best placed to bear them – and is compensated for so doing) onto consumers. In the event HAL successfully secures a DCO, HAL would feel entitled to unreasonably and significantly inflate the RAB.
64. In principle, we would support the development of a *‘licence condition for HAL that would require it to operate, maintain and develop [LHR] in an economical and efficient and timely manner...’*²²
65. We are not convinced that a five-year review period would be appropriate for such a large and long term investment as is under consideration.²³ In our view, without diligent safeguards, this runs the risk of front-loading recovery, in the way that the CAA has suggested (and we agree) would be inappropriate. Moreover, given its complexities, there is no guarantee that *‘the initial construction period’* would be complete in such a short space of time.
66. **Costs: Incentives and Efficiency Assessment.** For clarity, IAG supports both ex-post and ex-ante CAPEX efficiency incentives, but – in light of disincentives on HAL to overspend, should it not share efficiency benefits - is willing to consider ex-post benefits sharing.²⁴ For this to be effective, CAA ex-post reviews must display rigour that has not previously been in evidence.
67. Similarly – and notwithstanding difficulties arising from informational asymmetries, ex-ante CAPEX reviews must be rigorous and so we agree with the CAA when *‘[it] expect[s] HAL to provide strong supporting evidence for its forecasts of costs.’*²⁵ We would say more: that in the absence of such evidence (or quality of evidence), the CAA (in collaboration with stakeholders and the IFS) should set an ex-ante cost allowance, which it sees as reasonable and fair. (This can always be reviewed, ex-post.)

²² Paragraph 3.28

²³ Ibid 3.31

²⁴ Ibid 4.7

²⁵ Ibid 4.25

68. We do not agree with the CAA's suggestion of the use of an approach which makes assumptions about the chances of outturn CAPEX being higher or lower than a central case.²⁶ A central case ought to take account of all relevant factors and so, over a portfolio of investments, should be central at the end, as well as at the beginning. As it is described by the CAA, the 'p80' value for development CAPEX artificially increases cost estimates, so that 80% of the time, costs would be no higher than the central case. In other words, cost estimates would be artificially increased, in order to create an illusion of capital efficiency!
69. The CAA is aware of airlines' concerns that capital efficiency is the regulatory equivalent of over-forecasting, so it would be entirely unreasonable to replace HAL's hitherto regulatory gaming with an equivalent approach, cemented into regulation.
70. It would be wrong to consider LHR R3 on a project by project basis – for example: project A comes in at +£10m and the CAA makes a +£10m ex-post RAB adjustment, while if project B comes in at -£10m, the CAA shares the benefit between airlines and HAL, by making a -£5m RAB adjustment, so the net effect to the RAB is +£5m. Rather, it must take a portfolio approach; using the same example, there is no damage and nothing to be done to the RAB.
71. Whilst we agree with the CAA that it is necessary to prevent '*bias towards its associated companies*', the problem runs deeper than the CAA suggests.²⁷ Despite its protestations, HAL has relationships (formal and otherwise) with a range of suppliers, particularly in the construction sector. We therefore support benchmarking as a test of forecast CAPEX efficiency and will be happy to provide relevant examples of significant development at hub airports.
72. As previously mentioned – and for the reasons stated, we would welcome the CAA's intervention in regard to HAL's inadequate procurement processes.²⁸
73. Noting that HAL has unilaterally committed to paying 125% of statutory minimum compensation costs, in our view it is a matter neither for the CAA nor airlines. Were it not for an entrenched belief that airlines will pay for everything, whatever the cost, HAL could not have made such a promise; however, there is no reason (other than a desire to satisfy HAL) for the CAA to allow any more than the statutory minimum into the RAB - indeed, to do so would breach of its primary duty.

²⁶ Ibid 4.27

²⁷ Ibid 4.29

²⁸ Ibid 4.32

74. **Affordability and Financeability.** The CAA's stated position on affordability – that *'airport charges are maintained as close to current levels as practicable'* lacks bite!²⁹ HAL's intentions are made clear by its prior insistence on maintaining forecast CAPEX programme, which was only curtailed by the arrival of an alternative developer.
75. Affordability and financeability are effectively the same thing. If airlines can't afford to pay, then HAL won't get paid and consequently, neither will its financiers, be they debt or equity holders; albeit, debt interest will be paid before equity is reimbursed. So it is in HAL's shareholders' interests that any development by HAL is affordable. For clarity, affordability means no increases in unit costs, not some vague aspiration that they shouldn't increase too much.
76. While we continue work with HAL on scheme design, it is clear that external (financial) factors are more influential than any desire to reach a suitable agreement. So we agree with the CAA that *'much needs to be done'* – and would therefore encourage it to become more actively involved.³⁰
77. We fundamentally disagree with the CAA's proposal to assess passengers' *'willingness to pay'*.³¹ Notwithstanding the subjective nature of the Heathrow Consumer Challenge Board's approach, the CAA knows very well that airlines cannot pass through costs to passengers, because airfares are set by the market and airlines already (and rightly) operate revenue maximising strategies. The most significant impact of increased airport charges on passengers, as the CAA well understands, is that airlines are less disposed to allocate aircraft to an airport and so there is concentration onto higher yielding routes (at the expense of others) and consequential loss of choice to passengers – and connectivity to the UK.
78. In regard to notional gearing, we support an approach that would minimise WACC. Clearly, long-term infrastructure investment as contemplated by HAL will attract a considerable amount of debt at attractive rates and so a move from the current 60% debt assumption to something more realistic would be welcomed. That said; a financial structure comprising 70% debt may still be too conservative.³²
79. It is somewhat ironic that now, at a time of potential property price deflation, the CAA should consider moving from RPI to CPI indexation; although, it isn't clear why (CPI being lower than RPI) it believes that this would lead to higher charges in the short term. While the CAA's explanation suggests that the RAB would be inflated by

²⁹ Ibid 5.2

³⁰ Ibid 5.4

³¹ Ibid 5.6

³² Ibid 5.8 & appendices B17 & B20

the same measure as WACC is discounted, how the temporal variance arises isn't obvious.³³

80. **Surface Access.** We are happy that the CAA reiterates the '*user pays*' principle, which supports a proposal that HAL should divest HEX (or at least it should be removed from the single-till), as set out in paragraphs [19-22], above.³⁴ It is entirely appropriate that rail travellers, as opposed to airline passengers, pay the costs of rail access. Moreover, the principle that '*surface access projects [...] would be likely to deliver benefits in excess of costs...*' (Criterion A) should apply not only to new surface access development, but also to existing infrastructure.³⁵
81. Criterion B - that a '*surface access project as a whole is not over specified or costed*' ought to go without saying (and is covered in detail elsewhere), so we assume that it is included for completeness.³⁶
82. We disagree with Criterion C; that '*reasonable steps [should be taken] to ensure that direct users of surface access facilities defray the costs to be recover through airport charges to the maximum extent practicable through the application of direct charges for the use of such surface access.*'³⁷ If the CAA believes in its '*underlying principle*' (as it says it does – and so do we) that users should pay, then it is somewhat disconcerting that it would retreat from the point a few paragraphs later. Put simply, if users pay, then passengers don't.
83. Similarly – and for similar reasons, we disagree with Criterion D - that '*the proportion of surface access costs (after direct users have contributed through direct road or rail charges) should be based on the relative benefits derived by airport users...*'³⁸ Users are direct users and so once they have paid, there can be no residual proportion of surface access costs to be paid by airport users (passengers).
84. We note that (again) HAL has made a unilateral statement that it will '*meet the cost of surface access schemes required to enable a runway to open...*' Notwithstanding how financeable HAL must consider this development to be, if it is able to state (to Government) that it will meet whatever unspecified costs arise, this is further

³³ Ibid 5.25, 5.27 & footnote 37

³⁴ Paragraph 6.6

³⁵ Ibid 6.12

³⁶ Ibid 6.15

³⁷ Ibid 6.17

³⁸ Ibid 6.19

evidence of HAL's entrenched belief that airlines will pay for everything, whatever the cost.³⁹

85. We are concerned that HAL would enter into a '*statement of principles*' with the Secretary of State, when the inclusion of CAPEX into the RAB is a matter for the CAA. Does this not entirely cut across the independence of the regulator? HAL's agreement that various surface access development is '*either essential to the delivery of expansion, or essential to surface access strategy, while Southern Rail access would also be desirable*' flies in the face of the user pays principle.⁴⁰
86. We welcome the CAA's views on the recent High Court case, involving HEX and Crossrail, on which have commented in paragraphs [19-22], above.⁴¹
87. IAG's view remains that the existing CAA policy, predicated on a 'user pays principle' for surface access costs, is aligned with the CAA's primary duty to passengers and cargo-owners. Applying a 'user pays' approach to construction costs for surface access remains the most equitable method of apportioning cost, particularly where airport and non-airport users stand to benefit. The CAA must continue to support apportionment of surface access costs, in line with its primary duty to consumers.
88. **Timetable and the Extension of the Price Control.** Whilst the CAA captures IAG's proposal, it doesn't set out the rationale behind IAG's position on extending the current price control period.⁴² Nevertheless, it is simple.
89. The current WACC of 5.35% is too high (for various reasons); not least, because it caters to a volume risk (being a principle element of general business risk, notwithstanding that HAL is essentially indemnified by airlines, above) that has demonstrably not materialised and so it would be wrong to continue rewarding HAL for risk it no longer bears. As the CAA is aware, passenger traffic is around 4% ahead of forecast.⁴³ Therefore, our principle requirement is that the CAA reduce the WACC, in order to remove a risk that no longer exists (if it ever did) – as well as considering other unarguable determinants, where HAL has outperformed forecasts, such as (but not exclusively) other revenues.
90. Understanding (and having some sympathy with) the CAA's desire not to reopen the entire existing regulatory determination, we have sought to find a pragmatic solution. Our proposal is simply that if the CAA is unwilling to reopen the WACC (and

³⁹ Ibid 6.24

⁴⁰ Ibid 6.26

⁴¹ Ibid 6.28 & 6.29

⁴² Ibid 7.5 & 7.15

⁴³ Appendix B4

other variables), then it must rebase traffic forecasts (the denominator of airport charges) to current levels. This approach somewhat arbitrarily assumes that volume risk around current traffic is the same as at the last regulatory determination. For clarity, this is not our view; however, in the interests of expediency – and in the short term, we would be prepared to accept this as a solution.

91. In our experience, were it in its interests, HAL would be eager to reopen the regulatory settlement. The fact is that were the CAA to do so, it would expose HAL's under-forecasting of traffic and other revenues (amongst other things) and so it should come as no surprise (it doesn't to us) that *'HAL has cautioned against any reopening of regulatory building blocks...'*⁴⁴
92. For the reasons stated above, it would be unreasonable (and a failure in its primary duty), if the CAA was to simply *'roll-over the current pricing formula of RPI-1.5%'* – while there is no precedent to extending a price control period for more than one year.⁴⁵ For all the reasons it sets out, the CAA puts it too mildly, when it says that a simple roll-over *'would be less desirable for a longer price control extension.'*
93. The CAA goes on to praise the IAG proposal for being simple and (in the same breath) criticises it for being arbitrary; however, *simple* is something it desires and *arbitrary* is something it cannot avoid, without reopening the entire price control.⁴⁶ The CAA must therefore choose between two mutually exclusive paths!
94. The CAA then seeks to justify a proposal to roll-over the current price cap at RPI-0%, with a weak suggestion that *'airlines strong preference [is to] ensure future prices over the long term do not rise in any year by more than inflation...'*⁴⁷ Of course, airlines prefer lower prices – and anyway, the question is about one or two years, not the long term.
95. Regarding its timetable for developing the H7 regulatory framework, we are sure that when the CAA refers to *'HAL'*, it means to *any developer*.⁴⁸

⁴⁴ Paragraph 7.15 & appendix B13

⁴⁵ Paragraph 7.18

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Ibid 7.19, figure 2