

Economic regulation of new runway capacity: Airline Response

1. Introduction

This submission sets out airlines' views on the CAA's consultation document on the proposed regulatory policy on capacity expansion at Heathrow or Gatwick.

Airlines welcome the CAA consulting on this issue, and have worked across the airline communities at Heathrow and Gatwick to provide a consideration of these proposals. As such this response is submitted jointly from the ACC at Gatwick, the LACC at Heathrow and endorsed by BATA and IATA.

This paper supports the points already raised in response to the earlier CAA discussion paper, the Airports Commission's recent discussion paper on the regulatory treatment of issues associated with airport capacity expansion and the points that were discussed at a meeting earlier this year with the CAA.

Summary

The CAA's paper is helpful in setting out a number of the principles that need to be established in relation to the future regulation of new airport capacity at Heathrow or Gatwick. However, airlines have significant concerns with some aspects of the CAA's analysis.

- Airlines agree with the CAA's view that risk should lie with those best able to manage that risk. However, the draft policy does not always support this principle and airlines therefore disagree with elements including the proposals around category B costs. The political risk around the planning process remains high. This is one of the reasons why it is only appropriate for runway costs to be recovered once any additional capacity is in use. As well as being the outcome in a competitive market, ahead of this there remains a risk that the Government of the day will not accept the results of the Commission and/or that planning permission may not be granted or may be delayed or subject to onerous conditions.
- Airlines are also concerned the CAA places too much weight on commercially negotiated outcomes, or contracts, delivering the best outcome for consumers. Whilst in well-functioning markets this is clearly true, the CAA has recently determined that both Heathrow and Gatwick hold Significant Market Power and therefore continue to need Licence based regulation. Given the ability of the airports to exert their market power on their customers airlines have concerns that commercial deals may not lead to the best approach and the CAA should be considering other options.

- Airlines believe, commercial viability is an essential factor for the delivery of any new capacity in the passenger interest¹. Without commercial viability it is not feasible to allocate risks commensurate with rewards. However, it is not enough for a project to simply be viable for an airport's shareholders, as this can be achieved by abusing an airports significant market power, it must also provide value for money to passengers, who will be required to fund the airport's project.
- Perceived financing risks are likely to vary significantly between projects, according to the commercial viability of the scheme chosen. Airlines do not consider that airports would face real financing issues if a commercially viable option is selected, because the project would be attractive to airlines and passengers, to investors, and therefore to the CAA, significantly limiting risk of all kinds. Airlines therefore do not believe a case has been made as to why pre-funding of airport capacity is necessary or in the passenger interest.
- Airlines also believe there are significant flaws in the CAA's analysis of the functioning of competitive airport markets which is purely theoretical and contains no empirical evidence. This analysis also only focuses on competitive markets where there is capacity scarcity and the situation prevailing before there is any capacity expansion. It has ignored what happens after new capacity is put in place.

Further details on these points are covered in the remainder of this paper. Airlines would welcome an opportunity to further discuss these issues with the CAA.

¹ For stylistic purposes, users of air transport are referred to as 'passengers' throughout this document. However, air transport users make use of both passenger and cargo services.

Chapter 2 – The CAA’s Duties

The airline community welcomes the recognition from the CAA that its primary duty to passengers must be at the heart of its interventions and policy on new runway capacity.

Airlines believe they are best placed to represent passengers’ interests, reflecting the competitive nature of the industry and the fact that the CAA leaves airlines to represent passenger interests at competitive airports. The airline and airline association coalition responding to this draft policy represents carriers across Gatwick and Heathrow who have an interest in the needs of both current and future passengers at both airports.

However, we also agree it is essential that the CAA listens to input from a range of sources in order to ensure its policy is developing in the interests of passengers. In the draft policy statement the CAA highlights, in particular, the CAA’s consumer panel, passenger research, consultation and airline-airport operator negotiations.

Airlines believe it would be helpful for the CAA to publish the advice from the CAA’s consumer panel and passenger research that has fed into this draft policy. This would ensure transparent policy making and enable airlines to understand the assumptions that have fed into the CAA’s draft determination.

It would be especially helpful as the consultation periods for this work have been constrained and have not followed the twelve week best practice set out in Government better regulation policy. Moreover, the process so far has not allowed for structured airline – airport operator discussions, and the CAA does not believe this form of Constructive Engagement would occur until after a recommendation by the Airports Commission next year. Therefore the reliance on these other inputs is especially important.

Finally, airlines are concerned the CAA places too much weight on commercially negotiated outcomes, or contracts, delivering the best outcome for consumers. Whilst in well-functioning markets this is clearly true, the CAA has recently determined that both Heathrow and Gatwick hold Significant Market Power and therefore continue to need Licence based regulation. Given the ability of the airports to exert their market power on their customers airlines have concern that commercial deals may not lead to the best approach and the CAA should be considering other options.

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

1. How it will allow the costs of additional capacity to be recovered from passengers and airlines. This includes both the timing and overall cap on this recovery.

There should be no pre-funding or revenue advancement –

- I. Airlines have not seen a case for any change from what happens in a competitive market and therefore believe that airport capacity should only be paid for once in use, so that the airport has an incentive to start delivering benefits early and to defer costs where possible.
 - II. Inter-generational equity needs to be addressed – this is a long term investment with multi-generational benefits. Temporal cross subsidies are both unfair and could result in market distortions to the long-term detriment of passengers.
2. How it will determine whether the costs that will be passed through are efficient – in line with its current assessment of costs through the regulatory process.
3. How it best believes the balance of risks between airports and users should be managed in delivering any additional capacity.

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

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

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

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

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

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

For example, one way to cap risks to airports would be to require a phased development approach, so that outputs and benefits are delivered earlier and costs expended later. The airport would then bear the risk only of the next development stage. As there would be no regulatory commitment to fund the whole project, a back-up option would need to be put in place – for example, by allowing another developer to take the project forward.

Chapter 3 - Treatment of Category C Costs

Principle 1 – Risk should be allocated to those who can best manage it

In our previous submission to the CAA we commented extensively on the treatment of risk. We have seen nothing in the CAA's current consultation that would lead us to change our view.

In general we agree with the CAA that risk should be allocated to those that can manage it best, and agree with the CAA's arguments for doing so.

However, there are parts of the CAA's analysis that seem to us to be either contradictory or incomplete.

For example the CAA argue that risks can be passed downstream to users where no other party is better placed. The CAA do not however put an argument forward as to why passengers should be seen as risk takers of last resort. This seems to contradict the CAA's primary duty towards the passenger interest, which should dictate logically in the context of risk, that passengers should only take risk when it is in their best interests to do so.

The CAA's logic is difficult to understand. Regulatory risk is best managed by the CAA, political risk by Government, construction and planning risk by the airport, and airports are already expressly compensated for demand risk in their WACCs. It is not clear what risk the CAA intends that the passenger should take. Nor is it clear how the CAA expects to reward any party other than the regulated airport with SMP for taking risk.

The CAA also reject the notion that risk should be allocated to the party with the lowest cost of capital. They argue, and quite rightly, that the risk of a new project is invariant to who bears it. However, the conclusion that they then reach shows an incomplete understanding of the workings of the capital markets and how investors perceive risk. Whilst it is broadly true that the inherent risk of a capital project is invariant to the risk taker, what does vary, is how the capital markets view different agent's ability to take the risk. Airlines are inherently more risky than a regulated airport with SMP, and therefore when allocating the same risk between an airport with SMP and an airline, lenders will demand a higher price from the airlines. In short, price is a function of risk AND the ability to bear that risk, rather than just risk alone.

Airlines again have concerns that the CAA places too much weight on commercial contracts between airlines and airport operators revealing the true cost of the risk. In a situation with asymmetric information it is clear that commercial negotiations may not leave to the most efficient outcome.

Finally, the CAA appear to be looking at runway expansion risk solely in relation to the capital risk of the 'winning' airport. The CAA will need to ensure that it fully assesses the risks of runway expansion across all relevant markets in due course.

Principle 2: Commercial negotiations should be encouraged

In the presence of SMP airlines consider this principle to be in direct contradiction to principle 1. We consider that commercial negotiations in the presence of market power will result in risks not being allocated to those who can manage them best.

Asymmetric power between negotiating parties will lead to inefficient pricing

An airport with SMP will have asymmetric power in commercial negotiations and may be able to extract excessive profits. Asymmetric power will arise from a combination of the airport having more information about costs than the airline users and more bargaining power will place the airport in a dominant position.

Commercial negotiations in presence of SMP will lead to mispricing of risk

The presence of asymmetric power between parties will result in conditions that may prevent revealing the efficient price for the risks. In the absence of being able to exert excessive profits (in the case of a revenue cap) airports with SMP may abuse it to pass on risks to users that they, as airports, are better placed to handle. So while airlines will strive to achieve the best outcomes for the passenger, their ability to do so will be compromised due to asymmetric power of airports given the presence of SMP.

SMP airport can pursue strategic objectives leading to market distortions and unjustified differentiated pricing

Unbalanced contracts can arise because of asymmetric power between an airport and airlines. This can lead to differentiated pricing that is not cost related and difficult to prove. To ensure that abuse is not taking place this may require much more intrusive oversight that will have a significant administrative and regulatory burden.

In theory, commercial agreements can lead to competitive pricing and service delivery on parts of the airport business that are more exposed to competition. However, in the presence of market power the likely outcome would be that the airport would leverage its market power in areas where it's the strongest. Thereby allowing the airport to price above the efficient rate in areas where it has the highest market power and below the efficient rate where it does not. The flexibility afforded to the airport gives it the ability to pursue other strategic objectives, which may not be reflected in service and price delivery.

Existence of commercial contracts under SMP does not mean such contracts are "successful"

CAA seems to assume a binary choice (contract = success; no contract = failure). This is not the case. In practice you may have contracts but the terms of the contract might not be balanced. Given the asymmetric power, due to SMP, the airport will be in a position to extract terms, either on price or service provision, that are favourable to it. The existence of market power means that the airport's response to market forces is dulled and the contract terms are unlikely to fully reflect market dynamics. This may also potentially intensify the influence of non-market factors on the airport's

pricing and service quality terms it offers in its contract. Therefore, commercial negotiations in the presence of SMP related to future capacity can further be distortive.

London Gatwick – Potential for strategic behaviour

At London Gatwick airlines have entered into bilateral agreements with the airport under the framework of “Commitments”. Airlines had limited ability to influence service levels, or the airports’ Conditions of Use, which transfers all operating liability to airlines.

Constructive engagement between airports and airlines is a worthwhile process that can identify areas of potential mutual and passenger benefit that would not be revealed otherwise. However, codifying the outcome of such engagements in commercial contracts is not an adequate substitute for regulatory oversight as airlines have limited leverage to negotiate on an equal basis with airports on price, service quality or potentially both. Indeed, airports may be able to leverage their market power during the contract setting process, potentially leading to an outcome that is worse for airlines and their customers than would be the case under robust forms of economic regulation.

For airlines which are typically subject to default commercial terms under “Commitments”, airport charges may actually rise substantially to counter balance bilateral contract discounts agreed with other airlines, resulting from the airport’s right to recover the overall Core Yield over the term of “Commitments.”

The UK CAA acknowledged that the airport operator’s commitments framework is insufficient to mitigate the risk of the airport exercising its market power to the detriment of airlines and passengers, either on price or service. Accordingly, the commitments framework is supplemented by more traditional price controls and further safeguards under the airport’s license conditions. However, as shown above, even this regulatory back-stop, may not be sufficient to prevent the airport from using its market power over airlines to influence price and quality under this type of framework. Therefore, the 2016 comprehensive review of the regulatory approach employed at Gatwick is essential for determining whether this approach has functioned in the interest of passengers and whether alternative approaches (such as price cap regulation) are better able to serve passenger interests.

Principle 3: Capacity can be paid for before or after it is completed

We agree with the CAA that capacity can be paid for before or after it is completed. We see this as a statement of what is possible rather than a principle. The key question is whether it is in passengers' interests for capacity to be paid for before it is completed.

The CAA has set out a framework of objectives and principles, many of which support the case for pre-funding. However, we disagree with parts of the CAA's analysis and think the weaknesses in the analysis leads to an overstatement of the case for pre-funding.

The CAA's suggestion that pre-funding reduces the cost of capacity expansion

The CAA has set out several arguments that imply support for the case for pre-funding (the front-loading of payments).

First, the CAA states that pre-funding is likely to reduce costs overall (3.25). However, the total project cost of a project in NPV terms depends on both the timing of payments and the discount rate used. It cannot simply be concluded that pre-funding is 'cheaper' without an empirical assessment of the costs and different repayment profiles.

Pre-funding is only clearly cheaper overall when costs are considered in nominal terms, i.e. without taking any account of the value consumers place on deferring payments. However, costs have to be considered in NPV terms, reflecting standard project appraisal approaches. This ensures that the timing of payments and consumers' time preferences are taken into account.

Further, it is not clear that minimising the total cost over the lifetime of a project is necessarily the right objective for the CAA. It would be inappropriate for the regulator to take this approach if it distorted price signals and incentives in a way that led to relatively worse consumer outcomes. We note that in its Q6 settlements for Heathrow and Gatwick the CAA did not place any primacy on an objective of minimising costs to passengers.

An approach focussed exclusively on minimising the total cost would lead one to remove the return to the airport. But this is clearly not right, as it would have a negative effect on the incentives of airport owners to deliver efficient services for passengers.

Secondly, the CAA suggests that pre-funding can smooth increases in charges (3.26), implying that this is a positive outcome. However, we do not think price smoothing is a legitimate objective in of itself. The CAA has not set out any evidence on why smoothing is in the interest of passengers, or whether passengers would be prepared to pay extra for smoother charges.

The CAA risks pre-judging appropriate outcomes, and we suggest that the right approach must be to assess what price path would follow from the correct pricing framework, and then assess whether this is practically achievable or creates any unreasonable outcomes for passengers.

We also note that the CAA is ignoring the transmission mechanism between airport charges and the fares paid by passengers. The transmission mechanism between airport charges and fares paid by passengers needs to be taken into account. Changes in airport charges may not be reflected in fares, for instance if airlines can't pass on cost increases to passengers. Another reason why changes in charges may not track changes in fares is if other factors happen in parallel that also influence the fares. For example, alleviation of capacity constraints may support possible improved operational performance which can also help generate cost savings. If timing of the increase in charges coincides with the delivery of operational improvements then the impacts of the charge increase could to an extent be offset due to the potential improved operational performance.

How a competitive airport market functions

The CAA rightly focuses on competitive airport markets, suggesting that where possible the CAA should seek to replicate these markets. However, we note that the CAA has not provided any empirical evidence on this issue, only a theoretical debate. It is not clear why this is the case, as the UK has an active airports market and only two of the UK's airports are subject to economic regulation. We are unaware of any work by the CAA on how the non-regulated airports have either recovered, or plan to recover, the costs of capacity expansion.

The absence of any evidence-based assessment of the functioning of competitive airport markets significantly reduces the robustness and credibility of the CAA's assertions in this area.

We also believe there are significant flaws in the CAA's analysis of the functioning of competitive airport markets. At the core of the CAA's analysis appears to be a belief that higher airport charges both induce and precede significant new capacity. However, this analysis conflates several different effects.

We agree that prices tend to rise in scarce markets. However, this is not due to 'pre-funding', it reflects scarcity. There is no link between investment decisions and existing prices, as investment is based on future prices and costs, not existing prices. An airport's decision to invest will be based on a judgement of whether investment would lead to increased profits on an NPV basis, compared to an option of no investment. We note that if the market conditions that led to scarcity and high charges could be sustained, airport investment in new capacity (and potential lower future charges) could reduce future net profits and would not occur if it did.

Consequently we maintain our view that in a competitive market users only pay for new capacity once it is in place, as in taking the decision whether to provide new capacity a firm will only take into account incremental revenue from the use of that new capacity. It will not include revenue earned prior to any delivery of new capacity, as this revenue will occur anyway, whatever capacity decision it takes.

The CAA states that '*...to some extent these higher prices could pay for any capacity expansion...*' (3.34). We ask the CAA to clarify what it means by this statement and whether it accepts that investment decisions are based on future revenues and costs, not current revenues.

We agree with the CAA that in markets there is a role for current prices to send a signal of the potential benefits of market entry. We note this is often the basis of airline entry on a route.

However, this is not relevant to the CAA's consultation. We believe everyone is agreed there is a need for new capacity and the market participants (Heathrow and Gatwick) have proposals to deliver it.

It would be helpful if the CAA could clarify its view on whether it believes higher airport charges would provide any greater signal value of the need for new capacity in the South East.

We are concerned that the CAA seems to have only focussed its analysis of competitive markets on the situation of capacity scarcity and that prevailing *before* there is any capacity expansion. It has ignored what happens *after* new capacity is put in place.

In markets where capacity increments can be lumpy, like airports, prices often do rise ahead of new capacity. However, prices also fall after new capacity is put in place. The pattern of cyclical prices is common to industries with lumpy capital increments (power generation, mining, refineries etc.). We note this pattern ensures that over time these forms of investments do not consistently lead to excess returns.

Finally, we note that the CAA is ignoring a fundamental issue: the CAA has not regulated airport charges in a way that is designed to ensure they follow competitive market price paths, whatever a competitive price path might be. The whole basis of UK airport regulation has been to assess charges against the return it provides an airport on its Regulated Asset Base². Any move away from this approach, by allowing charges to rise on the basis that it reflects a competitive price path, would require a complete reassessment of how the CAA regulates airport charges.

What are appropriate prices in the airports market

Following its discussion of competitive markets the CAA says that '*the broad principle that where there is scarcity of airport capacity, prices would rise before any new capacity came on-line, seems to be a fair assumption*' (3.35). However, it is unclear in what context the CAA is making this statement. It is not reflective of its current regulatory approach to airports, which the CAA then effectively goes on to acknowledge.

We are concerned that the CAA goes on to say that it may be appropriate to allow prices to rise to levels higher than the 'cost plus' approach (3.37). If the CAA is to change its regulatory approach it needs to properly consult on this issue. Also, consistent with the CAA's statement that rising prices in a scarce market is a fair assumption is the assumption that prices would fall once new capacity comes into place, but the CAA has given no indication that it plans this. Indeed, not allowing pre-funding offers an opportunity for the CAA to move airport charges to be more reflective of what happens in a truly competitive environment.

The CAA also needs to recognise that it is saying that it would allow an airport returns in excess of its cost of capital in the period before new capacity if it increases charges ahead of new capacity, but it has not said that it would then impose returns under the cost of capital once new capacity is in place

² We note that this approach was also taken at Gatwick in Q6 in the setting of the CAA's 'fair price'.

to compensate. The CAA will need to set out how it is in the interests of passengers to allow excess returns in one period without imposing lower returns in a following period.

We should also note that the CAA is wrong to state that at Gatwick the discounts offered by the airport mean that absent regulation prices would not rise. The discounts are a mathematical requirement that flow from the regulatory approach whereby Gatwick is allowed to set published tariffs higher than the charge levels the CAA has set as a 'fair price'. We ask that the CAA recognise this error in any future documents and that it recognise that it regulates Gatwick in the context of a finding that it has significant market power.

Inter-generational issues

The CAA recognises that pre-funding raises intergenerational issues. However, it has not justified why passengers today should pay for new capacity for passengers in the future.

Airline competition issues

We note that pre-funding could affect airline competition. The CAA noted this issue in earlier consultations and discussed the issue of whether an airline could acquire some form of compensating right if it took part in pre-funding. The CAA has not addressed this point in the current consultation and we ask it to address the issue in any future consultation.

Whether pre-funding is in the interests of passengers

We agree with the CAA that the benefits to passengers from pre-funding need to outweigh the costs. We agree with the CAA that the demand risk taken on by passengers is a cost of pre-funding, although we believe there are additional costs that the CAA has not identified.

However, the CAA has not outlined any clear benefit to passengers from pre-funding. Instead it has simply summarised some theoretical arguments around the path of prices in a competitive market, but not set out any arguments or evidence on how this benefits passengers. The one potential benefit the CAA has alluded to, it has not addressed in this consultation, is the cash-flow benefits of pre-funding (3.26). The CAA suggest this could reduce the cost of financing a project, and presumably believes this could benefit passengers if it leads to reduced charges.

At the most extreme the potential benefit to passengers is that without pre-funding the project may not go ahead, as without the cash flow benefits the airport operator would be unable to finance expansion. However, the CAA has not addressed this point, nor carried out any financial assessment of whether this is a real issue.

Further, if pre-funding is needed to finance an expansion project, this suggests that the project has significant business case issues. We ask that the CAA address why passengers should cover the risk of a project that private markets are unable or unwilling to.

Chapter 4 - Price Control Structures

Introduction

The Airline Community welcomes the CAA's initial assessment of regulatory approach. Given the recent determination by the CAA that both the airports where capacity options are being considered by the CAA have market power, it is clear that License Based regulation will be required. However, airlines have two particular concerns, which are outlined in more detail in this section:

- the current approach used by the CAA poses problems and needs to be revised, such as:
 - The need to remove pre funding
 - The need to review the treatment on unexpected capex
 - The need to consider the smoothing of depreciation (particularly in the context of large scale developments with initial underutilization)
- the CAA's approach of wanting to rely on commercial agreements when there is SMP could fail to deliver efficient outcomes for the airline community and its consumers.

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

- There should be no pre-funding or revenue advancement – airport capacity should only be paid for once in use, so that the airport has an incentive to start delivering benefits early and to defer costs where possible.
- Only efficient costs should be passed through and this should be done fairly. It is not in passengers interests to reward airport shareholders for inefficient or poorly timed expenditure.
- There should be no 'gold plating' – investments need to take account of airline and passenger needs, with sound business cases showing clear passenger benefits.
- Innovation (by the airport and users) is stimulated by the regulatory framework for the betterment of consumers, with airport productivity gains shared fairly with consumers.
- Inter-generational equity needs to be addressed – this is a long-term investment with multi-generational benefits. Temporal cross subsidies are unequitable and can create inefficiencies in the market to the detriment of passengers.
- Consideration of capacity utilization is required when passing on costs to users.

Equally, we would not expect the CAA to settle on one type of regulatory structure at this stage, but to set out an approach that could accommodate different options (e.g. RAB based, SPV, hybrid ownership structure, longer control periods etc.). A much more detailed consideration of the regulatory framework and its design elements will be needed following the selection of the location

for the capacity expansion. For now the focus of the CAA needs to be at providing regulatory certainty while signalling flexibility but not taking any design elements (treatment of unexpected CAPEX, regulatory period etc.) of the regulatory framework off the table.

These principles and the tools that would aid to deliver them need to be properly consulted. The tools discussed below only refer to those raised in Chapter 4 of the UK CAA consultation, and therefore is just a limited subset of them.

Split/separate RAB

Airlines believe there is merit in exploring the concept of a split RAB, as it has the potential to meet a number of the objectives we see for RAB regulation.

A split RAB describes the circumstance by which the RAB is separated in two or more components, in which different regulatory tools could be adopted. For example, different depreciation approaches to the assets related to each of these RABs, a different cost of capital, etc. So a split RAB does not necessarily mean “split” charges, but it could also simply mean a separation of the components that would contribute to the calculation of the building blocks underpinning a single price cap.

The UK CAA suggests in its consultation document that a “Split RAB” could only be considered in the case of an SPV. However, Airlines consider that there may other instances in which a split RAB (as defined above) could also be useful in order to improve the RAB regulatory framework.

For instance, a split/separate RAB might be useful for “sculpting” depreciation. Sculpting depreciation can be done in different ways, mainly:

- “sculpting” the depreciation profile for the overall asset base
- “sculpting” the depreciation profile of certain assets

A split RAB is not necessary when dealing with the first case. However, a separate RAB will be useful in the latter approach. It could be the case that UK CAA decides to “sculpt” the depreciation profile of assets that will have a large unutilized capacity at least on the first years after they are commissioned (i.e. a runway). In this regard, a separate RAB to show the distinct depreciation treatments would improve the transparency in the calculations. This is also the case at Amsterdam airport, where an annuity approach is utilized for this type of assets.

As well, it could be the case that old (existing) assets depreciation profile is different from all new assets (i.e. straight line in the former, annuities in the latter)

Another example for using separate RABs could be in the event of fixing certain parameters of the control period.

In conclusion, there is merit in further analysing the pros and cons of utilizing separate RABs. This should be further discussed in a specific consultation in the next few years.

Unanticipated capex

It is unclear as to why the CAA will include unexpected capital expenditure in the RAB. This is particularly in the context where the CAA already acknowledges that other regulators do not apply such an approach.

Allowing for unexpected capital expenditure could provide the wrong incentives to the airport to start increasing the scope of a particular project in order to justify a higher cost.

Further details are provided in the section in this submission which comments on ex-post assessments of capital expenditure.

Capitalization of operating costs

We fully agree with the UK CAA's assessment that operating costs (in relation to capital expenditure) should be capitalized. As these costs are related to a facility that will not come into use until its completed, it makes sense that these costs are capitalized and depreciated over the life of the asset it is related to.

WACC

We agree with the CAA's statement that WACC should be related to the risks the operator is faced. Clearly, discussions around the quantification of such risk would be necessary at the appropriate time.

Sculpting depreciation

As suggested in our previous submission, we believe that sculpting depreciation is something that the CAA should seriously consider, as it will aid in achieving the principles defined in this paper. Particularly in the context of capacity expansion, we are speaking about large investments in which there could be a significant underutilization at least on the first years once they come into use. As such, the charges impact for the "initial" users could be potentially large.

A more equitable approach would be if costs are passed on to users according to the utilization of the new asset. In this regard, sculpting depreciation could be a recommended way forward to address this issue.

As mentioned in our previous submission, an annuity approach (adjusted for the utilization of the asset) could be a solution. That would be translated into passing on to users the same "unit cost" over time. This is already applied at Amsterdam and Dublin airports (depending on the type of the assets).

Another alternative would be to passing on “chunks” of depreciation once utilization of the asset reaches certain thresholds of utilization (also applied in Dublin).

We see that the CAA indicates that there could be an operator risk if depreciation is sculpted. In this regard, the CAA needs to further analyse how operator risk will be affected. There is a possibility that the operator could be faced with an increased “regulatory risk” under this approach. However, provided there is a stable regulatory framework (i.e. clear rules of the game), the additional risks would be minimum. And in any case, these risks might also be mitigated by locking in some aspects of the control period.

From a purely historic cost accounting perspective, it is well understood that there will be differences in the operator’s returns if depreciation is “sculpted” (lower returns in the initial years, higher in the latter ones). However, this shouldn’t be an issue if the “rules of the game” are clear.

We would welcome a more thorough consultation on the CAA about this matter, particularly on the pros and cons of sculpting depreciation.

Duration of the control period

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

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

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

Chapter 5 – Recovery of category A and B costs

The airline community welcomes the recognition by the CAA that both these sets of costs are borne before it's clear whether a project will actually be delivered for passengers.

The Airline Community also welcomes the determination on Category A costs – there can be no clear rationale for why these speculative costs are picked by passengers rather than airport shareholders.

Category B costs

Airlines believe that the CAA's proposals on Category B costs warrant significant further consideration and disagree with the proposals as set out. The current plan could still leave users having substantially contributed towards a capacity expansion could never be realised. As airlines have previously outlined, this is not desirable, nor is it in the passenger interest. It is essential that the CAA learns from previous experiences at Heathrow and Stansted.

Whilst Category B costs differ from Category A costs, in that airlines do not disagree that efficient planning costs should form the total final cost of the scheme and therefore there is a case for them to be recovered by the airport. This should only happen once a runway is being used and should form part of the total cost of the scheme.

Airlines therefore disagree with the CAA's view that there should be any recovery of costs before a runway has come into use we therefore do not believe there should be any collection of costs during Q6. We therefore do not agree with any of the proposed mechanisms for recovery of costs during Q6. This particularly applies to Category B costs.

The airline community therefore believes the CAA should be considering how to manage the risks associated with these costs in a more innovative way than simply passing them through to passengers because 'no one is better placed' to manage them. This goes against the principle of those who are best able to manage the risk, bearing the risk.

There are a number of questions airlines believe the CAA needs to better address:

Is there a case for these costs to be passed on ahead of capacity opening?

Airlines do not believe the CAA has set out sufficient justification for why planning costs need to be passed through ahead of capacity coming into use. These are a fraction of the overall costs, it is not clear why these cannot be treated in the same way as Category C costs.

Who is best placed to manage the risk associated with planning costs?

Even if there is justification for the costs being passed through, it is not clear why passengers should be bearing the risks of planning costs. Passengers have no control over the two areas of risk associated with this stage of the development:

1. The airport fails to submit a sound business case and development plan to the planning authority;
2. That the Government of the day recedes on its decision to allow permission and/or onerous conditions are imposed which ultimately make the development commercially unviable.

It would therefore seem that the best parties to underwrite risk at this stage of the process are the airport and the Government. If there were to be a risk sharing mechanism it would therefore seem sensible that this was between the airport and Government rather than the airport and passengers.

How can the best incentives be applied to ensure these costs are efficient as possible?

Airlines agree with the CAA's principle of trying to keep incentives to keep costs. However we are unclear as to whether the approach sets out in the draft policy document achieves this aim. As set out previously, airlines disagree with the CAA's view that there should be any recovery of costs before a runway has come into use we therefore do not believe there should be any collection of costs during Q6.

Furthermore it is not clear how picking an arbitrary amount of £10m per year provides any incentive for the airports to manage these costs efficiently. It seems that amount was simply picked because that is the level that GAL successfully lobbied to be allowed in its Commitments. Given that there hasn't yet been even a review of whether the Commitments are successful it seems odd to base such a significant policy decision on this basis.

Chapter 6 – Scrutiny of costs

The Airline Community agrees with the CAA that both ex-ante and ex-post cost scrutiny is needed to ensure that only efficient capex costs are passed through to consumers. This is an important element of ensuring that the CAA's duty to passengers is met.

Ex - Ante

The Airline Community also agrees that airport/airline discussion can have an important role in agreeing plans and scrutinising costs but these need to happen under a clear mandate from the CAA. Even under a mandate in Q6 there was difficulty getting the information required to make a valid assessment.

These sessions would need the involvement of the full airline community and a jointly agreed consultation process at different stages of the development. There would also need to be consideration of how conversations on Heathrow Hub could begin if this was the chosen option.

These sessions would also need to cover the entire business case for the development, not just capex, as elements such as the traffic forecast will have a big impact on the appropriate amount and timing of development.

However, the airlines are concerned by the potential for the business cases to be re-opened after the planning process. As the process currently works, the monopolist has an incentive to under-price the project to improve the business case and get it accepted and then inflate the price, albeit efficiently, thereafter.

The Airline Community believes that there must be proper incentives on the airports to specify and cost projects correctly. OFGEM is well aware of this potential problem, and has been operating a three pot approach to capex, as follows:

1. capex that is inefficiently spent or not required is not allowed in RAB
2. capex that is required and efficiently spent – allowed in RAB earns full return
3. capex that is efficient overspend (i.e. efficiently incurred, but due to things like project misspecification) – capex not allowed in RAB for five years, and depreciates as normal. After 5 years, depreciated level admitted to RAB.

The Airline Community believes that such an approach would make it easier for the CAA to ensure capex efficiency, and ensure sufficient incentive on the scheme operators to specify projects as accurately as possible.

Finally, it is not clear what the CAA's plans are in respect to changes that happen during the planning process. It would be helpful to determine ahead of time what the CAA would consider a 'material' change to plans during the planning process would be. It is not clear to airlines that passengers should be required to hold the risk for changes that are made during the planning process that may cause delays or introduce onerous conditions that impact on the viability of a scheme.

Ex-post

The Airline Community agree that ex-post scrutiny of costs is also an essential element of ensuring development is incentivized to be delivered efficiently. This would be true even when Constructive Engagement has been carried out.

However, there are some constraints to how useful the current ex-post assessments are carried out which could limit the constraint this process holds over the airports.

The CAA's current process simply looks at whether a proper process was followed by the airports and whether they 'consulted'. It does not consider elements such as the airlines' response to that consultation, whether the capex was initially mis-scoped and whether it delivers airline and passenger requirements.

Therefore in order for this to be an effective process during a long development period such as the development of new runway capacity there needs to be a clear process for:

- The criteria for determining efficient investment, as outlined in the previous section, the Airline Community believes that the Ofgem approach is one that the CAA should be considering to ensure there are incentives both for the correct specification and deliver of capex by the airports.
- The timing of when such scrutiny will take place. Airlines strongly disagree with passengers pre-funding airport capacity and so would oppose even efficient capex entering the RAB before the runway is in operation. However, there still may be a case for more timely determinations on elements of the project to reduce investor uncertainty and ensure the most relevant information is available when a determination is made.

Finally the introduction of an independent fund surveyor at Heathrow for Q6 could provide some insight into how ex-post scrutiny could be improved.

It is not clear to airlines why the capex scrutiny would be different in the existence of commercial contracts. If the CAA were to force airlines to enter into commercial contracts with airports that hold market power, it's clear that these could be expected to be asymmetric in nature. Furthermore, it may not be possible to reveal the efficient level of pricing in the presence of market power. Therefore, commercial contracts themselves will not provide market discipline to the airport to develop efficiently. Cost scrutiny carried out by the regulator for the benefit of passengers could therefore become more rather than less important in this scenario.

Chapter 7 - Market Power

The airlines welcome the CAA's suggestion that it will not carry out any new market power assessments until new capacity is much closer, or even after, the opening of any new capacity. This recognises that without any changes in actual market conditions the CAA would not be able to carry out any empirical assessments of market power and would instead have to rely on purely theoretical assumptions.