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**Response to CAA Consultation on Core Elements of the Regulatory
Framework to Support Capacity Expansion at Heathrow
(CAA CAP 1541)**

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Introduction

The Heathrow Airline Operators Committee (AOC) and the London Airlines Consultative Committee (LACC) welcome the opportunity to submit this joint response to the CAA on its consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow. Our comments break into two types: some general high level comments on themes that emerge from the CAA's consultation, and more specific comments on the detail of the CAA's proposals.

General Comments

The airline community welcomes the CAA's constructive approach to determining how its duties relate to expansion at Heathrow, and to how the regulatory regime may be adapted to best deliver affordable capacity. We fully support the CAA's constructive and collaborative approach.

Our general comments fall into three distinct areas: affordability; areas where we think the CAA should keep its options open; and the treatment of risk (and taking a more commercial approach to risk).

In the first paragraph of the introduction to 1541, the CAA state *'The CAA has consistently said that increased airport capacity in the South East of England would be in consumers' interests.'* Without further clarification from the CAA, the airline community at Heathrow would have to disagree with the CAA. It is our contention that expansion at Heathrow could be in the passengers' interests, but only if it is affordable. If it is not affordable, then there is the very real risk that the potential benefits from expansion at Heathrow will not be realised.

It would therefore be useful if the CAA could give more detail on its objectives for expansion at Heathrow – i.e. an increase of capacity, of the right type, delivered at the right time, at an affordable price. For us, expansion has to be affordable, because if it is not, then the benefits of expansion will not be delivered, and so for us, the key is for us all to work together to deliver an affordable solution. It is only by agreeing a common starting position that we can all work constructively towards a common goal.

The airlines have defined affordability as being no increase in real terms in any year on today's level of regulated charges. Affordability is our key goal. It is clearly in the passengers' interests for Heathrow to be expanded affordably, and we think that the CAA's focus at this stage should be to understand the separation between economic licensee, owner, and the design and construction of the airport. It seems curious to us that HAL, as the owner of Heathrow should be allowed to decide on the design of the expansion, choose the suppliers, and deliver and operate the new capacity. We strongly believe there are more opportunities to bring more competition into this process.

The CAA, compared to regulators in other sectors, is in a unique position in how it can approach developing the appropriate oversight arrangement over Heathrow airport. The airlines offer the CAA an opportunity to closely engage with a relatively concentrated and well organised user group whose interests are aligned with consumers. Consequently, we believe, as the only stakeholder in the expansion debate which has the commercial imperative to understand and deliver for the passenger, that the CAA should both ensure that our views are represented at every stage of the process and that significant weight is placed on them.

We also believe that the passenger would be better served if governance arrangements allowed the introduction of as much competition at each stage as possible. For example, the CAA should ensure a level playing field for third parties in the design, development, delivery, operation and ownership of expansion. The benefits of competition are well known and understood, and whilst there are clearly

limits to how much competition could be injected into the expansion process, the CAA should, nonetheless seek to encourage as much as possible.

For example, at the design stage, airlines should feel free to work with competing scheme designers, to explore how the needs of their customers should be best met and the price for doing this. There would then need to be an agreement on the best way forward to meet the needs of the airlines and their passengers, regardless of where it originates. We call on the CAA to explore mechanisms that would allow such competition in the expansion programme. 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.

At this stage, where the overall scheme design and its cost profile is far from clear, we believe that the CAA should not be closing down regulatory options. When we do not know what we are going to build, how much it will cost, and the nature of the financing problem, it seems curious that the CAA should seek to close down regulatory options. It seems to us that the first problem is to identify the desired outcomes of the scheme, second is to generate an efficient design that meets desired outcomes, the third is to come up with an efficient price and regulatory regime that meets the needs of financability and affordability. Therefore we would urge the CAA to keep its options open at this stage, and consider all regulatory options, including multiple RABs and control periods of different lengths, and not stick rigidly to things like a 5 year regulatory period.

We would also welcome a more detailed discussion with, and an explanation from, the CAA on its thinking on the treatment of risk. In terms of specifics this relates to the design of any treatment of cost recovery and associated incentive and of course the WACC. For us there are two key elements to consider in the treatment of risk. The first is in general terms, who bears risk and who is best placed to take it. The second element is understanding what the cost of the risk so that a reasoned decision on where the risk should lie can be taken. Clearly there is an interaction between these two elements.

It would be helpful if the CAA were to adopt a more commercial approach to the understanding and taking of risk. For example, there are a number of areas where the CAA talks about the allocation of risk, for example on volume risk or cost over-run on construction, where the CAA's approach seems unbalanced, and could benefit from a more commercial approach. The Airline community needs to decide on the risk-return trade off, and this decision is made on the basis of evidence. In order for the airline community to determine the appropriate risk-return trade off they will need data. Consequently, the airline community would need to have a clear understanding of the risk reward trade-offs. For example, in considering the appropriate risk allocation one could present information as follows: by taking on x amount of volume risk, the price would fall by y, and so on. Only then can the airline community determine the right level of risk exposure.

The airline community notes the CAA's discussion of a balanced incentive package for HAL at paragraph 16 *'Part of this balance involves avoiding incentive arrangements that would create undue risks for HAL (i.e. those that it cannot effectively manage)'* and wonders if this might be at odds with previous CAA statements that the passenger should not become the risk taker of last resort.

Chapter 2: The regulatory framework

The CAA, in its view, does not think that it is possible for it to use existing powers to force delivery of all or part of the capacity expansion program by a party other than HAL. The CAA does acknowledge that it does have regulatory tools that can be used to encourage HAL to facilitate commercial arrangements with other parties to delivery expansion activities. Given the importance of the project we would want the CAA to pursue two avenues in parallel:

- 1) Identify what powers of the CAA may need to be amended to ensure that it's able to pursue the most efficient delivery mechanisms so as to secure that consumer interests are safeguarded.
- 2) Identify options the CAA or other government body could employ within its existing statutes (for example via the CAA Act of 2012 or perhaps the latest Enterprise Act or other existing statutes) that will ensure that the most efficient delivery mechanisms are used so as to ensure that consumer interests are safeguarded.

At this stage, we believe that it is important that the full range of regulatory options are kept open. The expansion of Heathrow provides a once in a generation opportunity to deliver an airport experience that our passengers' deserve at a price they are willing to pay. Consequently, we would not want the CAA to rule out regulatory options. As a result we do not believe that regulatory options should be ruled out before we fully understand the scale and nature of the regulatory problem to be solved.

In terms of alternative mechanisms, we appreciate that the CAA's view is that it cannot force HAL to allow other parties to deliver expansion. However, we do think that the CAA should be clear that the airlines should be able to work with other suppliers, to come up with the most efficient design, build, ownership and operational proposals for expansion.

The CAA should also recognise that third parties will only engage in such a way if there was a realistic possibility of success. Therefore in order to introduce competition and ensure the best and most efficient expansion of Heathrow for passengers the CAA will need to consider alternative governance procedures. For example the 'best' design for Heathrow expansion may not be HAL's, in which case in order to fulfil its primary duty, the CAA may have to require HAL to purchase the best design. Another option may be to allow a third party to build, own and operate the terminal if their proposal was better than that HAL can offer. There are alternative mechanisms for doing this, but we do feel that the CAA needs to be more active in this area to ensure the best deal for passengers, and we look forward to working with them on that.

HAL has substantial market power over the airlines at Heathrow, and going forward, if expansion goes ahead, we understand that HAL will be, by RAB value, the second largest regulated business in the UK. That being the case we would expect a stronger presence and regulatory oversight of HAL from the CAA. We do not see the more commercial regulatory arrangements introduced by the CAA at Gatwick as being a suitable template for Heathrow.

Finally, we note the CAA's position on regulatory depreciation. The airline community supports the CAA's intent to consult on this later in the year. We support the principle of regulatory depreciation provided that: the profile of depreciation is for an efficient investment (i.e. profiling only comes after defining the adequate scope, cost & time of the delivery of the scheme); and it is not used for prefunding.

Chapter 3: Incentives

The consultation document focuses on the regulatory incentives for HAL that are associated with the delivery of the scheme. While we recognize the importance of setting the appropriate incentives for scheme delivery, for HAL or other potential developers, we see the immediate priority for the CAA as ensuring the right outcomes are defined and best design developed. Another pressing issue on which more focused engagement is needed is putting in place the appropriate timetable and extension of the price control (this issue will be addressed in more detail in our comments under Chapter 7).

We note that the CAA believes that it needs to design a specific package of incentives to incentivise HAL to meet the CAA's objectives. Whilst we understand this position, we start from a slightly different

perspective in that the airlines believe that the CAA should incentivise the efficient delivery of affordable capacity by an efficient developer. That efficient developer may or may not be HAL, but our passengers should not be asked to pay for or subsidise inefficiency.

In summary, we believe that the CAA should be looking at the incentive structure to do two things at this stage: to incentivise progress on the design for expansion; and to incentivise the design of a scheme that best meets the needs of our passengers – regardless of whether that scheme is designed by HAL or another third party.

Service Quality

The airline community notes that the CAA has referred to rebates paid under the SQRB as ‘penalties’. Whilst we realise that this was clearly in error, the term ‘penalty’ carries with it both legal implications under contractual law, and the strong implication the payments carry some punitive element. The rebates paid under the SQRB are exactly that, rebates paid to the airlines, by HAL, in lieu of services we have paid for on behalf of our passengers, not being delivered by HAL. They are therefore not penalties, and we would ask that the CAA makes this point clear when it responds to the consultation responses.

General Incentive Arrangements

We are generally supportive of the CAA’s proposal to leave incentives for operating costs and commercial revenue broadly unchanged for expansion. However, as plans develop and the scale and nature of the regulatory task become clearer we reserve the right to revisit this position.

We also note the CAA’s comments that it is the overall balanced package that matters. We are in broad agreement with this and would make two comments:

- the CAA should be clear that the airlines will not be required to ‘sign off’ on elements of the H7 package piecemeal, but rather give consideration to the settlement in the round;
- for Q6, one of the reasons that the airlines argued that the WACC was too high was because of the opportunities to outperform built into the settlement which was in our view too generous. As evidence has shown HAL has significantly outperformed its settlement. We would expect the CAA to give full consideration to the opportunities for outperformance built into the H7 settlement when setting the WACC.

Volume Risk

We support the CAA’s proposal to re-examine volume risk. In a non-expansion world the airlines continue to argue that volume risk is treated asymmetrically by CAA to the detriment of airlines and their passengers’ and to HAL’s benefit. Airlines pay HAL to take downside volume risk through the WACC and the adverse shock generator on the passenger forecasts. Yet all of the upside accrues to HAL. So airlines and their passengers bear all the downside cost and reap none of the upside reward. We submit that either HAL bears the downside risk at no cost to us in return for the upside rewards, or that the airlines should continue to pay for downside risk, but reap the rewards of upside volume performance.

In discussing risk and reward we would expect to have clarity that is backed by the regulatory framework on what are the trade-offs; e.g. if the airline community were to take x amount of volume risk, the WACC would reduce by y. By being clear this would enable the airline community to take informed decisions on the risk allocation, resulting in better outcomes for consumers.

Developing and Maintaining an Efficient Airport

The airline community shares the CAA's objectives that Heathrow Airport should be developed and maintained in an efficient manner. Whilst we recognise that HAL is a monopolist with SMP, we still believe that one of the ways to do this, is to open up the development and maintenance of the airport to as much competition as possible. Whilst we understand that a licence condition on HAL may at first pass appear an effective way of doing this, we would be cautious of such an approach. We would not want any licence condition to prevent third parties from offering or developing alternative, more efficient ways of developing the airfield.

Resilience

We are generally supportive of the concept of a resilience licence condition. However this would need to be very carefully drafted. In particular there would be two problems to overcome:

- the licence condition could only apply to HAL, and could not therefore require third parties to behave in particular ways;
- it would need to be drafted tightly enough so as not to create what would be in effect a 'blank cheque'

Interim Decisions

We note the CAA's interest in interim decisions. In principle, the ability to re-open a price control could generate more certainty for the regulated entity, or indeed it could generate more uncertainty. Thus it could either lower or raise the regulated price at Heathrow. In short the effect of an interim decision or re-opener will depend on how the conditions for it are drafted. Whilst in principle, the airline community is open to the debate, we see little value in such a debate in the context of a five year price control. As the CAA has stated its policy position in CAP1541 as being that future control periods will be for five years, there seems to be little value to us in continuing the debate on reopeners. However, if the CAA were to actively consider longer control periods, then it would make sense to also consider whether to have, and the conditions for activating, re-openers.

Chapter 4: Costs: Incentives and efficiency assessment

Category B costs

We support the appointment of an IPCR and the use of the existing IFS to inform the assessment of these costs. Additionally, the assessments and cost proposals of other third party developers and operators could be used to inform these assessments.

TOTEX

We agree with the CAA's decision not to move to setting incentives on a totex basis.

Ex Ante Incentives

The use of ex ante incentives for expansion is interesting, and the airline community would certainly support further investigation in this area. We also note that in para 4.20 the CAA state '*HAL would bear a pre-determined share of any cost variance*'. This seems to suggest that the CAA believes that airlines should pay a proportion of any cost over-runs incurred by HAL. We would note that airlines are not experts in construction and have almost no opportunity to influence the construction costs of expansion once the design is agreed. HAL on the other hand are construction experts and as they are in control of the build are fully able to manage the construction cost. Therefore all risk allocation best practice suggests that the risks are fully HAL's not the airlines.

However, should the CAA be able to demonstrate that taking on some construction risk was manifestly in our passengers' interests, and what the reduction in overall cost would be for taking on some of this risk, then we would certainly consider a proposal at the community level.

Treatment of early stage construction cost (early Category C costs)

The airline community believes that should HAL wish to take on any early Category C costs, then they should do so at their own risk. We take this position for the following reasons:

- At this stage, we do not know what the scheme will look like, whether it will be affordable, and what its prospects are for a successful application for a DCO. Nor do we know what the NPS will say. Consequently, it seems precipitous to sanction spending, presumably with a return, on initial building costs for an expansion that may never happen; and
- the airline community is opposed to pre-funding, because it increases demand risk, reduces the airport's incentive to build in an efficient way to meet consumer need and can generate distorting inter-generational cross subsidies. For the avoidance of doubt the airlines position is that HAL should primarily be achieving the required affordable charge through efficiency gains.
- Firms making investments in competitive markets do not benefit from pre-funding. Furthermore, from a consumer perspective we consider prefunding to constitute a more costly form of financing to consumers compared to the use of financial market (debt and equity).

We would also note the interplay between the CAA's logic on its Category B decision and early stage Category C costs. The CAA's argument on Category B can be broadly characterised as 'HAL needs to be incentivised to apply for and do its best to get DCO consent'. Given that you would only spend money on Category C costs if you were confident of getting DCO consent, the airlines submit that every penny that HAL spend on early Category C costs shows that the CAA did not need to incentivise HAL to get DCO consent as they would have done so already.

Our primary concern is that expansion should be affordable. The airline community would be open to a discussion on early stage Category C costs, if the CAA could address our concerns and demonstrate that allowing early stage category C costs to be remunerated before the runway opened was manifestly in our passengers interests.

Compensation Costs

As part of its drive to secure Government and community support for expansion HAL have made a number of generous promises on compensation. They have done so without consultation with the airlines or their passengers. Our position on compensation costs is clear. Statutory compensation schemes are very clear in terms of who can be compensated and what the level of compensation should be. We completely accept this and believe that this is the efficient cost for compensation.

If HAL's shareholders wish to make more generous offers of compensation to secure political agreement or because they believe it to be expeditious to do so, then we respectfully submit that this should be at their own cost. They have agreed to pay more than they are legally required to do and have done so without consultation.

Chapter 6: Surface Access

Thus far the CAA's policy on surface access has been to adopt a 'user pays' approach. The airline community fully supports this approach and believes it to be both consistent with the CAA's primary duty and economic theory. We believe that this approach to construction costs for surface access

remains the most equitable method of apportioning cost, particularly where airport and non-airport users will benefit from said infrastructure.

In terms of the application of this policy and the CAA's primary duty, we do not believe it is in our passengers' interests to pay more for surface access than they would under a strict application of the user pays principle. We are already concerned that as part of gaining Government support for expansion HAL have already made unilateral commitments on surface access including meeting the cost of bridging the M25, without any CAA oversight or airline consultation adding billions to the price of expansion to be borne by passengers. Heathrow must not be allowed to make any further commitments and the CAA surface access policy must be applied to the proposals for surface access to ensure that the passenger gets a fair deal.

Should these commitments, whilst expeditious, prove to not fall within a strict interpretation of the CAA's current policy, we would expect the capex related to it to not be allowed into the RAB.

We believe that the CAA's current 'user pays' policy is robust and fit for purpose and fully support its continued use and strict interpretation.

Chapter 7: Timetable and the extension of the price control

The airline community at Heathrow supports a further extension of the Q6 price control period. We believe that the main benefit of such an extension would be to allow the airlines and HAL the time and space to work constructively together on the expansion of Heathrow airport.

Whilst we agree with the CAA that it would make sense to align the regulatory and expansion timetables, the lack of clarity around the expansion timetable and the likelihood of further delay, makes this, in our view almost impossible. What is clear however, is that scarce airline and airport resources which could be deployed on expansion are already being diverted onto the H7 process e.g. outcomes, as in the absence of a decision on Q6 extensions from CAA, we are having to work to the Q6+1 timeline. We therefore urge the CAA to make a rapid decision on how far beyond Q6+1 the current control will be extended. This will provide clarity for all concerned and allow us to focus on expansion.

In terms of how the control is extended, it is clear to us that HAL has significantly outperformed the Q6 settlement and that any extension should be re-baselined to reflect this. We accept the CAA's view that any method for resetting the control needs to be simple and avoid the cost of and workload of a full review. However we cannot accept that our passengers continue to pay more than they need to. Consequently, a simple and pragmatic approach to the extension needs to be found and we are keen to work with the CAA and HAL to find one.

However, the most pressing matter is clarity from the CAA on how much further the Q6 control will be extended.

Yours sincerely



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