London (Heathrow) Airline Consultative Committee

Response to the CAA's Consultation on the Economic Regulation of Capacity Expansion at Heathrow: Policy Update and Consultation (March 2019)

CAA CAP 1782

24 May 2019

Introduction

The Airline Operators' Committee and the London Airline Consultative Committee (LACC) welcome the opportunity to respond to the CAA's Consultation on the Economic Regulation of Capacity Expansion at Heathrow (CAP 1782).

We note that the CAA's approach so far has been to consult on individual elements of the regulatory regime in isolation. As such, we have commented on each aspect individually. However, as the CAA has not yet issued a holistic position on the regulatory regime, we reserve the right to revisit our position on any individual aspect of the regime.

In responding to the CAA's consultation, we have attempted, in so far as it is possible, to structure our response to match the structure in the CAA's consultation.

Approach to Financability

In terms of policy objectives, the airline community supports the CAA applying a financability test to expansion, and indeed to its regulatory settlements. However, we believe that the CAA may be placing too much emphasis on just one of its secondary duties, and in addition, that it is confusing a financeable settlement with a settlement which is specifically financeable for Heathrow Airport Limited (HAL).

The CAA is well aware of its duties with respect to the economic regulation of HAL, as laid out in the Civil Aviation Act (2012). It will be well aware therefore that its primary, and indeed sole primary duty is to further the interests of users of air transport services (which as shorthand we refer to as passengers). This was a conscious policy decision to give clarity to the CAA and other stakeholders on the purpose of the CAA's exercise of its economic regulatory functions.

The CAA does have a number of other secondary duties, of which financability is just one. The 2012 Act was also written is such a way as to ensure that none of the secondary duties, either individually or collectively outweigh the primary duty. In short, whilst the CAA must have regard to a number of issues in making its regulatory decisions, its primary duty is clear and unwavering – it is to the passenger and **not** to HAL or its shareholders.

In terms of the emphasis that the CAA is placing on financability for example, we do not believe that the CAA has given equal attention to its other secondary duties. For

example, the CAA has no definition for efficient spend. In the case of Cat B, even when its own consultants showed categorically that HAL's Cat B spend up to the point of their report did not pass efficiency tests, the CAA still proposed awarding HAL over 90% of the actual spend. Furthermore, as we will comment on later in our response, the CAA is refusing to define key terms like *efficient* and *effective*.

The airline community has always been clear that for expansion to be in the passengers' interests (ie consistent with the CAA's primary duty) it must be affordable, deliverable and operable. It is the issue of affordability that is most important in this context.

HAL has consistently chosen a level of gearing that is higher than that assumed by the CAA for a notionally efficient company. The effect of this gearing decision, is to artificially lower HAL's WACC, and allow HAL to earn additional profit on capex. The CAA is well aware of this, and its policy has always been clear – that HAL's gearing is a decision for HAL. The CAA has also been clear that as it is HAL's choice, it is also for HAL to own the risks and the rewards that come from such decisions. In short HAL will earn the return for artificially lowering its WACC, but will also have to deal with any downside that comes from its decision.

The airline community believes that the passengers' interests are best served (and indeed the CAA's primary duty best met) by ensuring that any regulatory settlement only finances a notionally efficient airport company (in this case HAL). Consequently we believe that the CAA's current policy ie determination on the basis of notionally efficient gearing, and allowing HAL to make its own decision on capital structure accordingly is the correct one. Therefore, we are disturbed that the CAA should wish to change its policy now for the following reasons:

i. the CAA have provided no evidence that a change in policy is needed, or provided any cost benefit analysis that its proposed changes are indeed the most cost effective policy response;
ii. regulatory certainty and credibility – in much the same way as the credible threat of detection and prosecution is helpful in ensuring that competitive businesses behave in a competitive way, then the CAA's ability to effectively regulate is dependent on it being seen as credible. Consequently, its statements that it will only allow efficient spend for example must also be credible. HAL's shareholders have benefitted

by choosing a higher gearing level than that assumed by the CAA. If the CAA were to accommodate this and give a more generous settlement for expansion, then arguably the CAA will lose more credibility as an effective regulator with both HAL and the airline community. Furthermore, as it is a change in policy that is unsupported by evidence, it introduces unwelcome regulatory uncertainty;

iii. any move away from the current policy is arguably not in the passenger interest. A rough calculation shows that HAL is making an additional return of around £300m pa over each year in Q6 by its choice of gearing (therefore circa £1.5bn in Q6 and Q6+1 alone of value transfer from passengers to HAL – whom the CAA is supposed to regulate on behalf of consumers). To ask passengers to pay this sum of money, and then potentially further sums in future regulatory periods, because the choice of gearing may have been too high seems both counter-intuitive and counter to the passenger interest. Either HAL bears the benefits and the costs of its gearing decisions, or the passenger should. If the CAA believes that the passenger should, then HAL's shareholders should repay the additional premium they have earnt by their choice of gearing.

To be clear the airline community supports the application of financability testing and stress testing. But, we are clear that the regulatory settlement should be determined and tested on the basis of a notionally efficient company not on (or on a simplified approximation of) HAL's actual choice of gearing.

We do however see a useful role for the CAA conducting this testing on gearing close to HAL's, but in the following way:

i. CAA makes a provisional determination, and conducts its affordability testing <u>on a notionally efficient basis.</u> The regulatory settlement should be made on this basis;

ii. Once it is clear that its proposed settlement is financeable for a notionally efficient company, CAA repeats the financability tests but with gearing approximating HALs.

In our view the first step ie setting the control on a notionally efficient basis is the correct approach and that most consistent with CAA policy and its primary duty. The value of the second step (ie testing against something closer to HAL's actual structure) is that it would show what actions HAL's shareholders would need to take in order to deliver expansion. It maybe for example, that additional equity would be required. However, we are clear that HAL's gearing decisions and capital structure are HAL's own decision. As a consequence they are also HAL's problems and not the passengers'.

To be clear, if HAL is unable to finance expansion with a notionally efficient settlement, and unwilling or unable to take steps to remedy this then it should feel free to surrender its licence and allow a more efficient business to run the airport – just like in a competitive market. Regulation should not be used to insulate a monopoly from the disciplines and consequences of its financing decisions. (This would be in keeping with the CAA's duty to promote competition where possible). The CAA has already stated in previous responses that it agrees that the passenger should not be the lender of last resort. We agree with the CAA, and are concerned with any change to CAA policy that would signal the passenger having to pay extra because of HAL's decisions on its capital structure.

In short, we are concerned that the CAA's current proposals:

i. mark a departure from existing policy that could further undermine the CAA's credibility as a regulator and lead to additional costs for passengers'; and
ii. fundamentally confuses the issue of financability for an efficient company with financability for HAL.

In addition to these comments, we have a number of further comments on the CAA's proposals on affordability. These are:

i. whilst we understand the need to stress test in both the notionally efficient scenario (that would be used to stress test the settlement) and for the approximation of HAL's capital structure, we do not believe that all the risk is downside;
ii. furthermore, we are unclear what the CAA's actions would be as a result of conducting the tests – further clarity is needed on this;
iii. the stress tests need careful design, and should be no more (or less) than a competitive and efficient business would be expected to do.

We would like to engage with the CAA on the detail of these proposed tests;

iv. the CAA argues that the stress test is unlikely to be pass/fail and would require interpretation. This is potentially key area, and we are uncomfortable with there being so much opacity in how the tests would be applied and interpreted. We believe that such an approach would be more useful and indeed credible if the CAA were to be much clearer on what constituted a pass or fail, and what objective tests and measures would be applied;

v. in terms of credit ratings, we require further information on the CAA's proposed choice of a mid-point for a proposed credit rating. What are the additional costs and benefits against say a threshold (ie just makes the credit rating) or the choice of a different place in the range (say lower quartile). In other words, can the CAA demonstrate that their proposed choice of mid-point is the optimum balance of cost, benefit and risk?

vi. On financability adjustments we reiterate our point that if the settlement is financeable for a notionally efficient company, it is in our view for HAL and its shareholders to deal with that, rather than for our passengers to bear additional cost.

vii. Para 1.40 – the airline community notes that the CAA argues here that it may be necessary to adjust the profile of regulatory depreciation to facilitate financability. We also note that in CAP 1658 adjusting regulatory depreciation was the CAA's proposed mechanism for returning some of HAL's outperformance to the airlines. The CAA should be clear that uncertainty around the path of regulatory depreciation in H7 and indeed the CAA's position on it generates uncertainty for the airline community that any of the outperformance would be returned to them or their passengers. It is an important factor in the airlines being driven not out of choice but by regulatory uncertainty and inactivity into a 'commercial' deal for iH7.

In summary, the airline community supports the current approach based on a notionally efficient company. Whilst it may be interesting and indeed useful to look at financability with something approaching HALs current financial structure, this should not form any part of determining the regulatory settlement, In addition, given the current availability of cheap debt, and economic conditions, the airline community

would welcome a discussion with the CAA on what level of gearing could be considered 'notionally efficient' for a regulated airport operator.

Incentives for Capital Expenditure Efficiency

The airline community agrees with the CAA that HAL should invest capital efficiently, and that it should rewarded for efficient, and only efficient capital spend. In addition, we understand that the nature of capital incentives in economic regulation typically encourages capital spend, rather than efficient capital unless there is proper governance and efficiency is effectively policed.

Furthermore, given the sheer scale of capex associated with expansion, we are clear that the risks and incentives for capex inefficiency are potentially great, and that increasing attention needs to be paid to ensuring that only efficient capex is rewarded.

In considering what action to take the CAA appears to have moved directly to *ex ante* capex incentives, and is asking us to comment on which of the *ex ante* regimes is preferable. However, the airline community does not believe that this is appropriate at this stage.

In our view the CAA's analysis should be as follows:

Step 1:	CAA to identify the potential size of capex inefficiency;
Step 2:	CAA to propose methodologies to address the issue (note that in our view, this should include both the current structure and improvements to the current process);
Step 3:	CAA should assess the costs associated with each approach
Step 4:	CAA to compare the relative cost of each proposed methodology to determine the best approach

It is our view that the CAA has not yet conducted sufficient analysis on what the scale of the problem is likely to be, or indeed worked out what the likely costs of different approaches is likely to be. Therefore, the airline community does not deem it appropriate to engage in the detail of the CAA's proposals at this time.

Before progressing with any consideration of ex ante incentives the airline community would need to be assured of two things:

i. given the CAA's historically *laissez faire* approach to allowing HAL's capex into the RAB, it could be argued that both in principle and in practice the imposition of *ex ante* controls as proposed by the CAA could be argued to be transferring construction risk from airlines and their passengers to HAL. We would need to be assured that any increase in HALs WACC that the CAA might make to account for this risk transfer would be less than the cost of us bearing the risk ourselves;

ii. that the operation of *ex ante* incentives would be more effective than making the current system work more effectively.

Whilst we would welcome further discussion with the CAA on *ex ante* incentives specifically and improving HAL's capex efficiency more generally, for the avoidance of doubt, the airline community currently believes:

i. that without effective governance and much stricter enforcement of only efficient capital entering the RAB by CAA, that cost over-run on expansion capex is likely;

ii. that the WACC uplift that the CAA would likely grant HAL in relation to *ex ante* incentives is likely to be significant; and

iii. that reforming the current regime is likely to be the best option.

The Airline Community's preference at this time is to improve the current system.

Our proposal to do this is as follows:

i. projects at G0 to G2 to have greater transparency, and only to progress with airline agreement. Airlines and their representatives to be involved in project design, briefing and selection of designers and so on. (The CAA will recall that this is consistent with work by their own consultants, CEPA who called for greater airline involvement and transparency further upstream in the project). This may require CAA to enforce transparency, data share, and to ensure additional resources to airline community if required;

ii. when a project is approved at G3, with a P50 risk allocation, two things happen. First the price of the project (and what goes into the RAB if the spend is efficient) is fixed, and second that the risk allocation is held centrally at a programme level. So projects that come in under budget fund those that come in over. Provided that

there is no systematic bias in calculating project cost, over the portfolio of projects the net deviation should be zero. The price that goes into the RAB could be adjusted in the following circumstances however:

a. the airlines change the specification that they require;
b. agreed significant and unforeseable cost events;

iii. when the project is complete there needs to be a proper and thorough *ex post* evaluation so that:

a. the CAA can determine whether the spend (in whole or in part) was efficient and therefore allowable into the RAB. This would require the CAA to have a proper and objective assessment of what efficient capex actually is so that all parties would be aware, and that the CAA could police this spend effectively; and
b. all parties can see whether the project has delivered the anticipated benefits.

In our view, HAL should welcome airline involvement further upstream in the project life cycle as this should lead to greater collaboration and greater assurance that they are building what their customers want. The operation of the G3 gateway is what the airlines thought we were getting in the Q6 settlement, although in practice this seems not to be the case. However, unless HAL systematically make errors in project costing we see no increase in cost risk for them.

The biggest change required is for the CAA to actively engage in determining what was and what wasn't efficient spend, and to have proper objective tests for determining this. We understand that this may be a departure from previous CAA policy, but feel that this would have a strong impact on ensuring capex efficiency. As HAL should only be remunerated for efficient spend, and will no doubt argue that all their spend is efficient, there should be no increase in risk to their shareholders and consequently no demands (or reason) to raise the WACC.

In short, the airlines initial position, is that capex efficiency is a real concern, but with additional resources and support from the CAA, there is a process that works, and if the CAA were to rigorously enforce only allowing efficient spend into the RAB the current system could work. We also believe that this could be done without increasing HAL's risk, and indeed may well reduce it.

We would also point out that one of the weaknesses of the CEPA proposals as they current stand is that they seem to assume a static and fully worked out capex plan. This is not always likely to be the case, which is why the CAA adopted the core-development model to allow for changes in relative demand and cost efficiency.

Promoting Economy and Efficiency

The airline community has always been clear that its primary objective in this area is that HAL should be an efficient operator. As such we will consider any regulatory initiative that helps deliver this, and so are open to the concept of an economy and efficiency licence condition for HAL. However, in terms of the concept of such a condition, we noted in our response to CAP 1722 that:

- any licence condition should apply solely to the services provided by HAL under economic regulation;
- that any licence condition should not be instead of the CAA policing efficiency effectively and rigorously;
- given the CAA's pre-occupation with Outcomes, that any condition which examines efficiency must also examine outcomes ie not just activity but what the activity achieved;
- that many of the issues that the CAA see the proposed licence condition could be addressed by the CAA setting less generous price controls and by rigorously enforcing efficiency (for example capex, Cat B and so on).

For the avoidance of doubt, the airline community maintains the position outlined above and in more detail in our response to CAP 1722.

We have a number of comments to make in respect of the detailed drafting of the proposed licence condition. However, before we do so, it is important to make the CAA aware of the Community's disappointment that the CAA has not heeded any of the advice given to the CAA in our response to CAP 1722, or taken on board our concerns in the drafting of the proposed licence condition.

Consequently we are required to repeat many of the concerns and suggestions that we previously made in response to CAP 1722. Once again our primary concern in the drafting of the proposed condition is around B3.1, and specifically, *'conduct its business and activities that relate to the provision of airport operation services'*. Our concern is that any licence condition should clearly and unambiguously relate only to HAL. Airlines and other parties (eg UK Border Force) are not subject to economic

regulation, and any requirement on HAL should not allow the unintended extension of economic regulation to business which operate in a competitive environment or are provided by HMG.

The CAA should redraft this to make it clear that the licence condition applies solely to goods and services provided by HAL under the licence and not to any other party. For the avoidance of doubt the airline community will not support any licence modification that could have the consequence of extending economic regulation onto airlines.

In addition, we do not understand why the CAA does not wish to include the term 'effective' in B3.1. To take an example, HAL could build something where the design could be parsimonious, and the construction price efficient, but if the product doesn't deliver anything that anyone wants what would be the point? Surely the CAA wishes HAL to deliver what its customers want and to do so efficiently?

In addition, we are also concerned by the CAA's refusal to define key terms in this licence condition. These terms would include: reasonable demands; economical; and efficient. We believe that the refusal to define terms clearly is an issue because:

i. without clarity on what the CAA means by economical and efficient for example, how can HAL ensure it complies with the licence condition. In principle the CAA could be giving HAL a licence that it could have every intention complying with, but because it is unclear what the CAA means, it is unable to do so. We believe that it is not consistent with the principle of regulatory certainty to put HAL in this position;

ii. the CAA is unclear how the licence condition is to be enforced, but presumably, they expect the airlines to alert CAA if they believe that the condition is not being met. How can the airlines do this if they do not know what constitutes economical and efficient? For example, if HAL build something but it doesn't deliver the benefits in the business case, is that economical and efficient?

In short if no one understands what the licence condition means, it makes it difficult for HAL to objectively comply with it and for the airlines to take a view on the extent of HAL's compliance and for the CAA enforce it. And if the condition can't be enforced what's the point of having it in the licence?

iii. We disagree with the CAA that *economic* and *efficient* are situation specific. We understand that the CAA may wish to keep the terms as broad as possible to ensure as much regulatory discretion as possible. However, given the level of airline confidence in the CAA as an economic regulator, we would much prefer that the CAA's room for regulatory discretion was fettered and kept to an absolute minimum. We believe that this would lead to a far more objective condition, that would have a better chance of being successfully enforced, and would both enhance the CAA's credibility and potentially HAL's efficiency.

The CAA also has much more work to do to make it clear how they expect the licence condition to operate. For example, how will they ensure that they have the necessary information to assess any claim? Who at the CAA will conduct such an investigation, and does the CAA have the necessary resource and skill sets required? If not, how will they acquire it and who will pay for it?

In summary, and as the airline community stated in its response to CAP 1722 '…*the airline community is supportive of seeing a more efficient HAL, and for the CAA to have the tools to make that happen. And thus, in principle, we are supportive of the CAA's proposals. However, in practice an economic and efficient licence condition cannot be instead of setting tight price controls, and we have concerns that the current drafting has the effect of extending economic regulation into airline operations – and we cannot support that. We urge the CAA to redraft its proposals and think carefully about how it will give real effect to the condition by defining the terms closely, laying out the objective tests it will use and imposing the data requirements on HAL so that it properly test HAL's levels of efficiency and economy.'*

In short, whilst the airline community remains open to the principle of an economy and efficiency licence condition, we cannot support it in the current form proposed by the CAA. However, we would be keen to work with the CAA to develop an appropriate drafting of the licence condition that met our concerns and that we could support.

Alternative Delivery Arrangements

The airline community notes with interest the CAA's comments in this section of CAP 1782. However, we do not believe that the CAA position with respect Arora is consistent with the CAA's primary duty.

It is clear and understood that Civil Aviation Act (2012) gives the CAA the sole primary duty of furthering the interests of passengers, and indeed the CAA tends, helpfully, to make this clear in each of its consultation documents. However, the CAA's primary duty comes in two parts. The first is to further the interests of passengers, and the second is:

'The CAA must do so, where appropriate, by carrying out these functions in a manner which it considers will ***promote competition*** [our emphasis] *in the provision of airport services'*

The airline community interprets this part of the CAA's duties as being to actively promote competition at Heathrow Airport, and indeed on expansion. Consequently, the presumption should be that the CAA should accommodate Arora (or indeed any other alternative provider) rather than not. Indeed as the Arora proposal is already out to public consultation, and the group have every intention of progressing to DCO, it seems to us that this would be sufficient *prima facie* evidence for the CAA that the Arora proposal is credible, and therefore, the presumption to promote competition should be in play.

Consequently, the airline community does not understand the CAA's decision that it will not give clarity at this stage on how Arora would be accommodated in the regulatory regime. We do not understand how this position is consistent with the CAA's requirement to promote competition. Indeed, we also believe at this stage that some relatively high level regulatory thinking would provide a degree of certainty for HAL and Arora, and would allow all parties to further understand the robustness of any alternative delivery plan.

We understand that the CAA may want to put in place a number of conditions or tests for alternative plans. In terms of the tests that the CAA is proposing for Arora, the airline community wonders whether rather than promoting competition as its primary duty requires it do, whether the CAA is actually preventing competition. For example:

i. is the playing field level? In other words how many of the tests that the CAA proposes for Arora would HAL pass?;
ii. are all the tests still relevant given the revision to Arora's plans?;
iii. the CAA has presented no information on how each of the tests would be assessed. What objective criteria would need to be met? What

data would be required? How could a 'pass' be demonstrated? It appears that the CAA has left itself considerable room for the exercise of its regulatory discretion here. It is questionable whether such opacity and regulatory uncertainty is useful at this stage of the process.

In short, the airline community requests that the CAA reconsiders is current position with respect to Arora specifically, and other potential scheme providers in principle, in the light of its primary duty to further passenger interest by promoting competition.

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