

ECONOMIC REGULATION OF HEATHROW AIRPORT LIMITED

H7 FINAL PROPOSALS CAP2365

This is the Arora Group's (Arora) response to the consultation document published by the CAA in June 2022 setting out final proposals for the Heathrow H7 price control (CAP2365).

As a non-airline operator, Arora is not directly affected by many of the issues raised in CAP 2365. However, the CAA will be aware that Arora is profoundly unhappy with the CAA's failure to properly regulate Other Regulated Charges (ORCs) which are addressed in Chapter 8 of the Final Proposals. Therefore, our response to CAP2365 is principally focused on the CAA's proposals in this area.

We note that the Final Proposals are silent on Heathrow West's¹ request for funding of costs related to the preparation of a development consent order (DCO) with respect to new terminal infrastructure that would be necessary for a third runway at Heathrow. We have however been informed, on the day that responses are due to the Final Proposals, that the CAA is to issue a draft decision denying this request. We will consider our response and our options with respect to this draft decision in due course.

Previous submissions on ORCs

As a hotel owner and operator both in and around London Heathrow Airport, Arora is required for certain of our properties to use and pay for a number of services included in ORCs, in particular utility services (including gas, electricity and water / sewerage services). As the CAA is aware, Arora has very material concerns about the way in which ORCs are set and charged for by HAL. In our response to CAP2275², we supported our views with the following evidence as to why the regulatory framework for ORCs is not working effectively:

- Published gas and electricity charges at Heathrow are significantly higher than published charges at Gatwick and Manchester airports;
- On-airport water charges are multiples higher than off airport water charges (and are higher than other airports);
- HAL's response to requests for clarity fails to provide any clarification beyond highlighting that these are regulated charges; and
- HAL refuses to respond meaningfully to bilateral requests for transparency over charges.

The CAA's Final Proposals provide little comfort that the CAA has made any meaningful progress in addressing our evidenced concerns.

¹ Heathrow West Limited is an entity within the Arora Group.

² Licence conditions implementing the Initial Proposals contained in CAP2256.

We made a number of suggestions for improvement and we note that some changes to governance are proposed (which we comment on below). It is disappointing that our suggestions to require a form of market testing for services provided under ORCs, as a way of ensuring efficiency in the provision of services by HAL, have been completely ignored by the CAA.

Finally, we address the proposed changes in the suggested move to marginal cost pricing. While we continue to support this concept, the CAA's proposal for 2 tier pricing at Heathrow is particularly cumbersome. It is bound to result in non-airline parties being mischarged for the services that they are required to purchase from HAL as well as leading to unacceptable levels of price volatility.

We now turn to the proposals as set out in Chapter 8 of CAP2365.

Self-modification in provision in the licence

The CAA proposes that there would be a process to add or remove items from the list of specified activities. This seems a sensible provision (in part given the CAA's lack of interest in the subject of ORCs). However, it is limited only to the airport and airlines. We see no justification for excluding from this process legitimate consumers of ORCs, given the potential impact on them, and accordingly request that this flexibility is extended to them (or at the very least request that their views are required to be sought and taken into account before any final decision is made).

Governance and developing the Protocol

The CAA is proposing that the ORC governance process requires strengthening through stronger links to HAL's licence. Arora agrees.

While the CAA recognises that there are challenges with the quality, scope and timing of HAL's provision of information to ORC users, it then invites HAL and airlines to agree the detail of information provision. It is not clear to Arora why the CAA limits this privilege to airlines and accordingly Arora requests that it is extended to all users of the ORCs, consistent with the CAA's approach to its powers to intervene. Indeed the CAA notes that there should be no limit on who can raise an issue with the CAA for resolution provided they are a specified user of an ORC service. Arora supports this provision.

Marginal cost approach for non-airline users

The CAA proposed, as part of the Initial Proposals, to accept HAL's suggestion that a number of fixed costs currently recovered as part of ORCs should be moved into airport charges. Arora supported this proposal in its response to the Initial Proposals. The CAA is now proposing that the non-airline fixed costs should be left as part of the ORC charges leading to a re-allocation of around £18m of costs. HAL is to be required to appoint an independent reviewer to carry out a one-off review of HAL's allocation of costs of the specified activities between airlines and non-airline users.

Arora does not support the CAA's proposals in this area. The movement of fixed costs into the airport charges was intended (according to the CAA) "*to ensure that consumers (through airlines) are charged an efficient price for the services and facilities that they use and that the risk of significant price increases is minimised*". It is not clear to Arora why this policy objective has been changed. Leaving the fixed costs in ORCs will not lead to the objectives set out by the CAA in the Initial Proposals.

It is a feature of the calculation of the ORCs that it leads to a volatility in pricing as fixed costs are spread over variable volumes. This feature will remain under the CAA's revised proposals. In addition, the CAA's proposals will lead to complicated pricing discussions, and differential pricing,

as airlines and non-airlines seek to understand the pricing differentials between one pot of ORC costs and another pot of ORC costs. We believe that the relatively small amount of income at stake could also lead to unwelcome volatility in prices to non-airlines in that a small change in the airline-attributed costs could lead to a major change in the amount of non-airline-attributed costs.

On the separate point, Arora supports the appointment of an independent reviewer. However, such a reviewer should be appointed with the agreement of the airlines and non-airlines, rather than consultation only, which is what the CAA is proposing. Arora also considers that the terms of reference of the independent reviewer's appointment should not be unduly narrow and should focus on a broader assessment of how HAL sets ORC shared charges, including considering whether this is done efficiently. It is not clear to Arora why the CAA considers it is for ORC users to work with HAL to ensure efficiency and an appropriate quality of service, when these charges are regulated by the CAA. The appointment of an independent reviewer provides the ideal opportunity for an independent assessment of such costs.

Dispute resolution for ORC operational matters

HAL and users of ORCs are invited to agree a dispute resolution function to be built into the governance arrangements. Further guidance is to be published by the CAA in Autumn 2022. Arora supports the development of an agreed dispute resolution function.

Other issues

The CAA notes the submission from the Hilton Garden Inn that HAL's prices for utilities are set efficiently, including by market comparison or specific price caps. Arora supports these suggestions and is disappointed the explicit market testing is not required for all elements of ORCs where possible.

Concluding remarks

We would welcome discussion with the CAA on any aspect of this consultation response. We are disappointed with the lack of development of the regulatory framework of ORCs. The request for a recovery of DCO-related costs is currently subject to a separate consultation process with respect to the CAA's draft decision and will be addressed in due course.