

easyJet Submission to the CAA on CAPEX Triggers at LGW

Introduction and Context

1. easyJet continues in its support of CAPEX triggers at the regulated airports and considers that if diligently applied, they can provide a suitable incentive on airport operators to deliver major elements of investment programmes, on which regulatory settlements are based. It therefore shares the objectives of the CAA, which in its Q5 regulatory settlement said: *'The CAA considers capital investment triggers to be an important aspect of the financial incentives placed on BAA to encourage timely and efficient delivery of the investment projects which airline users have discussed in constructive engagement and for which they are paying through airport charges.'*¹
2. The CAA has set out a list of projects at LGW to which CAPEX triggers apply and easyJet is also in agreement that this is appropriate; however, it has a number of significant concerns about how CAPEX triggers are being implemented.
3. easyJet is aware that the JSG is making a separate submission in respect of CAPEX triggers – and supports the JSG's objective of reaching agreements on CAPEX projects with BAA; however, it does not consider that the approach taken by the JSG is likely to achieve a fair outcome. easyJet's primary concern is the regulatory context within which the JSG's discussions are taking place, which it does not consider provides appropriate protections for users.
4. easyJet is familiar with the content of the JSG submission – and has shared its thoughts on this, as well as the content of this submission with the JSG. In easyJet's view, the format of the JSG submission has been fundamentally influenced by BAA, to an extent whereby BAA has manufactured a virtual veto on many trigger projects.² Moreover, it seems to easyJet that the majority of the trigger projects remain poorly specified (at best), which makes it extremely difficult for airlines to understand what it is that they are agreeing to. So whilst it always seeks agreement – and considers this an objective in itself, easyJet is unable to subscribe to a document that in its view provides no benefits to users, whilst allowing BAA to take unfair advantage of the regulatory context.
5. easyJet considers that reasonable agreements with BAA can only be achieved in a framework of regulatory certainty and a fair balance of incentives – and so seeks these first and foremost.

Executive Summary

6. easyJet is surprised and disappointed that the CAA has reached a settlement for Q5, incorporating CAPEX triggers that remain to be fully defined – and therefore reserves its position on this issue, until such time as CAPEX triggers are finalised.
7. easyJet considers that CAPEX triggers at LGW meet neither the recommendations of the CC, nor the stated aims of the CAA. It does not understand how the CAA could design and sanction a mechanism that allows BAA to realise and retain returns against non-investment.
8. The financial incentive on BAA is not to invest at LGW, as it is unlikely to remain in ownership by the time the triggers come into effect. easyJet can therefore envisage a situation wherein BAA fails to invest and in the meantime sells LGW, retaining the extra

¹ Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013 – CAA Decision, 11th March 2008, paragraph 13.13.

² For example, repeated use of phrases such as: *'Consistent with the BAA Development process the scope of this project may evolve through consultation with stakeholders, in order to deliver the optimum solution, maximising benefits realised'*; and *'Any such changes to scope or programme agreed through Constructive Engagement will be recorded via the change control mechanism'* make meaningless any agreement that airlines may feel has been reached.

revenue it has extracted from users, while the same users and the new owner would be required to restart financing the same CAPEX plans as had already been paid for.

9. It appears to easyJet that grounds for not investing were prepared in advance of the Q5 settlement, while further evidence of such behaviour is now emerging. easyJet therefore considers that to fulfil its statutory duty to users, the CAA must take such steps as are necessary to prevent such an outcome – and at a minimum these must entail removing the ability of BAA to extract returns in the manner described.
10. easyJet considers that the three-month ‘lag’ in the timing of CAPEX triggers, as settled on by the CAA, introduces a systemic bias into the Q5 price cap, in favour of BAA.
11. easyJet considers a change control process for CAPEX triggers as neither necessary nor desirable. The CAA seems to believe that BAA would be in some way ‘punished’ for not delivering agreed projects, when this is clearly not the case: BAA would simply not benefit from a return that it had manifestly not earned. On the other hand, the CAA is proposing not only to deny users the benefit of such projects, but also to require them to continue paying. easyJet considers that this is wholly unreasonable – and does not understand how the CAA can propose a change control process over which BAA has an absolute veto – and then suggest it will be subject to user agreement.
12. easyJet considers that CAPEX triggers ought to be based on assets successfully entering operation, rather than any other ‘milestone’ that would not benefit users.

Regulatory Uncertainty

13. easyJet is surprised and disappointed that the CAA could reach a settlement for Q5 that incorporates CAPEX triggers that remained to be fully defined. Moreover, it is difficult to understand how the process of further definition could have been entrusted to BAA-led consultation and dialogue.
14. easyJet therefore reserves its position on CAPEX triggers at LGW until such time as these are clearly defined by the CAA – and understands that this will be by April 2009.³

The Sums at Risk

15. In order that CAPEX triggers provide an adequate incentive to invest, they self-evidently must ensure that there is no financial advantage to BAA in not doing so. Indeed, this precise point was made by the CC in its recommendations to the CAA: ‘[CAPEX triggers] would ensure BAA is no better off for not carrying out that investment.’⁴ Specifically, easyJet considers that this means that CAPEX triggers should not allow returns to BAA on unmade investment.
16. The CAA appeared to have agreed with this approach, when it said: ‘With regard to the level of penalty payments for late delivery of trigger projects, the CAA agrees with the Commission’s recommendation that this be set with regard to the return allowed on a particular tranche of investment. It also acknowledges the principle proposed by the Commission that the penalty for non-delivery in Q5 should be such that BAA would be no better off for not carrying out an investment.’ This appeared to be a clear statement of intent; however, the CAA continued: ‘The CAA interprets the intention here was that the trigger mechanism would reduce the present value of allowed airport charges over the remainder of the quinquennium by an amount equivalent to the present value of the projected returns on the assets in the course of construction.’⁵

³ Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013 – CAA Decision, 11th March 2008, paragraph 13.27.

⁴ Competition Commission report: BAA Ltd - A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd) - presented to the CAA 28 September 2007, paragraph 4.37.

⁵ UK Civil Aviation Authority Heathrow and Gatwick Airports – CAA price control proposals, November 2007, paragraph 9.67.

17. With the benefit of hindsight, easyJet now sees that these two positions are inconsistent.
18. easyJet had thought that the CAA had intended that triggers would reduce BAA's returns realised against a given trigger project, so that they reached an NPV neutral position over Q5; however, now sees that this is not the case. easyJet now understands the CAA's intention to be that returns would be reduced by the incremental amount associated with a particular project – that is, returns would no longer be realised, but previous returns would not be unwound. The CAA has subsequently confirmed this view: *'the level of monthly payments should be based on one twelfth of the return on the completed value of the asset as projected in the capital investment plan on which the price cap is based.'*⁶ Furthermore, easyJet understands that returns of the RAB (depreciation) would continue throughout Q5.
19. easyJet considers that this mechanism meets neither the recommendations of the CC, nor the stated aims of the CAA - and if it had been clear at the time, would have objected during the consultation process. easyJet does not understand how the CAA could design and sanction a mechanism that allows BAA to realise and retain returns against non-investment, in the face of the CC's recommendations, with which it outwardly agreed.

The Potential Sale of LGW

20. Notwithstanding the clear incentives for non-investment on BAA were it to retain ownership of LGW, the situation is brought into even sharper focus – and is exacerbated - by ongoing developments in the UK airports market.
21. In August 2008 the CC published its provisional findings in its investigation into BAA airports, saying: *'[w]e have provisionally concluded that Heathrow, Gatwick and Stansted could compete with one another and that common ownership results in an AEC. It is currently our view that divestiture of two of these airports to achieve separate ownership of each of Heathrow, Gatwick and Stansted would effectively address this AEC... and that... [o]n this basis the CC is unlikely to require the divestiture of Heathrow unless divestiture of Gatwick or Stansted is likely to be ineffective or impractical.'*⁷
22. easyJet considers it unlikely that BAA would choose to sell LHR and that there are significant incentives to seek retention of STN, not least because these two airports appear the most able to deliver new runway capacity in the near term. Accordingly, in a press statement of 17th September 2008, BAA announced that *'[it had] decided to begin the process of selling Gatwick Airport immediately.'*
23. easyJet considers that these developments place an even greater imperative on the CAA to ensure that CAPEX triggers at LGW meet their intended purpose. If (as may well be the case) BAA sells LGW by June 2009, not one CAPEX trigger will have come into effect, while only one (South Terminal Forecourt) will have come into effect before June 2010.
24. The financial incentive on BAA is then quite clearly not to invest at LGW, but rather to realise the returns on its non-investment, as it is unlikely to remain in ownership by the time the triggers come into effect. easyJet can therefore envisage a situation wherein:
 - BAA fails to develop the trigger projects, but earns a return nevertheless;
 - despite industry protests, users and the CAA find themselves bound to inappropriate and ineffective CAPEX triggers;
 - in the meantime, BAA sells LGW, retaining the extra revenue it has extracted from users;
 - LGW's new owner takes a view that whilst investment may be necessary, it must be financed – and that it cannot be penalised for the behaviour of BAA; and so

⁶ Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013 – CAA Decision, 11th March 2008, paragraph 13.35.

⁷ BAA Airports Market Investigation Notice of Possible Remedies under Rule 11 of the Competition Commission Rules of Procedure, paragraphs 14 and 15.

- users find themselves being required to restart engaging on and financing the same CAPEX plans as they have already been paying for during Q5; while in the meantime
 - LGW continues to provide sub-standard service quality throughout Q5 and beyond.
25. In this regard, easyJet notes that: *'BAA said it was paramount that there was a process in place for the ongoing revision of triggers through ongoing constructive engagement in Q5.'*⁸ BAA had admitted to the CC that the sudden increase in its CAPEX forecasts at LGW during the Q5 consultation was driven by its new owner, rather than any business requirement. *'BAA told us that a lower capital expenditure had originally been agreed with the airlines; but a higher amount was then suggested by BAA on the initiative of Ferrovial.'*⁹
26. It appears to easyJet that grounds for not investing were being prepared in advance of the Q5 settlement, while further evidence of such behaviour is now emerging. For example, a key element of this increased programme is Pier 7, which has a CAPEX trigger, but which BAA sought to re-classify as *'Additional Pier Service'* in its 2008 CIP. When this was highlighted by easyJet – and that this was the only trigger project that had been reclassified in this way, BAA subsequently reverted to the previous description; however, recent developments at LGW suggest that BAA is beginning to postulate that Pier 7 cannot be constructed as forecast.¹⁰ easyJet therefore considers that to fulfil its statutory duty to users, the CAA must take such steps as are necessary to prevent such an outcome – and at a minimum these must entail removing the ability of BAA to extract returns in the manner described.

The Timing of CAPEX Triggers

27. easyJet considers it inappropriate that CAPEX triggers are set to come into effect three months after the CIP date of a particular project. It understands the CAA's approach in terms of *'a large portfolio of projects'* and its argument that *'to specify the trigger milestones too tightly may take away the airport's ability in delivering the programme efficiently'*¹¹, but considers the latter in particular, to be misplaced.
28. A trigger date set three months after a CIP date is just as *'tight'* as one set on a CIP date: one date is very much the same as the other, just three months later. All this approach provides is a *'lag'* in the requirements of delivery dates – which were themselves set by BAA – and so presumably are considered reassemble and achievable. So as returns are calculated on a premise of on time delivery, BAA stands to benefit from an assumption that this will be the case, while at the same time users are denied the benefits of reasonable and achievable projects for which they have paid.
29. easyJet considers that this system of providing benefits to BAA (in the form of costs to airlines) in advance of BAA's own costs, is unfairly weighted towards the interests of BAA and against those of users – and that consequently the timing of CAPEX triggers, as proposed by the CAA, introduces a systemic bias into the Q5 price cap, in favour of BAA.

A Proposed Change Control Process

30. easyJet considers a *'change control process'* for CAPEX triggers, as described by the CAA, as neither necessary nor desirable.¹² If BAA is to make all the investment that was

⁸ Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013 – CAA Decision, 11th March 2008, paragraph 13.4.

⁹ BAA Airports Market Investigation Provisional Findings Report: 20 August 2008, paragraph 2.62.

¹⁰ For example, in the JSG submission, Pier 7 is described as: *'Additional Pier Service (Pier 7)'* following which: *'The above scope reflects the CIP Project Definition. However the airlines with GAL are considering other options in terms of scope and location.'*

¹¹ Economic Regulation of Heathrow and Gatwick Airports 2008 – 2013 – CAA Decision, 11th March 2008, paragraph 13.30.

¹² Ibid, paragraphs 13.41 and 13.42.

factored into the Q5 price cap, the mechanism for trigger payments as set out by the CAA, will provide it a return on all of this. If, however, for some reason, perhaps beyond the control of BAA, a project were not to be undertaken, the CAA proposes to redistribute the sums at risk. easyJet sees a number of problems with such an approach:

- the CAA has offered no suggestion as to what circumstances it would consider beyond BAA's control, so this is open to interpretation, whilst establishing the veracity of such circumstances might be difficult;
 - sums at risk could be redistributed to projects with later completion dates, thus deferring and mitigating desired regulatory outcomes;
 - sums at risk could be re-distributed only to projects that BAA is able to undertake, thus negating the purpose of CAPEX triggers; and
 - as the CAA points out, sums at risk may anyway be added to or reduced.¹³
31. The CAA seems to have adopted BAA's mindset on CAPEX triggers, in that BAA would be in some way *'punished'* for not delivering agreed projects. This is clearly not the case. If a trigger were to come into effect, BAA would simply not benefit from a return that it had manifestly not earned. On the other hand, by allowing BAA a return on undelivered projects, the CAA is proposing not only to deny users the benefit of these, but also to require them to continue paying. easyJet considers that this is wholly unreasonable.
32. easyJet also notes that the CAA is proposing a range of circumstances under which it *'could revise the substance of triggers in the price control without the agreement of users.'*¹⁴ It is clear that this would be at the behest of BAA and easyJet notes that under the Airports Act 1986, any such change would require BAA's agreement.¹⁵ easyJet therefore does not understand how the CAA can propose a change control process over which BAA has an absolute veto – and then suggest it will be subject to user agreement.

Milestones and Benefits to Users

33. The CAA has stated that: *'triggers should be based on the performance of events with demonstrable benefit to users;'*¹⁶ easyJet finds it impossible to reconcile this position with the CAA's subsequently stated inclination to *'base milestones for projects on the completion date'*, while at the same time recognising *'that benefits do not flow directly to users until an asset comes into use.'*¹⁷
34. The CAA goes on to discuss the meanings of *'completion date'* and *'practical completion date'*; however, does it not provide a firm definition of either. In any case, it is clear to easyJet that neither of the two, whether or not they are the same, relate to an asset entering operation – that is, providing the *'demonstrable benefit to users'* that the CAA states is its objective.
35. easyJet considers that CAPEX triggers ought to be based on assets successfully entering operation; otherwise, projects could reach some earlier *'completion'* milestone, thus avoiding trigger coming into effect, but with associated assets never being of benefit to users. easyJet considers that this approach would be manifestly wrong.

¹³ Ibid, paragraph 13.42A.

¹⁴ Ibid, paragraph 13.42B.

¹⁵ Ibid, paragraph 13.42Bi).

¹⁶ Ibid, paragraph 13.13.

¹⁷ Ibid, paragraph 13.25.