



London (Heathrow) Airline Consultative
Committee

The Airline Community Response to the CAA Q6 Final Proposals for the Regulation of Heathrow Airport

25th November 2013

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1 Introduction

The Heathrow Airline Community (The Airline Community) welcomes the opportunity to provide further views on relevant developments since the publication of the final proposals in October 2013. The Airline Community response will review the relevant material from the CAA and HAL and focus on the following

- WACC
- Operational Costs
- Commercial revenue
- Traffic Forecast
- Willingness to Pay
- The Capital Plan
- Service Quality
- Licence

2 WACC

The Airline Community supports the analysis conducted by CEPA on behalf of British Airways (BA). This focuses upon new information since the Final Proposals - both from regulatory bodies and HAL's response to the Final Proposals. New information has been provided by the Competition Commission, the Office of Rail Regulation, Ofgem and Ofwat and is outlined in BA's submission. This unequivocally points to the CAA having over-estimated the cost of capital and in particular the cost of equity. This difference is over 110bps on the cost of equity when using the Competition Commission parameters on the risk free rate and equity risk premium for HAL. The analysis by CEPA also highlights factual errors made by HAL in their response, both in terms of data analysis and their understanding of financial theory. These errors should lead to great caution when looking at the arguments put forward by HAL.

The Airline Community will provide additional comments from its independent consultant Dr Jonathan Mirrlees-Black by 29 November 2013. Although these comments are outside the timeline for responses to the CAA, it is hoped that they may be taken into account due to the specialised nature of the subject matter.

3 Operational Costs

The Airline Community does not recognise HAL's 'stretch target' figure of £360m (excluding pensions) quoted within their Alternative Business Plan (ABP). Moving from the Initial Business Plan (IBP), which was the source of much of the discussion within Constructive Engagement, to the ABP, it is estimated that the HAL task is circa £330m. This figure ignores changes that have occurred since the publication of the IBP. Since the IBP there are a number of savings needing to be accounted for, the baggage system savings of £115m and the accelerated closure of

Terminal One with an estimated saving of £35m. Consequently the stretch target becomes significantly below £200m.

Additionally the pay freeze (£80m) and introducing more commercial terms within contracts (such as reducing the 70 minute paid breaks) does not form part of an unknown 'stretch'. Considering the benefits that will yield from two years of planning the 'Workforce Strategy' the Airline Community is persuaded that HAL have zero unknown stretch. The Airline Community urges the CAA to rectify this and introduce a target that reflects the findings of their consultants and offers benefit to passengers and all stakeholders.

The Airline Community agrees with HAL that proposed efficiencies must be achievable, but these targets should not be so 'easily achievable', with the benefit of over-achievement accruing only to HAL shareholder and not the passengers.

Whilst the Airline Community would concede that direct comparisons between airport and airlines are difficult, the relative scale of change can be compared and it would be expected that companies operating within the same industries, to be directly correlated in controlling their costs. The reality is that whilst airlines control and reduce their operating costs on a large scale, HAL ignore the fact that they are a key part of the supply chain and by continuing to increase their charges they place further pressure on an already struggling industry.

IDS are industry experts with a wide range of data to compare salary and reward costs. Given the importance of their study, and the time they took consulting with HAL and gathering data, it is simply not plausible that errors could be made on the scale that HAL are suggesting. The Airline Community can only assume that this is a defensive strategy.

The Airline Community does not support the HAL view that adjustments within the price control period should be made in respect of pension payments agreed with trustee's post any actuarial review. HAL do not have a history of offering their employees a pension benefit in line with commercial businesses and just being allowed to pass on increases without any pressure to manage costs is not an acceptable situation for airlines. If payments were to increase HAL should be expected to absorb this and find innovative ways to offset this increase elsewhere in their organisation rather than just increase their price. The Airline Community does not have such a luxury, and neither should HAL.

The Airline Community does not agree with HAL's desire to include past excess pension payments into the opening Q6 RAB. Again, these are costs that could and should have been mitigated through greater cost control in Q5 which would have benefitted the opening Q6 position. Again, to suggest just charging this back to airlines is not acceptable.

The saving associated with the new baggage contract is expected to rise to approximately 40% within three years. The Airline Community therefore disagrees with HAL's position that SDG has applied the same level of saving to other maintenance and cleaning costs. HAL quote 12.5%, but do not mention this has a glide path over five years. A greater challenge should be applied, with a minimal glide path, given the relative un-complex nature of these costs (in comparison to baggage systems).

The Airline Community disagrees with HAL that all efficiencies must be considered as a 'stretch'. Those identified, with a definitive plan (and even being implemented), together with an accurate financial assessment of benefits, must not be included in any frontier shift. Frontier shift accounts for new and innovative ideas that present themselves to any organisation each year, and therefore must be considered an addition to identified savings.

4 Commercial Revenue

The Airline Community is unable to comment on the figures that HAL are quoting regarding an increase in challenge from £20m to £50m, relating to renegotiated contracts. This has not been shared with the Airline Community and is not obvious or believable when you consider that HAL's commercial revenue has fallen by £13m between their Full Business Plan (FBP) and ABP.

The Airline Community finds it misleading that HAL is quoting £12 per passenger within their Commercial Revenue section, as this also includes ORCs. This figure should be ignored as the true figure is considerably less.

When assessing current trading the Airline Community cannot acknowledge that the '*per passenger*' figure alone is falling and will have a negative impact on all revenues for the next five years. Total Commercial Revenues also depend significantly on mix and volume, and as volume is growing above previous expectations at Heathrow, commercial revenues also should be expected to be above expectations. The Airline Community believes HAL has concentrated on the negative interpretation in this instance, and when taken out of context can lead to the wrong conclusion and the wrong decision. There has been no evidence provided to show that revenue per passenger has fallen, and this would need to be contextualised to prove that this would lead to lower Commercial Revenues.

5 Traffic forecasts

Since the Airline Community submitted its response to the CAA's final proposals, HAL has published its traffic numbers for October which were 4.6 per cent higher than the same month last year. These therefore continue both to show strong year on year growth and significantly outperform the forecasts in the CAA's final decision.

As set out in the Airline Community response, the base year of the forecast (2013/14) has a significant impact on the overall level of traffic over the quinquennium. If just an increase in the base year is built into the projections (with no change in the CAA's projected growth rates) this increases the projections for Q6 by 10m, as shown in the table below. The latest figures from HAL continue to prove that this type of adjustment is necessary.

The Airline Community continues to believe that in order to reach a fair settlement this growth needs to be captured in the base of the CAA's assessment. Failing to do so would mean the Q6 proposals start from an incorrect base and would therefore be a clear error of fact by the CAA in reaching its final decision.

Furthermore, on the 19th November the OECD published updated growth forecasts for the UK. This showed a significant boost to growth prospects. The Airline Community therefore believes, as well as the adjustment to the base year, the growth rate used in the forecast also warrants re-consideration by the CAA.

	CAA	LACC
2012/13	70.3	70.3
2013/14	70.2	72.4
2014/15	70.8	73.0
2015/16	71.0	73.2
2016/17	71.7	73.8
2017/18	72.5	74.6
2018/19	73.2	75.2
Q6 total	359.2	369.7

6 Willingness to Pay (WtP)

The Airline Community would like to make it absolutely clear that it was not consulted, as indicated by HAL on P14 4th paragraph, on HAL's Willingness to Pay research. Whilst the Airline Community was informed of HAL's intentions to carry out research, the Airline Community was not involved in the requirements capture, the design or the analysis of the findings or the recommendations which emerged from the research. In the opinion of the Airline Community, the survey was designed to elicit a specific outcome, not to objectively measure consumer choices.

As outlined in the previous response on the 15th August, the Airline Community is unable to support any of the findings of HAL's Willingness to Pay research which was undertaken by HAL on the Airlines' passengers. Difficulties have been detected in the following areas which cast major doubt on the reliability of the results:

- The scenarios and service propositions under review
- A lack of rigour in the academic underpinning for some of the work
- A lack of any effective consultation with the Airline Community

In light of the above, the Airline Community believes that the work undertaken by HAL is not reliable enough to substantiate the claims made in HAL's Revised Business Plan (RBP) and FBP and the CAA should not rely on the results of HAL's research to support the claim by HAL that passengers are willing to pay more for certain aviation products and services.

7 Capital Plan

Whilst there is a broad consensus regarding the level of investment required in Q6, the baseline cannot remain, solely, with HAL's ABP. The airlines have consistently maintained an Airline capital plan which meets the needs of all airlines at Heathrow and further efforts are required to ensure full convergence as this is in the passengers' interest. The airlines continue to believe that HAL's RBP of £2bn is not in the interests of passengers. Furthermore the Q6 Capex programme must start with a clear expectation that around £3bn as set out in the Airline's prioritised plan is necessary to enhance resilience and the passenger experience in Europe's most capacity constrained airport. While the exact amount actually spent will depend on overall affordability and the strength of the business cases presented, the Airline Community believes that the initial licence issued in February 2014 should contain terms to ensure the appropriate Capex programme including the necessary triggers to deliver the key projects.

One example, reflecting the dynamic nature of the planning framework, it is now apparent that Terminal Three may have a longer operational lifespan in the event that HAL are permitted to build Runway Three. If Terminal Three is now potentially required to remain in operation for c.20-25 years then this should be reflected in the assessment of business cases relating to it. With a 20-25 year lifespan the requirement for investment to improve the passenger experience and the longer period available for these projects to payback must be taken into consideration.

8 Service Quality

8.1 Introduction

HAL makes the comment that its proposals have been evidenced and data driven. The Airline Community notes that the proposals from HAL have, to a significant degree, been based on qualitative research. This research has then been analysed using quantitative methods but it should be noted the results of this analysis are still based on subjective qualitative research rather than objective evidence.

The Airline Community notes that HAL indicates that it is focussed on what matters to passengers. However, it is difficult to reconcile this position with the statement from HAL that it should not be burdened with increasing service quality regulation – this seems an anomalous position for the airport.

8.2 Control posts

The Airline Community notes the HAL comments on control posts. The standard which is in place in Q5+1 is that which should have been in place for most of Q5 and was the eventual fulfilment of a commitment HAL made to the Airline Community in the Q5 review to improve the standard for control posts in the first years of Q5.

HAL states that 'no evidence has been provided that anything other than a consistent service is being offered across Heathrow'. This statement seems to not take account of the performance records which show that Control Post 10A and Control Post 24 have both failed the standard for each of the previous 7 months. In addition CP20 the main control post for IAG Cargo's access

to T5 has also failed consistently. These have had a significant impact on the air transport operations associated with those control posts. However, HAL has continued to pass the service quality standard for control posts due to the airport wide averaging of the standard. Therefore, the CAA is correct in aggregating the control posts into groups for measurement rather than an airport wide average.

8.3 Bonuses

The basis of the quality based Public Interest was specifically in regard to the performance of the airport and need for HAL to pay rebates if quality was below particular standards. Therefore, the HAL comment that bonuses are required to maintain symmetry in the SQR scheme is not relevant.

Service quality regulation should be about ensuring HAL delivers the quality to the standards set by the regulator in return for the airport charges the regulator allows the airport to levy. The SQR scheme is not about incentivising HAL to outperform the regulatory standards – which should already be set at the levels most in the passenger interest. In any case HAL has not demonstrated any value to passengers from outperforming service quality standards.

8.4 Staff search

The Airline Community notes the importance of staff search for the punctual and efficient operation of air transport services – something that is recognised by all stakeholders to be in the interests of passengers. An interim standard was established by the CAA in Q5 with the expectation that stakeholders would work together to improve the initial standard. This did not occur. Unless the standard for staff search is improved by the CAA for Q6 there is a risk of the interim standard being locked in for the eleven years of Q5 and Q6 combined.

8.5 Pier service

The Airline Community notes the proposed pier service alleviations in the HAL response to the CAA's Final Proposals. An agreement has been reached between the HAL, the CAA and the Airline Community that Delta and Virgin will accept levels of pier service in T3 below the regulatory standard until Air Canada relocates from T3. However, this agreement also confirms that the other carriers should expect to receive the same level of pier service as they are currently experiencing in T3.

It should be noted by the CAA that the wider pier service alleviations in T3 have not been agreed with the Airline Community. Nor has the HAL proposal to combine the pier service levels of T1 and T2.

8.6 Licence modifications

The Airline Community notes the HAL request for clarification on the definition of a representative proportion of airlines for discussion on any licence modifications. The Airline Community considers the CAA to be correct in requiring agreement between the Licensee and the Airline Community. The LACC and AOC provide cross campus airline representation to the Airline Community covering all aspects of strategic development and operational needs. Coordination of this consultation will be undertaken by the AOC on behalf of the Airline

Community. The AOC represents an airport wide constitutional governance structure with a democratically elected Executive Committee of senior airline managers; combined with terminal specific AOC Standing Committees with elected Chairs and deputy Chairs and subject specific stakeholder groups with cross airline representation.

8.7 Automated security queue measurement

The Airline Community continues to welcome the proposal from the CAA that security queues should be measured on a per passenger basis through automated means. It is important that any such automated means are able to capture the actual queuing time of passengers. The Airline Community continues to work with HAL in the consideration of the Facial Recognition Queue Measurement technology and looks forward to developing this work with HAL under the auspices of the CAA.

9 Licence

The Airline Community notes the comments by HAL requiring it to agree certain protocols risks breaching of its licence. This is not the case because the CAA has indicated that where HAL and the Airline Community are not able to agree to a protocol the CAA reserves the right to opine on the issue. Therefore, a failure to agree would not result in HAL breaching its licence. The need to reach agreement with the Airline Community simply ensures that HAL is incentivised not to leverage its substantial market power in discussions with the Airline Community. This is something that is in the interests of passengers.

The need to reach agreement is not effectively a binding of third parties because any agreements would be willingly entered into by the Airline Community. However, if HAL is able to establish protocols which do not require agreement with the Airline Community this would be an application of licence conditions to bind third parties and is therefore not appropriate

The experience of the Airline Community in consultation with HAL over the course of Q5 and especially in the latter stages of the Q6 review demonstrates the importance of requiring HAL to agree proposals with the Airline Community rather than simply require HAL to undertake consultation.

The Airline Community refutes the claim by HAL that it has been unable to agree protocols (referred to as rules of conduct by HAL in their response to CAA). A significant number of protocols have been agreed between HAL and the Airline Community. For example the Airline Passenger Welfare Protocol which has been agreed. It has also been agreed with HAL that whilst the Airline Passenger Welfare Protocol is referred to in the Conditions of Use it is not part of the Conditions of Use. Therefore, the claim by HAL that it has been unable to agree protocols with the Airline Community is not credible.

HAL's recent disengagement from the Airline Community and unilateral re-assessment of the capital proposals which were agreed in Constructive Engagement evidences the need for a licence condition requiring greater accountability on the part of HAL with respect to capital delivery.

The Airline Community recognises the resources committed by HAL to the Constructive Engagement process. However, in the period post Constructive Engagement the evidence indicates that HAL has unilaterally amended its position on many of the outputs agreed in Constructive Engagement. For example, the capital plan and also the Joint Priorities agreed to inform airport development and operations. Therefore, it is necessary for the Constructive Engagement process and policies to be reflected in the licence.

9.1 The CAA's proposal to develop a licence condition on capital

Whilst the formal process of Constructive Engagement concluded in December 2012, it must be emphasised however that HAL ignores the fact that it had agreed to continue talking to the Airline Community about developing the capital plan post Constructive Engagement, and had done so for some months (January – June). It is these conversations that HAL suspended unilaterally.

It is also true that the HAL SOP included Scenario A, which was a £2bn plan. However, all of the discussions thereafter with airlines related to a £3bn plan, and all of HAL's work internally was based on a £3bn plan until June 2013.

The following points are in the same order as they appear in HAL's paper on page 68:

- The Airline Community cannot accept HAL's statement that the proposed condition is not consistent with CAA's statutory powers. The issue is not that the airlines could come up with investments without HAL's support and force them through. The CAA is suggesting, and the Airline Community strongly supports their position, that the airlines simply have a right of appeal if HAL is trying to force through investments in projects that airlines do not support, or to appeal if it is believed that expenditure is unjustified (e.g. additional expenditure on T3IB)
- The Airline Community rejects HAL's assertion that the proposed Capex condition is effectively irrational, unreasonable or inconsistent with other aspects of the CAA's price control decision. Whilst the Airline Community supports CAA's price control process to "generate certain outcomes" and HAL being free to choose the manner in which it achieves the outputs, this cannot be at the expense of HAL proceeding with projects that do not have airline support for commercial, operational or strategic reasons. Consequently a licence condition is required to protect the passenger interests.
- Proposed condition is disproportionate – the existing safeguards which they mention will not address the situation in which HAL is proceeding without airline support.
- Undermine Heathrow's legitimate expectations – this issue was discussed in Constructive Engagement in the Capex Efficiency Group, and the Airline Community made its position clear on more than one occasion. Furthermore it does not believe that the License condition would "lock in" the Capex programme – it would only simply ensure that HAL did not proceed without airline support.

10 Other Price Control Issues

10.1 S - Factor

The Airline Community notes the comments from HAL on the treatment of the S-Factor. The Airline Community position remains unchanged. This is that it is consistent with best practice regulation for HAL to be incentivised to achieve any security requirements as efficiently as possible. The application of a dead band achieves this. Also this dead band should be uplifted by RPI to the revised figure of £20m proposed by the CAA.

The suggestion from HAL that there should be a threshold for each claim would simply add complexity to the S-Factor process and allow HAL to disaggregate holistic solutions into below threshold initiatives. This would blunt the incentives of the dead band and not be in the interests of passengers.