YOUR LONDON AIRPORT
Gatwick

5 MARCH 2018

Stephen Gifford
Civil Aviation Authority
CAA House
45-59 Kingsway
London WC2B 6TE

Dear Stephen,

Re: CAP 1610 Economic regulation of capacity expansion at Heathrow: policy update and consultation

Gatwick Airport Limited (GAL) welcomes this opportunity to comment on the CAA policy update and consultation.

As in our previous responses, we note that the price control elements outlined by the CAA are not developed with the circumstances at Gatwick or any other UK airports in mind, and would thus not apply directly or automatically to other airports than Heathrow. We would therefore expect future policies in relation to Gatwick or other airport to be considered from first principles and appropriately consulted on.

In our previous response to CAP1510 and CAP1541 we raised a number of specific concerns:

1. The potential impact of Heathrow's charges on airport competition;
2. Ensuring that Heathrow delivers the NWR scheme that was selected;
3. Ensuring that Heathrow's charges are kept flat in real terms; and
4. Surface access and cost allocation.

We remain concerned on each of these points and re-iterate our previous responses on these subjects. We continue to consider that it is vitally important that the CAA consider the impacts of its policies on competition in the London airport market to avoid creating distortions, which may have the effect of compromising the incentives on private parties to undertake investment in the London airport market.

In terms of the content on CAP1610 we offer the following specific comments.

Cost of Capital
While the CAA is heavily caveating the range of cost of capital estimates developed by its consultants PwC as "early and preliminary", we note that when combined with the two to three year extension to the start of H7, it is now potentially four or five years before any cost of capital estimate would apply. During this period there are significant risk factors which may play out in the investment markets, including:

- the economic impact of Brexit; and
- the expectation that the currently expansionist monetary policy[1] will need to be scaled back during that period.

We would therefore caution that these estimates need to be considered very narrowly in the context of Heathrow expansion and may need updating more than once before they are ultimately adopted for the purposes of setting Heathrow's price control.

Debt indexation
We note the policy on debt indexation, as well as its background in the National Audit Office report into the previous water price control (PR14). We do however note that under normal market conditions indexation is unlikely to materially affect the variance between forecast and outturn cost of debt over a full interest rate cycle. Much of the observed variance over the recent period is likely to be attributable to quantitative easing continuing for longer than expected following the financial crisis.

Cost of debt indexation is furthermore not a "cost-free" policy option. In particular, the CAA should carefully consider:

- how it may negatively impact on the incentive to raise debt finance in the most efficient way; and
- how a lagging index will systematically either under- or overestimate the cost of debt (depending on whether the yields are increasing or decreasing over time). This gap in turn could create pressures on financeability and on the regulator from different stakeholders to adjust the indexation policy *ex post*.

These are new challenges arising from such a policy which were not present in a world where the metric was re-set periodically.

Financeability and inflation
We note the CAA's proposal to retain RPI indexation for the period 2021 to 2025. We consider this to be a sound approach. In time it is possible that a market in Government debt investments which are linked to the CPI- or CPIH-indexes may develop, which would in turn enable commercial debt issuance with this inflation indexation.

Financial resilience and ring fencing
We note the extensive discussion regarding potential additional financial resilience and ring fencing provisions. While we note that these provisions are proposed to be specific to Heathrow's licence, we would nevertheless caution against importing lessons from other licensed utilities into aviation without first checking against the regulatory costs and benefits of doing so in the specific context of the airport under review.

In particular, we note that the market-based incentives on an airport to remain financially resilient are already very strong, arising from the requirements imposed directly through bond covenants. These convents require the airport to comply with its licence conditions. Further, the ability to raise

[1] As exemplified by the current negative real interest rate, measured by the difference between CPI inflation at 3% and the Bank base rate at 0.5%.

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additional debt will depend on, among other factors, the bond holders and rating agencies being satisfied that the airport will not deviate significantly from the commitments it has made to the regulator through its business plan (including how it plans to finance itself and the level and timing of equity contributions and proposals for any dividend holiday). These are strong commercial safeguards.

Furthermore, even in the case of financial distress, a large airport is very likely to generate positive operational cashflows and therefore continue to operate and provide services to consumers.

We would expect the CAA to test any new licence conditions against its duty to regulate only where necessary and to evaluate carefully the cost and benefits of specific conditions.

Regulatory treatment of early construction costs
In a normal market where the product cannot, or is expensive, to store, scarcity of capacity will lead to forward market prices rising to signal to providers that additional capacity is needed (and ultimately spot prices will also rise to ration capacity). This means that in the short term prices for use of capacity would be expected to rise somewhat until the scarcity is lifted. This is particularly relevant for airport capacity given the capacity developer (the airport) unlike the capacity user (the airlines through the slot system) does not see all the economic effects of scarcity.

However, we would also note that many infrastructure projects in the UK[2] and elsewhere have been financed have been by the developer entering into contracts with users. Such contract would typically stabilise prices for users in return for a capacity right or utilisation commitment.

We note that the CAA's proposed approach may mimic these outcomes for customers by allowing prices to rise somewhat in the short term, while stabilising charges over time.

Please do not hesitate to contact me if you wish to discuss any aspect of this response.

Yours Sincerely

Mattias Bjornfors
Economic Regulation Manager

[2] This includes investment in the BBL, Interconnector UK and Langeled pipelines, and the Isle of Grain, South Hook and Dragon liquefied natural gas terminals from 2005 to 2010 – sufficient to meet more than 50% of the UK's daily peak winter gas demand, as well as numerous power standards and gas storage facilities.