

Promoting cost efficiency and financeability – seminar note

Wednesday 20 April 2016: 9:30-11:30am

CAA House, Kingsway, London

CAA	HAL	Airlines
Stephen Gifford	Richard Hepburn	Karen Brand (VA)
Rob Toal	Matt Greenfield	Simon Begby (AOC)
Maggie Kwok	Manish Madhas	David Hart (BA)
PJ McCloskey	Antonio Diaz	Becky Hammond (BA)
Rod Gander	Carmel Blair	Ramona Klopfer (LH)
Stuart Holder	Louisa Pashis	Andrew Cunningham (AOC)
	Sam Burnell	Simon Arthur (AOC)
	Jonathan Sandbach	Cesar Raffo (IATA)

Welcome and introductions

1. The CAA welcomed stakeholders to the meeting and explained that the purpose of the seminar was to discuss and receive views on the CAA's proposed approach to the H7 strategic theme related to promoting efficiency and financeability. This was the first of four seminars over the coming months that will be used to help the CAA to develop its thinking ahead of the H7 'Policy Update' document scheduled for September 2016.
2. The CAA explained that a paper had been circulated in advance and the seminar would consist of three main sections (i) a discussion of the timetable including when HAL should be asked to produce its initial business plan and the relationship of that plan to the process of constructive engagement (CE) (ii) the proposed approach to assessing

efficiency including a number of priority studies that the CAA proposed to carry out over the coming months and (iii) aspects of the financial framework including the allowed return assumption that HAL should use in its plan, the treatment of debt and the prospect of switching the price control from an RPI to a CPI basis.

Timetable

3. The CAA noted that timetabling issues were complicated by uncertainty around runway development and that some stakeholders had expressed an interest in extending the current control period by one year or more. These circumstances may require a more holistic review of the timeline and they would be considered further in due course. For the purposes of the seminar it was agreed to focus on the timetable issues set out in the CAA paper.
4. The CAA explained that the H7 discussion document envisaged HAL's initial business plan being issued in January 2017 followed by constructive engagement. This approach implicitly assumed that there would be a period of informal engagement between the airport and airlines during the second half of 2016 to help inform that plan.
5. HAL had subsequently suggested there may be a case for the initial plan to be received later in the process around June 2017. This approach would mean that the plan is issued closer to the date of the determination reflecting the up to date position at that time. This would also give more time for the Consumer Challenge Forum (CCF) to be established and for HAL to account for the benchmarking that the CAA plans to carry out.
6. The CAA considered that HAL's proposal may unduly back end load the process although the CAA did see the case for allowing more time for the CCF to be formed and to help with the efficiency assessment. On that basis, the CAA had set out an alternative timeline which assumed that the plan would be issued in March 2017 and effectively straddled by two phases of CE. The first phase would focus on the inputs to the plan with the second considering the scrutiny of the assumptions within the plan.

7. Airlines expressed general support for the revised approach including the prospect of two separate phases of CE. Airlines considered that they would want to consider further the timings of CE particularly the respective length of each phase.
8. HAL was also supportive of the proposal and noted that it's priority was to produce a high quality initial business plan and there were a number of options for handing the pre-plan phase of the process e.g. through less formal think tank style engagement. In that context, HAL had been considering hosting an industry event to kick the process off. HAL mentioned that it would be helpful if the overall process could take account of its governance constraints including the need to allow time for Board engagement and sign off.

Efficiency assessment

9. The CAA outlined its proposed overall approach to carrying out the efficiency assessment for H7. This was based upon splitting the benchmarking phase into two parts, an initial baseline analysis to be undertaken in 2016 to inform the earlier stages of the process followed by a second phase to inform the CAA led part of the review.
10. The airline community commented that how the CAA approached the assessment of efficiency was important. They believe that the CAA should set the H7 control according to what an efficient business operating in a competitive environment would need, rather than adopting HAL's current OPEX and adding an efficiency challenge.
11. There was general support for the proposed approach to the studies with airlines noting they would like to drill into the detail of the studies and that the CAA should consider casting the net wider than it has in the past for example by looking at comparators from other industries and from other regulated sectors. It was noted that normalisation and ensuring comparability would need to be carefully considered.

Terms of reference for studies

12. The CAA set out an overview of the 5 priority studies it planned to commission. HAL queried the purpose of the cost and revenue allocation work and noted that its accounting practices were already subject to an audit process. The CAA clarified that the focus of the study would be ensuring that HAL's accounting policies (and practices) are consistent with best practice regulatory economic principles such that the outputs in the HAL business plan are appropriate and in line with the CAA's statutory duties.
13. On the capital study, airlines noted that they would prefer to see more emphasis on capital efficiency at this stage of the review and suggested that the IFS be commissioned to review HAL's capex efficiency and to make proposals on changes to the regime to improve it. HAL noted that the capital efficiency handbook had been developed to oversee the process and that any work should have regard to the principles set out in there.

The allowed return

14. The CAA explained that it did not intend to focus, at this stage, on specific estimations of the WACC, but rather how it should approach this issue overall. The CAA was interested in views on when it should provide more information on the allowed return during the H7 process, and in particular whether it should give an updated estimate prior to HAL submitting its business plan. The CAA also asked for views on the continued use of the CAPM to estimate the cost of equity.
15. There was a lengthy discussion of the pros and cons of different approaches with HAL favouring an updated view on the WACC early in the process so that its business plan is based on the most up-to-date information possible. Airlines proposed it may be premature to provide a view at this stage as it may gain undue traction throughout the review process. Airlines suggested the Q6 WACC could be used as a holding position with HAL free to use other illustrative WACCs if they could provide

a rationale for deviation from the Q6 WACC. There was a general preference to use the CAPM as this was well understood by all parties.

The cost of debt

16. The CAA noted for information that it would, once again, be considering the implications of potentially indexing the cost of debt and that it had commissioned a joint study with Ofwat to consider this issue in greater detail. The parties agreed that it would be useful to examine this further through the H7 review.

RPI / CPI

17. The CAA explained that it was also considering the possibility of using CPI instead of RPI to adjust for inflation in the regulatory framework. In discussion HAL raised that there was currently no market for CPI-indexed debt, the CAA had partially moved to CPI in the NATS context and that other regulators had been considering similar issues. There was agreement that there were a number of issues to consider including the relevance of CPIH so it would be helpful to consider the detail through the H7 review.

AOB / next steps

18. The CAA noted that two additional seminars had been arranged for the next two weeks considering the approach to involving consumers and the incentive framework. A further session related to increasing resilience would be set up for mid-June.