

To: The Civil Aviation Authority

ECONOMIC REGULATION OF HEATHROW AIRPORT LIMITED: H7 INITIAL PROPOSALS – DRAFT LICENCE MODIFICATIONS

This is the Arora Group's (Arora) response to the consultation document published by the CAA on 23 November 2021 setting out draft modifications to Heathrow Airport Limited's (HAL) licence as part of the H7 price control review (CAP2275)¹. The response date was extended by the CAA to 21 January 2022.

Since CAP2275 was issued, CAA has put in place a one year "holding price cap" for HAL (CAP2305), which was implemented because the framework for a "full H7" (including a true up for the year 2022) would be set during 2022. This one year time period also provides the CAA with the time to address the concerns raised by Arora as it considers the enduring H7 arrangements for HAL, which is the purpose of this response to the CAA consultation.

Given that many of the issues relate primarily to airline operators, as a non-airline operator Arora, should not, prima facie, be directly affected by the issues raised in CAP2265. There are however some notable exceptions, primarily relating to particular charges arising under 'Other Regulated Charges' (ORCs), which Arora has attempted to engage HAL upon for quite some time, with the last letter from Arora to HAL on this matter being sent on 25 October 2021 (to which no response has been received). Since nothing has come of that engagement, Arora has been and is nevertheless materially impacted by HAL's pricing regime.

Arora has been significantly impacted by the changes in ORCs through Q6 (and the various extensions) and our experience in seeking to address these changes, both with HAL and the CAA, raises the concern that the issues that will not be resolved by the CAA's proposed licence modifications. Therefore, we have, where relevant, set out our views and concerns below relating to certain of the issues raised in the CAP2275 proposed licence modifications, as well as suggesting changes to the licence conditions to address our experience of the operation of ORCs.

Our response to CAP2275 is principally focused on the licence conditions that are intended to implement CAA's proposals relating to ORCs for specified services and facilities. Hence we provide comments on the main elements of the CAA's proposals together with our comments on the proposed licence modifications, and as well as addressing our concerns about the lack of protection with respect to ORCs.

Having addressed the issues set out in the proposed licence conditions, we then turn to the issues that are not set out in the proposed licence conditions. That is, we touch on the issue of Heathrow West's² request for funding of costs related to the preparation of a development consent order (DCO) with respect to a new terminal infrastructure that would be necessary for a third runway at Heathrow.

¹ CAP2275 seeks to put in place the policy proposals contained in the October 2021 Initial Proposals (CAP2265).

² Heathrow West Limited is an entity within the Arora Group.

General approach to 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 material concerns about the way in which ORCs are set and charged for by HAL with the result that Arora, along with other non-airline operators at Heathrow, is required to pay disproportionately large sums for utility and other services which seemingly³ bear no relation to the economic cost of their supply. These, we say wholly unjustified charges, are ultimately borne by passengers using hotels and other facilities and thus operate against the consumer interest.

The regulatory framework for ORCs is not working

Published gas and electricity charges at Heathrow Airport are significantly higher than published charges at Gatwick and Manchester airports. Further, 'on' Airport water charges at Heathrow Airport are multiples higher than 'off' Airport water charges. When Arora has sought clarity of these charges, HAL's substantive response to date is to effectively avoid providing any such clarity and hide behind a purported explanation that "these are regulated charges".

Arora therefore supports the CAA's general approach as articulated in CAP2265D (and set out in the licence conditions set out in CAP2275) to ensure that the interests of consumers are properly protected and to ensure that HAL has incentives to efficiently provide various services. However, we do not consider that the proposals set out by the CAA in the proposed licence conditions go far enough to ensure that customers are protected as there are no incentives to ensure that HAL provides these services efficiently and economically. Our concerns with respect to consumer protection, and lack of HAL incentives, are then exacerbated by the proposed approach to the ORC governance process which is centred on the airline community at Heathrow Airport. The discussion in CAP2265D, and subsequent licence conditions in CAP2275, make little or no reference to non-airline operators. There is, however, a significant non-airline community who are actively competing to provide a wide range of associated services for passengers and airlines at Heathrow Airport and who are affected by the proposed ORC regime.

We therefore discuss 2 principal areas that are missing from the CAA's licence proposals. First, we suggest changes that would ensure efficiency on the part of HAL in the provision of ORCs. Second, we suggest changes that would address the governance shortcomings in the licence conditions proposed by the CAA. We then comment on the marginal cost approach suggested, and then conclude with comments on the licence drafting itself.

Ensuring efficiency and economy

It is essential that these services provided by HAL (in most cases with no possibility of alternative provision) can be provided competitively, that consumer interests impacted by ORCs are treated equivalently to consumer interests impacted by airport charges, and crucially that HAL is sufficiently regulated by the CAA and its licence so that it cannot unfairly exploit its position as dominant airport operator vis-à-vis non-airline operators.

³ We have repeatedly sought to understand how HAL has arrived at its unit costs for services such as water. Despite multiple letters to, and meetings with, HAL regarding this issue we have yet to receive sufficient information to take an informed view.

As has been set out by Arora in previous responses, and in correspondence with the CAA and HAL, it is clear that the current ORCs are not subject to the regulatory rigour and oversight that applies to airport charges. Further, once ORCs have been set, there seems to be no regulatory investigation as to whether charges set during a price control period are appropriate, economic or efficient. Arora's exposure to these charges, and experience of trying to understand and challenge such charges, has led us to conclude that ORCs need further regulatory oversight. The proposals below, which would be incorporated into the existing HAL licence conditions, seek to improve the regulatory oversight of ORCs.

Arora therefore proposes 4 areas for development in the licence conditions put forward for consultation:

1. HAL should be required to demonstrate that where it is procuring services in a competitive market (such as electricity, gas or water), that such procurement has resulted in costs to HAL that can be competitively benchmarked.
2. This demonstration of competitive sourcing would then be subject to an independent value for money audit. This would be in line with other regulated companies, whereby services have to be demonstrably procured in an efficient way and are subject to independent audit accordingly.
3. That ORCs are only able to come into force once the CAA has confirmed that the charges are in compliance with the ORC methodology statements.
4. That the licence conditions not only require a greater element of transparency in the level of detail provided about the ORCs, but also provide stronger controls on HAL's ability to make unilateral changes to costs and charges.

Governance arrangements

The changes above would improve the overall regulation of the charges covered by ORCs. However, because the focus relates principally to airlines, as a non-airline operator, Arora's ability to properly influence the setting, and oversight of ORCs is effectively frustrated. We therefore call on the CAA to provide greater rights to non-airline operators with regards to ORCs. As such, Arora supports the strengthening of the ORC governance arrangements, albeit that the CAA's proposals need to go further. To date, Arora has had significant concerns that HAL has not provided full transparency in its approach to setting ORCs. HAL has consistently failed to provide details of how it allocates costs for the purposes of the ORC charging mechanisms and what costs are actually included within annuities and allocated costs, and how costs are recovered from year to year.

The 2 further proposals below, to add to the 4 above, seek to address these shortcomings:

1. That non-airline operators who are required to pay ORCs are put on a level footing with airline operators in the scope of the rights to receive information and raise objections in the licence conditions.
2. That the licence modifications include a dispute resolution mechanism and right of appeal for non-airline operators in respect of ORCs.

Move to marginal cost approach

CAP2265D sets out HAL's proposal to move to a marginal cost approach under which the fixed costs (or annuities) and allocated costs would in future be recovered through the regulated airport charges rather than ORCs. The CAA has supported this stating "We

consider that this change is needed to deliver the benefits of marginal cost prices 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”.

Save for the focus (again) in this statement on airline customers, Arora fully supports this approach given that the inclusion of annuities and allocated costs, combined with periodic under or over recovery, has resulted in very significant charges for basic utilities which bear no relation to their economic cost. This means that in relation to certain operators at Heathrow Airport, whom are told by HAL they must procure services through HAL, they are then disproportionately bearing a significant portion of HAL’s cost base. This, taken together with the lack of choice permitted by HAL in terms of procuring services from parties other than HAL, leads to a wholly inequitable outcome.

We note that the proposal suggests a marginal cost approach for airlines and non-airline parties. Clearly, should this proposal be changed following consultation, Arora would need to understand the impact of any change to this proposal.

Comments on the proposed licence modifications

We have provided comments below on the specific conditions, however, by way of a general comment we find the drafting contained in CAP2275 of Condition C2 confusing, inconsistent and that it does not achieve the CAA’s stated aims in CAP2265D.

Licence condition (as renumbered)	Comments
C2.1 and C2.2	<p>Arora supports these amendments but suggests that the obligation is tightened so that sufficient detail about its methodology is published. We therefore suggest that the words “to a sufficient degree of detail and with sufficient clarity so that the CAA and users of the Specified Facilities can fully understand the methodology” are added to the obligation in C2.1. This ensures that HAL does not simply provide an overview or a confusing set of data and adopts a similar approach to the wording in C2.4.</p> <p>We also suggest that there is insufficient time between publication of the cost methodology and any CAA notifications to change the methodology, particularly since this time is meant to include a “reasonable period of consultation”.</p>
C2.4 and C2.5	<p>Arora supports these amendments which will help to provide much greater transparency of HAL’s approach to costs.</p> <p>It is unclear, however, how the proposed C2.5 will sit with the requirement to provide the methodology in C2.1.</p> <p>It is within these licence conditions that Arora’s proposals to ensure efficiency, including the requirement for an independent audit, would be incorporated.</p>
C2.6, C2.7 and C2.8	Whilst C2.2 permits the CAA to intervene in setting the cost

	<p>allocation systems in C2.1, C2.6 would appear to allow HAL to depart from the cost allocation methodology or the pricing principles without any oversight or intervention from the CAA (contrary to the approach set out in para 13.31 of CAP2265D which states that “<i>We therefore intend to make some changes to the licence to explicitly require HAL to agree and comply with the governance protocol, including the cost allocation and pricing principles</i>”). We note however, that the proposed modifications to Condition F1 include “The Licensee’s charges that are subject to Condition C2”.</p> <p>We suggest the drafting of Conditions C2 and F1 are more closely aligned and/or cross referenced to ensure that the proposed changes achieve the stated objectives in CAP2265D. If there is ambiguity, then whilst HAL is required to provide transparency as to any changes, the controls on them doing so are unclear. Arora requests that there is greater clarity to ensure that the CAA, and users of the Specified Facilities, have clear rights to intervene with regards to such changes in advance of these being made.</p>
C2.9 – C2.13	<p>We note the CAA’s objective set out in CAP2265D which states “<i>We will work with HAL and the airlines to ensure that we have an appropriate role in determining disputes, which should allow for effective dispute resolution and a targeted and proportionate approach to regulation</i>”.</p> <p>It would seem from this drafting that “modifications” covered within these conditions, relate to modifications to the licence conditions and not to the costs or charges. Our understanding is that the latter is covered by the proposed mechanism in Condition F1.</p> <p>As currently drafted, modifications and requests for a CAA determination can only be made by the AOC. As noted elsewhere in this response, the CAA’s focus appears to be only on airline operators. Such an approach is also inconsistent with the approach taken in Condition C in which HAL is required to provide information not only for the CAA but also for “users of the Specified Facilities” and seems inconsistent with the definition set out in C2.15. Arora requests that the rights in C2.9 – 2.13 are extended to all users, including non-airline users, of the Specified Facilities.</p>
F1	<p>Arora supports these proposals. However, there is some ambiguity as to whether Arora and other non-airline operators would be covered by this Condition. “Relevant Parties” is defined as “<i>those stakeholders that need to be consulted for each protocol, including any groups or boards already established for the purpose of developing protocols</i>”.</p>

	<p><i>and in place at the date this Licence was granted</i>". In the context of the changes to F1, this is unclear and Arora requests that greater clarity is provided and that Relevant Parties includes non-airline operators and users of Specified Facilities so that they have a clear right of recourse with regards to the charges and framework under Condition C2.</p> <p>Further, Arora calls on the CAA to amend Condition F1.8 to refer to "shall" and not "may" when referring the matter to the CAA. It also calls on the CAA to expand the right in Condition F1.8 to allow parties other than the Licensee to refer the matter to the CAA for determination. Without such a right, users of Specified Facilities (as well as airlines) have no recourse or ability to invoke the supervision of the CAA over the charges for Specified Facilities which are regulated as a result of their inclusion within the licence.</p>
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Costs associated with the Development Consent Order prepared by Heathrow West

In Arora's submission to CAP1940, we set out the case for the CAA to consider the case for recovery of costs associated with the preparation (by Heathrow West) of a DCO with respect to terminal infrastructure connected to the proposals for a third runway at Heathrow. The CAA has gone to considerable lengths to ensure that costs incurred by HAL in respect of its own DCO are to be reimbursed back to it through its own regulated asset basis mechanism. Arora made the point, with extensive argumentation, that such an approach with respect to Heathrow West's costs was consistent with the CAA's duties and its approach towards HAL. CAA consulted on Heathrow West's request for recovery of costs in Appendix 0 of CAP2139 and Arora notes the responses by parties to that consultation.

Since that consultation, CAA has yet to address the Arora request, including seeking views from Arora as to the responses made to that consultation. While we note that the CAA has put in place a 1 year price control for HAL, we are concerned that it appears little consideration has to date been given to Arora's request.

In a meeting of 3 September 2020, Arora requested that the CAA deal with its request for cost recovery by way of consultation ahead of CAA's decisions on the final HAL H7 price control. CAA advised that it was intending to consider this request as part of the HAL H7 process and this was undertaken by way of consultation in CAP2139. We are now in 2022, with the HAL H7 interim control commencing on 1 January 2022. There has been no further elucidation of CAA's consideration and analysis of Arora's request. We do not see how any request for cost recovery can put into effect unless by way of an amendment to the HAL licence. We note that the CAA's consultation on the H7 licence conditions is silent on any inclusion of a cost recovery mechanism in line with Arora's request as is the licence condition imposing the interim price control.

In summary, Arora's request for recovery of costs has not substantively been taken forward by the CAA since the consultation carried out via Appendix of CAP2139 (in April 2021) and remains therefore with the CAA for due consideration. We look forward to consideration and resolution of Arora's request by the CAA and we request a timely response from the CAA as to its proposed way forward.

Concluding remarks

We would welcome discussion with the CAA on any aspect of our consultation response above. Arora, as with a number of other operators based at Heathrow Airport, are key stakeholders for the purposes of the CAA's regulatory oversight, as well as in relation to the obligations that HAL owes to all users of the airport.

As a result, it is imperative that full and proper regard is made by the CAA and HAL concerning the interests of all non-airline operators throughout the H7 price control process. Arora will therefore seek active engagement in the price control with a view to protecting its interests.

From: The Arora Group

21 January 2022