easyJet response to the CAA consultation on its draft policy for the economic regulation of new runway capacity

Introduction

easyJet supports the joint airline response to the CAA's consultation. The issues raised in this response are additional to those raised in the joint airline response.

Summary

We support many of the CAA's proposals in its consultation. We agree that commercial contracts, if achievable, would be preferable to intensive regulation. We also recognise that it is too early for the CAA to definitively set out how it would regulate any new capacity.

However, we have two fundamental concerns with the CAA's proposals. The first is that by supporting the pre-funding of any planning costs the CAA is undermining and distorting any future commercial discussions. We should also note that we believe pre-funding is the wrong approach.

This leads to our second concern. The CAA risks taking decisions based on theoretical assessments that do not reflect the operation of airport markets or empirical evidence. Evidence from easyJet's own airport contracts contradicts the CAA's theoretical analysis that in competitive markets investment is pre-funded.

We urge the CAA to carry out an empirical assessment of the issues before it puts in place any regulatory measures.

The role of commercial contracts

easyJet supports the objective of airport/airline transactions being governed by commercial contracts. This is the best way to deliver services that passengers value. The CAA has said it wants to create space for commercial discussions over new capacity and easyJet would welcome a successful commercial outcome.

Over the last few months we have worked with both HAL and GAL to try and achieve this. However, we have made no progress with either airport on a commercial agreement. [✂].

[✂] We note it is in practice likely to be difficult for either an airport or an airline to reach a contract covering a period of at least twenty years, particularly when there are so many unknown factors in any development of a new runway.

We also note that neither airport has outlined any potential benefit to easyJet, or our passengers, of the pre-funding of new capacity. Instead the airports have focussed on arguments that increasing charges ahead of new capacity reflects the demand and supply balance at the airport (GAL) or that pre-funding is the prevailing regulatory framework (HAL). This is not what we expect from a commercial discussion, where we would expect a supplier to outline the benefits of higher charges.

The CAA's proposals make it clear it continues to want airlines to try and achieve commercial outcomes with the airports. However, the CAA's proposals will hinder these discussions and bias any potential outcomes. By proposing that either HAL or GAL could pre-fund planning costs through their regulated charges, the CAA is putting in place two significant barriers to airlines and airports reaching commercial agreements.

The first results from the CAA taking a decision on the path of future regulated charges, which it is doing by proposing that the airports can charge for planning costs. The CAA has determined that both Gatwick and Heathrow have significant market power. The CAA's decisions on charges are therefore very likely to affect actual charges. By taking a decision on future charges, the CAA will therefore bias and potentially quash any commercial discussions.

Secondly, the nature of the CAA's proposal will impact the terms of any potential negotiation. If the CAA signals up front that it will support airports pre-funding planning costs through their charges, it is unclear what incentives the airports would have to move away from any form of pre-funding for the capital costs of new capacity. Their expectation must be that the CAA will allow the pre-funding of capital costs,

We also note that where an airport has significant market power mutually beneficial commercial contracts can only be agreed within a framework set out by the regulator. Without some form of regulatory intervention there is nothing to stop the airport setting charges above the competitive level.

Competitive markets and the treatment of the costs of new capacity

The CAA's consultation document has failed to provide any empirical assessment of the charges in competitive airport markets. There are also significant flaws in its theoretical analysis, which are covered in the joint airline response.

We are concerned that the CAA does not appear to have developed any evidence to support its analysis. We are not aware of the CAA discussing the operation of the airports market in the UK, or other States, with either airlines or airports or of it seeking evidence based on existing contracts. This is unfortunate as the UK has a well-developed market with a history of airport/airline contracts going back many years.

easyJet has contracts with a wide range of airports, including both Luton and [✂] in the UK.

London Luton airport is planning a significant expansion, almost doubling capacity to at least 18m passengers. [✂] This expansion will involve a very significant increase in the value of the airport's fixed assets. easyJet reached a long term agreement with Luton in 2014, replacing an older contract. This agreement spans the period of Luton's expansion. Under the new contract easyJet's charges are lower (if we reach agreed passenger volume targets) than those of the earlier contract, which did not anticipate any airport expansion. There is no increase to pre-fund the investment.

[✂] airport is also considering a significant investment in its terminals. [✂] These discussions are not predicated on any increase in charges to ‘pay’ for this investment.

We suggest that the CAA carry out an in-depth study of the UK market, in particular focussing on airports that either have expanded or are planning to, before it reaches any conclusions on the price profiles of competitive airport markets.

Developing empirical evidence

There are two distinct arguments for pre-funding.

1. Pre-funding reflects competitive market outcomes and therefore should be allowed in regulated charges.
2. Pre-funding is needed to support the investment cash flow costs of the airport as otherwise expansion would not occur.

Each of these requires a separate empirical assessment of the evidence. We believe the evidence does not support the first argument. The second will rest on a cash flow and funding ability assessment of the proposed expansion. We would suggest that any reliance on forced effective taxation (through pre-funding) brings into question the business case of an expansion project. However, while not supporting this form of pre-financing, we do recognise that it may be seen as a practical necessity.

We ask that the CAA bring empirical evidence and clarity to any future debate on pre-funding and any proposed justification of its use.

Gatwick

We disagree with the CAA’s suggestion that in the absence of regulation prices at Gatwick would not rise (3.36). It seems to reach this conclusion because under the regulated commitments regime at Gatwick, GAL has agreed discounts to its published charges with some airlines.

There are two significant facts that the CAA should take account of.

First, the regulated commitments regime sets out a regulated price cap and a regulated average price. It effectively *requires* GAL to agree discounts, unless it charges no airline more than the regulated average price. So the existence of discounts is not evidence that prices would not rise absent regulation. We also note that GAL is explicitly allowed to recover these discounts through charges to other airlines. This is not the approach taken to any discounts offered at Heathrow, or under previous regulatory regimes at Gatwick. We would challenge any suggestion that these discounts reflect a competitive outcome; they are a product of the regulatory regime.

Secondly, the CAA itself has set out in its regulatory decision that it expects GAL to deliver an average price (of RPI-1.6) below the level that GAL has offered to achieve (RPI+0). This clearly suggests that the CAA believes GAL is planning to charge more than is reasonable, and presumably therefore in excess of competitive prices.

The regulation of new capacity

We agree it is too early for the CAA to decide how it will regulate new airport capacity. However, the regulatory structure will have a significant effect on how any new capacity is charged for, and consequently the business case for new capacity. The CAA will need to set out its approach to regulation once the government has taken a decision to support a new runway and the planning permission process is underway.

It is important that the CAA use the period up to its decision to fully assess all the options for a future regulatory structure, and that it engages with both airports and airlines on this issue. We support the proposal to review the progress made on commercial discussions six months after any government decision to support a new runway. Alongside this we urge the CAA to use the intervening period to carry out a full review of any potential regulatory approach, rather than risk having to rely on incremental change if it decides in the future that a regulatory approach is needed.

This assessment should take an outcomes focussed approach, and in particular should look at the empirical evidence on how competitive airport markets price new capacity.

easyJet supports an approach that regulates for a long-term price path over the lifetime of the project. It is important that the airport is allowed a proper return (subject to risk allocation etc.) over the lifetime of a project, but we believe it is unhelpful to attempt to equalise the return in each period. This is not reflective of the profile of returns for capital intensive sectors, which instead tend to see a back loading of returns, with debt used to fund investment, and it leads to irrational price paths, with prices declining as usage increases.

We urge the CAA to carry out an open and in-depth assessment of any future regulatory approaches to new capacity during the potential 'breathing space' between now and any future planning application.

easyJet

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