

## easyJet response to CAA discussion paper on the regulatory treatment of issues associated with airport capacity expansion

### Introduction

easyJet supports the joint airline response submitted through the Gatwick and Heathrow ACC's. This submission addresses additional issues and does not seek to repeat the points made in the joint airline response.

### How the CAA should regulate new capacity

The CAA's current regulatory approaches are not geared for large scale and long-term capital projects. The five year RAB approach provides no long-term view on the price path and charges passengers for assets ahead of their delivery. The Gatwick Commitments approach relies on a set of commitments made by Gatwick airport, so in the current absence of Gatwick commitments to cover the period of new capacity this approach can not be relied on.

The CAA should seek where possible in its regulation to reflect commercial market outcomes and ensure that user charges reflect costs and the services received by those users.

### *Pre-funding*

The CAA's current regulatory approach allows airports to charge for assets ahead of their coming into use. This means that user charges do not reflect the service received nor the costs of those services, as they are effectively being 'taxed' to pay for future assets. This pre-funding is a significant distortion of the market and has several negative outcomes. The long term nature of capacity investment and the scale of this investment mean that pre-funding would create significant distortions over a very long period of time.

Pre-funding is an inefficient outcome, as charges do not reflect the cost of services received. This leads to inefficient allocations of capital. It also increases the incentive on the airport to gold plate investment, as it reduces the risk faced by the airport.

Allowing pre-funding for either of the expansion options will also distort airline competition. There is clear evidence, supported by both the CAA and the then Competition Commission, that airline services at each of the London airports compete with services provided at the other airports<sup>1</sup>. Allowing pre-funding will lead to airlines at one airport having to pay higher charges (for no service benefit), distorting competition in the downstream market as airlines at other airports will not have to pay these higher charges.

A further distortion in the airline market may occur if the airlines that are forced to pre-fund new capacity are unable to benefit from this new capacity. Existing, and likely future,

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<sup>1</sup> This is not to say that the airports compete. The competition between airline services at different airports and airports themselves are two very different issues.

slot-allocation rules mean that there can be no guarantee that current airlines at an airport will benefit from future capacity.

Finally, pre-funding does not occur in commercial markets. The ability to pre-fund through charges is due to the airports' significant market power. Without this they would not be able to pre-fund. We note that there are many examples of markets where pre-funding does not occur, including infrastructure developments such as toll-roads, airport developments [excised – commercially confidential] and the airline market, where new aircraft are financed through debt and not passenger charges.

We do not see pre-funding as a generational issue, instead it is one of economic efficiency.

The CAA notes that it has been suggested that pre-funding is beneficial as it smooths prices. It is important to note that we do not value price smoothing in this way and do not think that passengers should pay extra simply for the benefit of smoother prices.

Finally, the CAA also suggests that pre-funding may be needed to allow an airport to finance new expansion. It is important that this claim is supported by evidence if it is used to justify pre-funding. We note that both airports and many other large infrastructure providers have been able to raise significant amounts of debt on the financial markets, including Ferrovial which raised over £10bn of debt for the purchase of then BAA. If an airport is unable to raise debt to support expansion it may be that financial markets see the expansion as uneconomic, in which case the CAA should not support the project either.

### *Regulatory approach*

We agree that the CAA should start to explore the options for the regulation of future capacity now. While we have not come to any firm view on what would be the best approach we do think it important that the CAA explore the potential for a long-term regulatory settlement. This would ensure that the airport takes some or all of the demand risk; allow for a sensible funding profile; provide the airport with comfort around ensuring it will earn its return; and provide some certainty around the long-term price path.

### *The role of commercial agreements*

We have already seen the benefit at Gatwick of a regulatory regime that encourages commercial contracts<sup>2</sup>. We believe there may be a role for commercial agreements to facilitate the delivery of new capacity. However, the CAA will need to ensure that any agreements are mutually beneficial, and not an outcome of an airport having market power and airlines having no viable alternative but to sign a commercial agreement set out by the airport.

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<sup>2</sup> We note that regulation never precludes commercial contracts; the Gatwick regime simply encourages them.

## **The CAA's role in determining what expansion takes place**

It is clear that the CAA will not play a role in determining where new capacity should be sited. However, the CAA does have a clear duty to ensure that the costs of any new expansion are efficient and in the interests of passengers.

We are concerned that limited attention has been paid to the cost of new expansion. While cost is part of the Airport Commission assessment there has not been any meaningful airline/airport consultation on the design costs. We believe this should happen ahead of any Airport Commission and government decisions, to ensure that these decisions are based on a scheme that has been subject to cost scrutiny. If this does not happen there is a real risk that the cost of any new scheme will be baked in and the CAA will not be able to satisfy its statutory obligation to ensure that the costs of new airport infrastructure are in the interests of passengers.

The CAA itself has identified this risk and we believe it is vital that the CAA set out how it will mitigate it.

We suggest that either the Airport Commission or the CAA should carry out a cost scrutiny process involving stakeholders over the next 12 months. This process could be based on Constructive Engagement, and would ensure that there is full transparency around scheme costs. This would allow a high-level assessment of whether the costs are in the interests of passengers. We recognise that there is still considerable uncertainty around final costs, but given that the airports' are setting out their proposed costs we see no reason why airlines can not be consulted on the high level costs now.

## **Airport market power**

We agree with the CAA that it is helpful to have a discussion now on how the CAA will consider airport market power in the context of new capacity. It is too early for the CAA to say if and when it will be appropriate to assess whether the market positions of any of the London airports has changed as a result of new capacity, as there has been no change in the economic dynamics of the London airport market. However, we recognise that airport capacity plays an important role in the determination of whether an airport has market power and there may be value in the CAA providing more guidance on how it will assess market power in the future.

The CAA has already provided significant guidance on the issue of airport market power, through its guidelines and the recent assessments of Heathrow, Gatwick and Stansted's market power. However, it may help market participants and potential airport investors/financers if the CAA set out its current thinking on how it would carry out a market assessment given any new capacity and in particular the factors that it would be focussing on to assess whether there has been any change in the market power of Heathrow and Gatwick.

Finally, we note that the CAA is relatively dismissive about the role of critical loss analysis in the assessment of airport market power following any new capacity. We are surprised that the CAA has gone in to this level of detail at this stage, and it is unclear why it thinks critical loss analysis may have shortcomings. We believe that critical loss analysis will be as

robust a tool under any new capacity scenario as it was in the CAA's recent assessment of market power at Heathrow and Gatwick.

### **The CAA's next steps**

The CAA only allowed for a short consultation period on its discussion paper. There are several significant issues that the CAA and airlines have identified as needing further work. We urge the CAA to set out soon its timetable for future work, as this will allow airlines to ensure we can provide fully evidenced submissions to the CAA.

easyJet

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