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**Response to CAA Consultation on
Economic Regulation of Capacity Expansion
at Heathrow**

(CAA CAP 1610)

2 March 2018

Introduction

The Airline Operator's Committee (AOC) and the London Airlines' Consultative Committee (LACC) welcome this opportunity to submit this joint response to the CAA's consultation on regulating capacity expansion at Heathrow (CAP 1610).

The airline community has retained the services of Cambridge Economic Policy Associates (CEPA) to advise us on the Weighted Average Cost of Capital (WACC). A report from CEPA analysing the CAA's discussion on WACC in CAP 1610 and its PWC report is attached (see Annex A). The airline community fully support the CEPA findings. Furthermore, the CAA should assume that this CEPA paper forms the airline community's current position on the WACC.

Our response below follows as far as possible, the structure of the CAA's CAP 1610 document.

Affordability

The airline community was pleased to note that in his most recent evidence to the Transport Select Committee, Andrew Haines, the CAA's Chief Executive, noted that he thought that it was plausible to build the 3R infrastructure at Heathrow Airport and keep costs flat. We fully support this position, and believe that such an outcome is not only plausible, but also necessary if we are to protect passengers' interests.

We do however, have a number of concerns on the detail of the CAA's position on affordability. Our first concern is that despite our request in response to CAP1541 that the CAA clarifies its position with respect to affordability and its objectives for expansion, it has failed to do so. And indeed, affordability only appears in CAP 1610 in relation to depreciation profiling.

The Civil Aviation Act (2012) gives the CAA a very clear primary duty to further the interests of passengers. If expansion is not delivered affordably, then the CAA will have failed in its primary duty, and will have allowed the business case for expansion to be undermined. This is surprising to us given that our concerns around affordability are on behalf of passengers who should only have to pay for a project design that meets their needs in the most efficient and cost effective way possible. They should not pay for the inefficiencies of a monopoly supplier. In our view, our position is exactly the position the CAA should adopt given its primary duty to protect the interests of passengers.

The CAA is incorrect to state in paragraph 1.26 of CAP 1610 that airlines support keeping charges as close as practicable to current levels. This is not the airline community position. For the avoidance of doubt, the airline community believes, and has said consistently, that expansion at Heathrow Airport must be delivered with no increase in charges in real terms from today's prices.

Finally we are unclear by what the CAA means by *'the assessment of consumers' willingness to pay (WTP) should be part of this process and may inform decisions on how best to proceed with specific aspects of capacity expansion, but within overall envelopes that also deliver wider objectives relating to affordability and financability.'*

We agree with the CAA that the consumer should be at the heart of everything that we do, and indeed, the airlines are the main group of organisations involved in Heathrow Airport expansion with the primary and direct commercial imperative to ensure that passenger needs are met. However, we are concerned that the CAA may be placing too great an expectation on what any WTP research may reveal.

There are a number of methodological issues to address, such as whether our passengers understand the context of what they are being asked, or indeed have sight of everything that would be needed during expansion for example. Even if this could be achieved, there are still limits to what WTP can be reliably used for. At the Outcomes and Consumer Research and Engagement Group meetings it has been the view of the airlines and the CCB that whilst WTP may be useful in helping to reveal consumer preferences it will not be suitable for determining what is or isn't affordable, what price in £s passengers would actually be willing to pay for facilities, or what airport charges would be. In other words WTP helps with choice not price.

Approach to Risk Allocation

In our response to CAP 1510, we highlighted the need for the CAA to conduct further work on risk allocation (we expanded on these themes in the Annex to our submission). We noted that how the CAA chooses to allocate risks associated with expansion will have fundamental implications for financability and the cost of capital.

We note that the CAA is yet to begin detailed work in this area, and urge them to progress this work with some urgency.

Engagement of third parties

The airline community shares the CAA's view that the engagement of third parties, or alternative providers of expansion, could have a key role in delivering an affordable and efficiently expanded Heathrow Airport. We understand the CAA's position that it does not currently have the powers to impose or force HAL to enter into particular commercial arrangements to promote competition.

This was why we asked the CAA, in our response to CAP 1541, to consider what powers it would need, and how it might go about acquiring them. The CAA has responded that this is not a practicable solution, as any delay *'would also have significant costs to consumers in terms of less choice, poorer service levels and higher fares.'*

The airline community disputes this statement on a number of levels. Firstly, we believe that the costs to the passenger that the CAA lists are exactly those that stem from an unaffordable Heathrow Airport, not ones that could come from a short delay. Second, we are puzzled as to why the CAA sees any delay as having significant costs. It is surely better that if the expansion of Heathrow Airport is to go ahead, that it is affordable, and is the most efficient design delivered by the most efficient company. It is our view that any potential delay would be small (as HAL would continue to work to its timetable), and that the benefits of third party engagement are potentially large; an opportunity which the CAA should not leave unpursued.

Finally, it is not enough to argue that any delay is not to be tolerated. In order to come to this conclusion objectively, the CAA would need to have calculated the costs of any delay, alongside the benefits of third party engagement. It would be useful to see the CAA's assessment in this regard, as the airline community believes that the benefits of third party engagement outweigh the costs of securing it.

Consequently, whilst we acknowledge that the CAA's position is certainly expeditious, we do not believe it to be consistent with the CAA's primary duty.

Given that the CAA has chosen not to pursue powers to force HAL into engaging competitively with third parties on expansion, we are sceptical about the likely effectiveness of the CAA's policy. Whilst the CAA is correct to argue that alternative plans by third parties, may reveal more efficient ways of producing expansion, it is unlikely to be a policy to bear fruit.

The CAA will be aware from monitoring HAL that there are costs associated with developing a scheme for expansion. A third party is only likely to bear those costs if it has a reasonable chance of success. Given that there is no compelling reason for HAL to enter into agreements, it must be unlikely that third parties will commit the large sums needed to develop schemes, and therefore that the CAA will be deprived of the very benchmarks its policy seeks to deliver.

Consequently, we ask the CAA to urgently do two things:

- to actively consider what powers it needs to compel HAL to enter into particular commercial solutions to promote competitiveness and efficiency; and
- to work with the airline community and HAL to develop regulatory options that would facilitate third party engagement.

In order to progress the debate on third party engagement in a practical and pragmatic way, the airline community wishes to propose an alternative approach that we believe is worthy of detailed consideration alongside the exiting options. Clearly the details will need to be worked out with the CAA and with HAL, and we look forward to engaging with both parties to do that.

The airline community is interested in the idea of establishing of a separate company (a 'Buildco') which would be responsible for the actual construction and delivery of the 3R expansion programme. HAL, the airlines and any interested third parties, would effectively buy a stake in the Buildco. The Buildco itself would then undertake the 3R expansion programme for a fixed price and scope.

When assets were completed by Buildco, they could be sold to HAL for the fixed price, or if all parties agreed and the asset was separable (e.g. say a Terminal), the asset could either be sold to a third party, or sold to HAL, with rights to operate the terminal bought by a third party for a fixed term. This latter approach could lower the overall price of the scheme (aiding affordability and financability) and give the CAA a valuable benchmark on the true cost of operating an airport asset at Heathrow.

The airline community believe that such an approach could have the following benefits:

- i. It would allow the CAA to keep open the option of separate RABs and WACCs at this stage. Thus allowing the CAA to choose the regulatory options best suited to incentivising HAL to continue to run and invest in a 2R Heathrow Airport efficiently, whilst delivering an affordable expansion plan;
- ii. separating the construction of 3R from the development and maintenance of a 2R Heathrow Airport, especially if there were separate RABs and WACCs, would prevent the distortion of incentives for HAL (this is equivalent to the concerns of OFWAT around the Thames Tideway (TT), and pivotal in why they chose the Buildco option that they did);
- iii. a fixed price for delivery of the expansion programme delivers certainty to HAL, lowering its WACC;
- iv. freed from HAL's existing capital structure, Buildco would be able to opt for the most efficient financing options possible;
- v. it would encourage third party expertise and finance into the expansion programme;
- vi. by giving airlines an Executive position(s) on the Buildco Board, it delivers two key requirements to deliver the CAA's current policy successfully:
 - i. it gives airlines transparency on build progress and cost, and the Executive authority to intervene where necessary;
 - ii. it would align airline (and hence passenger) and HAL incentives
- vii. it would give third parties a vehicle for engaging in expansion, and therefore the incentive to both continue to develop their own plans, and bring their expertise to the table.
- viii. this approach is, in effect, a modified version of the solution that OFWAT opted to adopt for the TT. This approach is delivering the TT at levels of cost much lower than OFWAT initially expected, and our expectation is that our proposal could do the same for expansion at Heathrow.

The airline community recognises that there is still some detail to be discussed and considered. But, we hope that the CAA will regard this suggested alternative approach as a constructive contribution to the debate, and look forward to discussing it with you, and in due course, with HAL.

Cost of Capital and Debt Indexation

The airline community has retained CEPA to advise them on the cost of capital and their report is attached at Annex A. The comments that follow in this section are in addition to and not instead of the comments in the CEPA paper.

We are pleased that the CAA recognise the importance of the WACC in the price control process and are pleased that the CAA are consulting widely and considering the determinations made by other regulators. We note that at paragraph 2.12 the CAA states that it has been consulting a group of senior experts on the WACC and on 'the areas of additional focus for future consideration'.

For the purposes of transparency, and so that the airlines can respond effectively and assist the CAA in its deliberations, we would ask the CAA to make public:

- i. who are the experts the CAA is consulting;
- ii. what are the terms of reference for their engagement;
- iii. what has been their advice?

It is our belief that the CAA will come to the most robust, and safest, decisions, when the evidence it bases its decisions on are subject to scrutiny and dialogue by all parties. Consequently we would urge the CAA to be fully transparent in its thinking and the advice it has received, or will receive in the future, on the WACC.

Debt Indexation: as part of the Q6 process, CEPA, on behalf of British Airways put forward a proposal for debt indexation. This proposal was supported by the airline community, but not, at that time by the CAA. The airline community is pleased that the CAA wishes to consider the issue of debt indexation again. Of course there is much work to be done on the detail of such arrangements, and we would look forward to exploring this with the CAA.

In the context of a 2R airport, and in principle, the airline community continues to support the indexation of debt (dependent on the selection of the appropriate index, tenor and so on). However, whilst we remain sympathetic to the idea of indexation, we would wish to explore in more detail, how it might work in the context of expansion.

Financing and Indexing for Inflation

The CAA has suggested that it wishes to look at the WACC not only with its traditional 'notionally efficient' assumption on gearing, but also with respect to a level of gearing that more closely matches HAL's current levels. The airline community understand why the CAA may want to do this, and in theory, agree that it could generate a lower WACC and therefore lower charges for our passengers. We also agree that in principle it is sensible that the CAA should re-examine what the correct level of gearing should be (adjusted for tax and so on) for a notionally efficient company.

However, we feel that it is important to remind the CAA of its current policy in this area and highlight the need for regulatory certainty with the CAA maintaining its stance. The CAA has always been clear that it is up to HAL's Directors to determine their own financial arrangements and levels of gearing. By gearing more highly than the CAA's notional approach, HAL have effectively lowered their WACC.

The CAA has also been clear that the actual level of gearing is HAL's choice, and along with taking the benefits of such an approach, HAL must also take the risks. If HAL's relatively high level of gearing means that raising more capital for expansion is more expensive than if there was a lower level of gearing, then this is a problem of HAL's making. And one, under existing CAA policy that HAL would not be compensated for.

To take any other position would mean that our passengers have paid more for previous investment by HAL than they should have done, and will pay more for future investment

than they need to. We do not believe that such a position would be consistent with the CAA's primary duty.

In short, if HAL's gearing is HAL's decision, then the upside and the downside of such decisions belong to HAL and its shareholders, and any downside risk should not be placed on the shoulders of the passenger.

Financial Resilience and Ringfencing

We note that the financial ringfence imposed on HAL by the CAA is not as strong or as complete as that imposed on other regulated businesses by other regulators.

We understand that in principle a 'full ringfence' is applied to HAL, but that part of the ringfence sits with HAL's creditors, and the rest in its licence imposed by the CAA. If HAL's creditors have the same objectives towards our passengers as the CAA, then in principle the ringfence should be fine.

The problems arise if the ringfence is either not complete and/or the objectives of HAL's creditors differs significantly enough from the CAA's statutory duties. It is this scenario that gives cause for concern, and consequently we support the CAA's ambitions to move towards a more complete regulated ringfence.

We agree with the CAA on the potential additions to the ringfencing conditions that it proposes to look at. But we are also mindful that any changes that the CAA makes, may disturb HAL's current financial arrangements, or indeed its ability to raise debt in the future, and the price it would have to pay.

Consequently, we believe that this is an area where the CAA should proceed with care. Any potential changes should be subject of a rigorous cost benefit analysis that shows the benefit of any changes to our passengers, along with the potential financial costs.

For the avoidance of doubt, the airline community's interest in this area is largely focused on ensuring the continuous and efficient operation of Heathrow Airport, and ensuring that in the event of the airport operator failing, that the airlines and their passengers are insulated from any debt and unpaid bills. Our focus is less on HAL per se, as we believe that the licence for economic regulation at Heathrow Airport should be granted to the business that can run, invest in and operate the airfield in the most efficient way.

Regulatory Treatment of Early Construction Costs (Category C)

The proposal in CAP 1610 has taken a narrow and functional view on the treatment of any early Category C costs, missing a fundamental step in who should bear the risk. Therefore, the airline community does not agree with the CAA's proposals for the regulatory treatment of early Category C costs. We believe that all early Category C costs should be incurred at HAL's own risk, at least until after DCO consent (at which point the relevant mechanics of testing efficiency including those indicated in the proposal should be applied) because:

- i. At present, HAL cannot provide any detail on what they are planning to build or what it will cost. Therefore it is unclear whether the expansion project is affordable and can be supported by airlines;
- ii. in a competitive commercial world, these costs would be born by the scheme promoter (i.e. HAL) until the asset could be used by its customers. HAL's shareholders should not be allowed to make early and additional returns simply because they are regulated;
- iii. it will better ensure HAL's own due diligence and assessment of need to incur early costs and subsequent commercial arrangements.

Consequently, the airline community proposes that any early Category C expenditure should be at HAL's own risk. For the avoidance of doubt this would mean that should DCO consent not be granted, then the cost of early Category C spend would need to be borne by HAL and its shareholders.

We have a number of further comments related to the CAA's comments in this section of 1610:

- i. Unlike the CAA, we do not believe that the questions of inter-generational equity are particularly difficult or open to a range of interpretations. The point is a simple one – passengers should not pay for an asset that they cannot currently enjoy, or may not enjoy in the future. This is especially the case for 3R, where it is not yet clear whether the proposed expansion can be delivered affordably;
- ii. the CAA suggests that HAL needs to be treated differently to competitive businesses with respect to pre-funding and early category C costs. We disagree completely because:
 - a. The CAA argues that short-term capacity constraints lead to rising prices which 'fund' expansion, whereas HAL's prices are fixed. While this could be true in theory, the CAA has not cited any real world evidence of businesses raising their prices specifically to fund investment
 - b. the CAA seem to argue that regulation in this context is perhaps a drawback for HAL. However, being a regulated monopoly is a very privileged position. Unlike regulators, a competitive market does not ensure that businesses are financeable or that there are generous opportunities for outperformance. Nor do competitive businesses have such certainty of revenue, or typically exhibit equity type returns for gilt type risk. In short the CAA needs to look at HAL's privileged position in the round. It has the capacity, performance and certainty to plan ahead and take reasonable long term risks. The CAA should allow HAL's shareholders to do that and not ask our passengers to fund that risk for them. What HAL's shareholders need, to deliver expansion efficiently and affordably, is not a strengthening of their privileged position, but a greater exposure to the commercially disciplining forces of market competition.
- iii. We are happy for HAL to propose compensation for local communities over and above the statutory minimum, but passengers should pay no more than the minimum efficient cost, and that is the statutory minimum. If HAL's

shareholders wish to be generous with compensation they should do so with their own money and not that of our passengers'. We are surprised that given its statutory duty, the CAA believes that our passengers should effectively overpay. Indeed the CCB has criticised HAL in this regard for being too concerned with the views of the local community and not enough with passengers. Given that the CAA seems to be supporting HAL's position, it appears that the CAA would also be open to the same criticism from its own advisers.

- iv. We agree with the CAA that progress on expansion for HAL is not a menu where they can pick and choose what to progress, but rather that progress must be made across the board. We do not believe that there has been sufficient progress on affordability or scheme design to merit taking on early category C costs at this time. Indeed we note that in CAP 1610 the CAA themselves state that HAL must make 'adequate' progress on overall affordability for their Category C proposal to apply.
- v. the CAA is proposing to act as a decision maker if HAL and the airlines cannot agree on specific early Category C investments. The CAA has made policy statements to the effect that expansion (without regard to price in any way) is always in the passenger interests (CAP 1541), and that no delay in expansion could be tolerated as it would expose passengers to costs (CAP 1610). We question whether these policy positions create a conflict of interest were the CAA to be asked to decide on whether an early Category C project should go ahead, and whether if the CAA does go ahead with its proposals whether another body should act as the appellant

Interim Arrangements to Extend the Q6 price control

The airline community supported the extension of Q6 by an initial period of one year. We also understand the CAA's desire to align the expansion and regulatory timetables. However, we feel that it would be difficult to ensure complete alignment, given the likelihood of delays in the expansion timetable.

It is clear from the CAA's analysis and by examining events in other regulated industries since the Q6 settlement that the price path at Heathrow Airport should be unambiguously downwards. It is also clear that HAL has enjoyed a significant windfall in revenues by dint of events that are not of their own making (i.e. falling debt prices and airlines putting more passengers through Heathrow Airport than forecast).

With this in mind, the airline community is clear that neither of the CAA's two proposals for price paths for an extension to Q6 (i.e. RPI-0 and RPI-1.5%) are acceptable. This is because both of these suggestions mean that our passengers will continue to pay significantly more than they should, and will fail to benefit from events in the capital markets and the success of the airlines at Heathrow in attracting their business.

Whilst in theory our passengers could be 'made whole' by the CAA's truing up mechanism of adjusting depreciation, it is unclear on what basis the CAA is proposing to do this, and whether or not our passengers will be 'made whole'. There is also of course the question of inter-generational equity as today's passengers will over-pay, but may not be the future passengers that would benefit from the CAA's truing up mechanism.

Consequently, given the uncertainty around the CAA's proposals, and our passengers clear desire for lower ticket prices now, the airline community favours lower prices at Heathrow Airport now rather than adjustment mechanisms which come into effect in the future.

Consequently, we would be willing to accept an additional one year extension to Q6 (so it effectively becomes 'Q6+2'), but only on the following conditions:

- i. the extension is limited to a period of one year;
- ii. the price path set is calculated by adjusting the building blocks for actual and expected performance on pax, opex, single til revenue and WACC – as per the CAA calculations we believe that this would set a price path of £18.8 in 2020;
- iii. airline passengers are fully compensated at the beginning of H7 for any overpayment; and
- iv. that the CAA, the airline community and HAL are able to reach an agreement over the windfall gains.

We do not believe it is necessary to continue to extend the Q6 price control indefinitely. The CAR's example at Dublin Airport gives the CAA a clear model that it could follow to deal with price paths when expansion is uncertain. In short we would expect the CAA to set a 2R price path (which would clearly be a downward price path), together with another price path (an uplift) for expansion that would kick in when a set of pre-agreed conditions were met (in the case of Dublin these related to passenger volumes that triggered the need for capex).

The airline community wishes to specifically address the issue of outperformance of the regulatory settlement by HAL. For the avoidance of doubt, we want HAL to be a sustainably profitable business. We also believe that HAL and its management team should be incentivised to deliver efficiencies over and above those contained in any reasonable and challenging regulatory settlement.

We are also clear that the CAA's current policy on the treatment of outperformance is out of step with other regulators. Typically, other regulators draw a distinction between:

- a. outperformance driven by actions taken by the regulated business to improve its performance (e.g. pay restraint, efficiency programmes over and above those implied by the settlement, delivering capex projects at lower cost); and
- b. outperformance driven by other factors (e.g. failure to invest, cost of debt lower than the regulated WACC and so on).

In the case of the former, typically the benefits are shared by the regulated business and the consumer. And in the case of the latter all the benefit goes to the consumer.

The CAA's policy is not to draw a distinction in how outperformance comes about, and to award all outperformance rewards to HAL within Q.

The airline community believes it is important to distinguish between how outperformance has come about. For example, in Q6, driven by availability of cheap debt and the performance of the airlines in attracting passengers (despite HAL's ever rising

charges), HAL will land windfall profits in excess of £1bn. Note that this 'outperformance' is not through the actions of HAL's management but by pure luck and the actions of the airlines. The airline community notes that £1bn if hypothecated to expansion rather than as an unearned dividend for HAL's shareholders, would make a significant contribution to delivering an affordable expansion at Heathrow Airport.

Therefore, the airline community proposes that future outperformance by HAL, that cannot be directly attributed to the actions of HAL, should be hypothecated to lowering the costs of expansion and delivering a more affordable Heathrow Airport.

We realise that this is a departure from existing policy and that therefore the CAA may wish to implement this change from a suitable point in time. Suitable options might include:

- i. a go-no-go decision on expansion;
- ii. the start of H7;
- iii. DCO approval;
- iv. the beginning of construction of the third runway

Our initial suggestion would be that hypothecation would begin from a go-no go decision on expansion.

The airline community also notes that given the level of unearned outperformance in Q6, the challenges of affordability, and the national importance of an addition runway at Heathrow Airport, that the question of whether to hypothecate Q6 outperformance is also a relevant one for CAA consideration.

- ENDS -

Yours sincerely



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