



London (Heathrow) Airline Consultative Committee

**Response to CAA Guidance for Heathrow Airport Limited in
preparing its business plans for the H7 price control**

8 June 2017

Introduction

The Heathrow Airline Operators Committee (AOC) and the London Airline Consultative Committee (LACC) welcome the opportunity to submit this joint response to the CAA on its guidance for Heathrow Airport Limited (HAL)¹ in preparing its business plans for the H7 price control.

We note that the CAA is seeking feedback on three areas: what constitutes a good business plan from HAL and whether they should be rewarded for producing one; outcome based regulation; and how to align the H7 timetable with the DCO and NPS timetables for Heathrow Airport² expansion.

In our response we cover each of these areas at a relatively high level. We have further more detailed comments which we do not put forward here. As we are sure that the CAA will wish to work closely with us and HAL to develop its proposals, it may be more appropriate to discuss our more detailed comments with the CAA across a number of meetings.

Guidance and Incentives for High Quality Business Plans

The airline community³ agrees with the CAA that it is important that HAL produces a high quality business plan, and welcomes the CAA's guidance as a helpful intervention to move HAL in the right direction. We also note that a comparison of Q6 actuals to the final proposals put forward, at the time, by the airlines, HAL and the CAA shows that the airlines proposals are generally closest to actual performance and HAL's the furthest away. This would seem to suggest that the CAA give greater rather than less weight to the airline position.

In terms of the Guidance on what constitutes a good Business Plan, the airline community makes the following observations:

- i. We continue to find it odd that the CAA is asking a monopolist to define what the interests of the passengers of our members are. We take this view because HAL is regulated by the CAA precisely because if left unregulated it will act against the passenger interest. We continue to believe that the CAA should place greater emphasis on the views of the airlines who operate in a highly competitive market at Heathrow Airport and who therefore have the interests of the passenger at heart;
- ii. we continue to assert, as the CAA has previously agreed, that it is the airlines, operating in competitive markets, who have the incentive both to understand the needs of current and future passengers, and the commercial incentive to speak and deliver for them. Therefore, we believe that any Business Plan, that is not signed off by the airline community cannot be considered a good one;
- iii. affordability needs a much greater weight in the criteria. Passengers will only gain the benefit of flying from Heathrow Airport if airlines can afford to operate from there;

¹ Heathrow Airport Limited - the company owning and operating Heathrow Airport

² Heathrow Airport - the airport as a transport hub geographically located to the west of London

³ The airline community – the collective of airlines operating services to and from Heathrow Airport

- iv. scope – as we have not yet debated any change to the regulatory treatment of HAL, surely the Initial and Final Business Plans should be for a 5 year control period. HAL should be free to propose alternative lengths of control where this can be shown to be demonstrably in the passenger interest;

The CAA has also requested feedback on how to incentivise HAL to produce a good Final Business Plan (FBP). We continue to believe that credible business planning is essential for both HAL and the airlines that operate from Heathrow Airport. It is our view that the best way to achieve this is for HAL to engage openly, transparently and collaboratively with the airlines, and for the airlines to have sufficient time and access to the raw data to perform proper scrutiny of HAL's proposals.

We do not believe that HAL should be rewarded simply for producing a good business plan as this is would be tantamount to rewarding it for doing something that it should do anyway. If the CAA feels that HAL should be incentivised to produce a good business plan, then we feel that the incentive should be a penalty for producing a 'bad' plan rather than a reward for producing a 'good' one. For the avoidance of doubt, the airline community agrees with the CAA that administrative and procedural incentives are inappropriate. In addition, we make the following comments:

- i. the CAA's proposals for what constitutes a good business plan are vague and open to interpretation. If the CAA were to continue with its proposals to reward HAL then we would expect the criteria it was judged against to be scientific, measurable and objective.
- ii. the CAA needs to exercise care in transplanting regulatory models from other industries into the regulation of HAL, without recognising the differences that mean that any model would need to be adapted. Specifically, both OFWAT and OFGEM are lucky enough to regulate multiple monopolists. This gives them two advantages over the CAA, which mean the CAA should exercise caution in transplanting the RIIO model in whole into the regulation of HAL. Namely:
 - a. OFWAT and OFGEM are able to and indeed do collect extensive comparative data across their industries. It is therefore possible for them to make, to a certain degree anyway, a quantitative and objective assessment of what is a 'good' plan. The CAA does not collect such data, and to some extent cannot. It therefore cannot, with the same degree of objectivity tell a 'good' plan from a 'bad' one;
 - b. It is true that the RIIO model 'rewards' the best business plan with fast track approval and a marginally higher return. However, it is wholly inappropriate to transfer this model to HAL. The beauty of the RIIO model is that it effectively forces these monopolists to compete to have the best business plan. This delivers three advantages: it puts greater emphasis on delivering for the customer efficiently; it drives down costs across the industry; and the 'winner's' increased return is effectively paid for by the 'losers'. The net effect for the consumer is, in theory, low prices and more responsive monopolists. The CAA is not in such a position, and so all its proposals to reward HAL for a good plan will do is drive up prices for passengers.

Service Quality Regulation

We welcome the CAA reaching the point of providing its guidance on the development and inclusion of ‘an outcome-based approach to service quality regulation for H7’. In our view the CAA is correct to highlight that the objective of the provision of quality services by HAL is the achievement of quality services for passengers. It is also correct in highlighting that, given the substantial market power of HAL, the provision of this service by it needs to be regulated. We remain convinced that our proposal to the CAA that the bedrock of the provision of service by HAL – the current Service Quality Regime (SQR) – overlaid by a small number of Outcomes would be in the best interests of passengers. It would also achieve the regulatory policy objective of the CAA to ‘include an outcome-based approach to service quality regulation for H7’.

Quality of airport services

At Heathrow Airport our member airlines are completely reliant on the services provided by HAL on a monopoly basis to provide the airport services needed by airlines for the processing of their passengers and operation of their aircraft. It is in the interests of passengers that these services are provided consistently to a high standard. The SQR achieves this with its mix of more passenger facing services and the application of standards to services which are, as indicated by the CAA, ‘focussed at enabling airlines to provide services to passengers’.

In all cases the services provided by HAL are on a monopoly basis in return for the charges levied by them on the airlines. Therefore, it remains entirely appropriate that only the quality of services provided by HAL at Heathrow Airport is measured, regulated and reported on transparently through the service quality and outcomes based scheme to be in place in H7. The quality of services provided by the airlines are done so on a competitive basis and so should not be considered to be in the scope of the regulation of quality in H7. In fact to do so could risk unintended consequences and introduce distortions to an already functioning competitive market. We are aware that we have previously highlighted this point to the CAA. However, we emphasise it again for clarity and transparency amongst all stakeholders as we all jointly commence on the work set before us by the CAA.

Principles

We welcome the principles set out by the CAA and look forward to engaging with all stakeholders within these principles. The CAA has set out a bit more detail on the Outcomes, Measures, Targets and Incentives set out in Principle 2. Our comments on these are below:

Outcomes

We welcome the CAA highlighting that outcomes should encompass the aspects of the airport’s performance with regard to the services it provides to both consumers and airlines.

Measures

We welcome the CAA highlighting that the measurement should also be applied to the services provided by the airport which are not visible to consumers but which are fundamentally in the interests of passengers through enabling the airlines to provide services to passengers.

The performance of HAL should be measured through objective rather than subjective measures. We are aware that 4 areas of quality in the current SQR are measured through HAL’s own subjective

Quality of Service Monitor (QSM). Our concerns about the ability of the QSM to accurately measure and report on the experience passengers receive from HAL are well on record throughout the Q6 review. We have not seen anything regarding the operation of the QSM methodology to change our position on this.

A fundamental weakness of the QSM is that it is a subjective survey of the impressions of passengers regarding the levels of service they have received from HAL. Subjective surveys of the impressions of consumers have a much greater application, and meaning, in competitive environments than they do in monopolistic supply scenarios from a company with substantial market power. This is particularly the case when the execution of the subjective survey is undertaken and analysed by the monopoly supplier itself – as in the case of the QSM by HAL. Therefore, we would be concerned about the use of subjective measures to gauge the level of service provided by HAL and we would recommend consideration of objective measurement techniques for the 4 areas of service in the SQR currently measured by the QSM.

Targets

The CAA notes that the service standard targets should be based on evidence. It also states that any studies of the willingness of passengers to be pay for investments for further improvements should be based on robust appraisals. We welcome this and look forward to engaging jointly with stakeholders on this work.

Incentives

We welcome the CAA indicating that it expects HAL to work with the CCB and airlines in the development of the incentives within the framework for H7. We also welcome the CAA highlighting its expectation that the majority of incentives will be financial. Whilst we are open to reviewing the prospect of reputational incentives we remain of the view that reputational incentives are likely to have little impact on a monopolist supplier with substantial market power.

We would also note however that we remain of the view that the airport should not be rewarded for service improvements above those established through the CAA regulatory settlement. There is currently sufficient ‘upside’ for the airport in the regulatory framework through the prospect of increased passenger numbers being able to be processed through an airport which is functionally consistently well.

Joint development of outcomes

We welcome the indication by the CAA that it expects HAL and the airline community to ‘work together to take this [outcomes] framework forward’ and that HAL must prepare a business plan which reflects the views of the airline community. We are ready to commit the combination of passenger service and regulatory expertise to facilitate this working together. We can give the CAA our assurance on two counts. Firstly, we will look objectively at all proposals which may be presented by HAL. Secondly, any eventuality of us not agreeing with HAL would only emerge if we did not think the proposals from HAL were specifically in the interests of passengers, were not based on a robust means of measuring the performance of HAL and did not recognise the fact that the framework is about measuring the performance of HAL – the company with substantial market power regulated by the CAA.

Happy Passengers

We note that HAL consistently states that one of the ‘outcomes’ they are proposing is ‘Happy Passengers’. Passengers travel through Heathrow Airport for many reasons. Some may indeed be happy when travelling through the airport. Others may be stressed or nervous due to the purpose of their trip. We should not forget that many of the millions of passengers who travel through Heathrow Airport may be travelling for reasons which are personally sad or traumatic. Within this context, it is bizarre that HAL would suggest a measure of the ‘happiness of passengers’ could be used as a gauge of its regulatory service performance. When questioned about this HAL has indicated that they mean a measurement of the satisfaction of passengers. This has more merit but is still fraught with difficulties for at least two reasons. These are; firstly, it is a subjective measure of the performance of HAL and secondly, the level of satisfaction of passengers will be dependent on their expectation of the service they feel they are likely to receive. If the service is better than expected passengers will be more satisfied and vice versa. In either case, the passenger satisfaction measure would not be an objective measure of the level of service passengers should be getting from HAL for the charges they pay.

In contrast to this, we have already proposed to the CAA that one of the outcomes could be a measure of whether passengers are receiving the full range of services from HAL to the standard set by the CAA. This would not be a subjective measure of whether passengers are satisfied. It would be based on whether (or not) the more passenger facing service elements in the SQR, such as security search, are performing to the scientific service standard performance requirement set by the CAA.

Resilience and Quality

The CAA is correct to highlight the importance of resilience as a key strategic theme for H7; particularly in the context of expansion. There is much to discuss amongst stakeholders in this area and we look forward to engaging in these discussions in the overall interest of the passengers of our members. In the meantime, we would highlight the direct link between the current SQR elements of quality and airport resilience. The operational elements in the SQR incentivise HAL to maintain these elements of their performance at a high and consistent level. This consistency of operational performance provides the foundation for a robust and resilient operation of Heathrow Airport.

Common awareness and dependence on this level of performance enables all stakeholders to be able to determine what extra resources are required for particular levels of resilience above the baseline. Therefore, the consistent baseline operational performance provided by the SQR is at the core of resilience planning. The absence of this fundamental baseline would make resilience planning more complicated and subjective; both of which would reduce the accuracy of, and add cost to, the resilience planning and provision. Therefore, any move away from measuring and incentivising the operational performance of HAL through the SQR would be directly against the interests of passengers and pursuit of airport resilience.

Aligning Regulatory and Business Planning (Expansion) Timetables

The airline community agrees with the CAA that there is considerable merit in attempting to align the regulatory and business planning timetables. Consequently, we fully support the CAA's proposal to extend the Q6 price control beyond the current Q6+1 extension.

The CAA discuss two scenarios/proposals for extending the Q6 control by one further year. The airline community does not believe that either scenario is acceptable. Rather we would prefer to work with the CAA and HAL to find a more suitable mechanism to extend the Q6 control. We have come to this view on the CAA's two scenarios for the following reasons:

- i. we believe that there are three formal phases of engagement for the airline community in H7: engaging constructively with HAL in the run up to the Initial Business Plan; constructive engagement with HAL leading to the FBP; and engaging with the CAA as they conduct their deliberations. We would not want to see any of these periods of engagement shortened. Also, given the many new features of the regime (OBR, CCB and so on) we are particularly keen for the period of engagement with the CAA, as they come to their decision, not to be shortened;
- ii. the DCO and NPS timelines are still uncertain and it may well transpire that even with an additional year the regulatory and business planning timetables may not align. Consequently, it seems to us that the best course of action would be to develop a flexible and objective mechanism that the CAA could use to align the timetables regardless of whether the adjustment needed was 9 or say 15 months.

Consequently we think that there would be value in working with HAL and the CAA to find a flexible and objective mechanism to extend the Q6 control period. In order to begin the debate, the airline community proposes the following:

1. the CAA would set a price control based on rolling on opex, capex and commercial revenues (with the same efficiency and growth tasks as in Q6). This would be done initially for a 12 month extension to Q6+1. However, it would express the control as a regulated revenue requirement ie it would not express the cap as a per passenger charge, rather a total revenue cap.
2. As part of its H7 work, the CAA would be able to observe actual outturn values for the control variables. It would then apply a truing up mechanism based on HALs actual performance.

We believe that this approach is flexible, objective and does not involve excessive work for a relatively short extension.

There may also be merit in reopening the Q6+1 decision and applying this mechanism. When the CAA extended the Q6 period by one year, the expectation was that only one extension was required. Quite rightly the CAA was keen to find a way to extend the control by 12 months without spending excessive time and resources in doing so.

However, as it seems likely that Q6 will now be extended for around 24 months it may make sense to find a solution that covers the whole of the extension period and is both fair to all parties and transparent.

We look forward to engaging with the CAA on this, and would be happy to go through our proposal in more detail.