

Incentivising the right consumer outcomes – seminar note

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CAA House, Kingsway, London

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		Gabrielle Stoll (Lufthansa)
		Emi Spanakis (Oneworld)
		Simon Scoggins (Star Alliance)

Welcome and introductions

1. The CAA welcomed attendees and explained the purpose of the meeting was to discuss and receive views on the CAA's proposed approach to the H7 strategic theme related to incentivising the right consumer outcomes. The CAA had circulated a paper on its proposed approach to:
 - Introduce a new outcome-based approach to regulation;

- Incentivise a high quality initial business plan that strongly reflects the outcomes consumers value; and
 - Consider the impact of other incentives that are relevant to the H7 regulatory framework.
2. The discussion during the seminar will be considered alongside feedback on the strategic themes discussion document.
 3. To begin, the CAA provided an overview of the existing Service Quality Rebates and Bonuses scheme (SQRB) which has been in place for several years. Considering the CAA's primary duty to consumers, as well as the important recent developments of the UK regulatory practice, the CAA considers it is the appropriate time to review the SQRB scheme and assess whether it is delivering the outcomes that consumers value. The CAA noted that it intended to conduct a thorough review of the existing regulatory arrangements and would be keeping an open-mind with respect to possible recommendations. For example, the CAA might conclude that passenger preferences are being met, and thus that wholesale change is not required.
 4. The CAA also noted that it is shifting towards a more explicit focus on consumer outcomes, which need to be fit for purpose from the start, including through the attachment of appropriate incentives to these outcomes.

Outcome-based regulation

5. The CAA explained that it intended to go much further than it has previously to put consumers at the heart of its airport economic regulation, in order to fulfil its duties under the Civil Aviation Act 2012 in furthering the interests of consumers.¹ The CAA considered that the proposed outcome-based approach to regulation would allow it do this more effectively.

¹ For the sake of simplicity, we use the term consumers to mean both present and future passengers and cargo owners.

6. In explaining the proposed approach, the CAA drew on Figure 1 in the Seminar Paper setting out the ‘outcomes, standards and incentives illustrative framework’. The CAA stressed that the purpose of the diagram was to provide a high level overview of the proposed structure of an outcome-based approach to regulation and that the examples included in the diagram were for illustrative purposes only. The CAA noted that it expected HAL to initially populate the matrix based on robust consumer research and engagement, in consultation with the airlines. The CAA also clarified that the framework accounts for the degree of control that HAL has on performance and consumer preferences.
7. Turning to the structure in Figure 1, the CAA explained:
 - **Outcomes:** the first row represented the high-level objectives that HAL’s actions are intended to help deliver, and which could then be incentivised and monitored through the regulatory regime. As noted above, these outcomes should be informed by robust and transparent consumer engagement.
 - **Outcome performance standards:** the second row represents lower-level, tangible and measurable performance standards that contribute to higher-level outcomes being achieved.
 - **Performance measurements:** the third row provides illustrative examples of how metrics could be used to measure each outcome performance standard. These metrics could be either adapted from the current SQRB scheme, where appropriate, or newly created.
 - **Incentives:** the fourth row represents the incentives associated with the delivery of each performance standard and thus the delivery of the corresponding outcome.
8. In assisting HAL to develop the proposed outcomes, the CAA proposes to develop and issue a set of guiding principles to govern this process. One of these principles is for the CAA to reserve the right to mandate specific outcomes or outcome performance standards where this is in the interests of consumers. Further detail on these draft principles are set out in paragraph 22 of the Seminar Paper.

9. The airline community welcomed the CAA's consumer-focused approach to the economic regulation of HAL. However, it queried what the CAA considered needed to be improved. They said the SQRB was working well, and that performance at Heathrow Airport had consistently improved. The CAA clarified that the review was not about assessing what is and what is not working within the SQRB scheme but more about having a fresh look at arrangements that have been in place for some time and assessing whether they deliver the outcomes that consumers value. The CAA also stressed that the SQRB scheme was developed prior to the Civil Aviation Act 2012, to which they now must have regard.
10. HAL considered that while there had been many improvements to the SQRB scheme, it was the appropriate time to check whether the right outcomes are in place using consumer research which might demonstrate that certain elements are no longer required.
11. HAL and the airline community debated the difference between an outcome and an output. HAL considered that an outcome is an end result, whereas an output may be less reflective of consumer preferences. HAL also noted that the ideal outcome is 'happy passengers arriving/departing on time with their baggage' but that this was too high level and difficult to measure, hence the need for service quality regulation as a proxy. The airline community considered inputs and outputs could be measured but the concept of an outcome as a 'happy passenger' is nebulous and difficult to define. The airline community also considered one person's output might be another's outcome and that definitions needed to be carefully considered. The CAA clarified that outcomes are designed to map out what the regulatory framework should encompass, reflecting consumers' preferences.
12. HAL also commented that the ACT Term in the SQRB scheme already was a form of outcome regulation. HAL provides outputs through asset investment and management. Congestion on the runway is recorded in a superlog which can be attributed to NATS, airlines and other stakeholders who then collectively review performance against the standard to minimise

delay and maximise throughput of the runway, which is the overall outcome.

13. The airline community said that passengers choose to fly with specific airlines. To deliver that service, airlines buy services from the airport such as the use of baggage and runway infrastructure, central search and operational posts. The airline community considered that the CAA's role is to regulate the services HAL provides because of its substantial market power, not the service that airlines provide.
14. The airline community queried what the CAA's objective is for outcome-based regulation and what it is trying to measure. For example, is the CAA intending to focus on whether services bought by airlines on behalf of passengers are delivered efficiently or whether passengers enjoyed their flights? The CAA does not see this as a binary choice and asked stakeholders how far the proposed outcome-based regime should extend. An outcome-based approach could have a narrow focus on HAL or wider view of all aspects of the passenger journey.
15. The airline community considered there was a danger of selecting specific aspects of the passenger journey while ignoring other parts that the passenger does not see but which are still important, such as control posts and cargo vehicles. If these unseen parts of passenger journey are not working efficiently the whole system breaks down. The CAA considered these unseen elements of journey were important and wanting to find an overarching framework in which they can sit.
16. The airline community also noted that some airlines differentiate their service based on a number of factors and the CAA should be careful not to set broad overarching outcomes. They said the CAA should be focussing economic regulation on addressing the substantial market power of HAL, not on different airlines' commercial strategies. They said that airlines already operate in highly competitive markets which adapt very quickly to what consumers wants.

17. The airline community also considered that consumers attach different degrees of importance to on-time performance, which is a very complex area. In considering on-time performance airlines break down all elements of punctuality, looking at smallest building blocks and consider how to improve these individual elements. Therefore setting broad outcomes in this area is not workable.
18. The airline community considered baggage is a big issue for consumers and when things go wrong it has a huge impact. The airline community wanted to be assured that when airlines give passengers' baggage to HAL it will arrive on time. As such, they welcomed further incentives for baggage performance but only where performance is in HAL's control. The airline community noted that they are already incentivised in the area of baggage performance as missed bags have to be repatriated, causing reputational and financial damage. The airline community also considered passenger automation and fuel resilience are important projects that need to be progressed.

The role of HAL's business plan

19. The CAA outlined that it would like to incentivise HAL to deliver a high quality business plan that reflects consumers' interests. The CAA's analysis of how this works in other sectors reveals that regulators have identified at least four types of incentives; reputational, administrative, financial, procedural. Without ruling out any particular incentive at this stage, the CAA noted that it considered financial incentives may be difficult to implement given the lack of comparator companies on which to make an objective assessment.
20. The airline community questioned the CAA's proposal to incentivise HAL to produce a good business plan. They believed that HAL should be expected to provide a good plan and therefore have no need to be rewarded for delivering a good plan. Rather they should face disincentives if they produce a plan that was not good. The airline community also considered a quality business plan is reviewed and debated and then updated through

constructive engagement – having an initial and a final business plan is the right approach. Airlines considered the process for developing the alternative business plan in Q6 was outside this process and caused difficulties.

21. HAL considered that it made sense not to include financial incentives. They considered there might be some procedural incentives that could provide benefits. HAL considered it was helpful to develop business plans early on as this would improve Constructive Engagement. Both the airline community and HAL saw value in reputational incentives.
22. The airline community considered the Capital Portfolio Board was very effective in managing the capital plan, and that the Board already has a process in place to develop business plans and make planning process continuous.
23. There was general agreement between HAL and the airline community that more clarity was needed on what was meant by high quality business plan and on how the CAA's will assess the business plan. The CAA considered that what is a high quality business plan would be informed by Constructive Engagement, the views of airlines and the CCF. The airline community considered that the measures for whether a plan is high quality or not is given by effectively answering the questions: 'is this a business plan that a commercial business operating in a competitive market would produce?'
24. HAL considered that the Q6 process was heavy handed and wanted to avoid that in H7. The airline community wanted assurance that the CAA will undertake proper scrutiny to assure that business plan is good quality. The large gap in operating expenditure in Q6 between the airlines and HAL was discussed. The airline community also noted that their forecast for HAL's Q6 operating expenditure was the closest to the CAA's forecast. They also considered the CAA should learn from lessons of Q6 in ensuring such a gap doesn't materialise in H7.
25. HAL considered the assessment of what is a good business plan is very subjective and that principles needed to be agreed and shared across the

industry in order for parties to understand who is making decisions. The CAA clarified that it is ultimately for the CAA Board to make decision informed by Constructive Engagement, the CAA's own analysis and the CCF.

26. There was consensus between the airlines and HAL that the CAA's proposal of Board level engagement between the CAA and HAL, for example in presenting HAL's business plan, was a useful approach. There was also consensus between the airlines and HAL that the CAA proposal of requiring HAL Board sign-off of the HAL business plan was a positive proposal requiring HAL Board ownership of the business plan.

The wider incentive framework

27. In addition to the incentives in terms of consumer outcomes and business plan, the CAA also proposed to consider wider incentives that are at play, such as totex, risk allocation ('gain and pain' sharing), and innovation.
28. Regarding totex, the airlines and HAL were sceptical that totex would lead to better incentives. The driver for totex in other sectors had been a perceived capex bias which airlines and HAL don't see as an issue at Heathrow.
29. The CAA suggested that if Heathrow is approved for increased runway capacity, a significant increase in capex would need to occur, which may mean a totex approach has merit. The airline community considered that a new runway is likely to require change in how HAL is regulated anyway, so there is no need for totex.
30. Regarding risk allocation ('gain and pain' sharing), the airlines considered it would be remiss of the CAA not to look at risk sharing and were supportive of a general review and learning from other regulated sectors. However, they also noted that airlines already do a lot on risk sharing and many changes were introduced in Q6. The airline community also wanted to guard against consumers becoming risk takers of last resort.

31. HAL considered there was scope for traffic risk allocation which might become more important in the case of additional runway capacity. The airline community also agreed a review of traffic risk allocation may be helpful as the community believe passenger risk is dealt with asymmetrically to the detriment of the consumer.
32. Regarding innovation, the airline community considered an innovation fund was not appropriate and that the airlines already incentivised HAL to innovate. They also considered there was already good practice and governance in place to encourage innovation, and that competition amongst other airports and the airlines themselves generated innovation for HAL to adopt.
33. The airline community considered incremental innovations are more effective than innovation funds. Incremental improvements include Time Based Separation and A-CDM which help deliver higher runway utilisation. The airline community considered Constructive Engagement was the correct forum for airlines to discuss innovation.
34. HAL considers an innovation fund could be useful where parties do not agree on a business case, or for research and development projects to address environmental and community concerns. HAL also considered there might be a role for the CCF, such as in identifying an area which is important to consumers and challenging HAL and the airlines to reflect it.

Next steps

35. The CAA thanked stakeholders for their attendance and input and confirmed that it would continue to engage and keep them updated.