

## Economic regulation of capacity expansion at Heathrow: policy update and consultation

1. This submission is made by International Airlines Group, SA (IAG) in response to the CAA's consultation of March 2019 on its policy update for the economic regulation of capacity expansion at Heathrow (HAL) (CAP1782). It sets out the initial views of IAG and its subsidiary airlines: British Airways, Iberia, Vueling, Aer Lingus, LEVEL and IAG Cargo.
2. It does not seek to comment on every point raised in CAP1782 - rather, it focuses on what appear to be the key issues; however, we may subsequently comment on others.
3. For ease of reference, it will broadly follow the structure of CAP1782. Unless otherwise stated, **emphasis** is added, throughout.

### Executive Summary

4. The CAA has taken on a role, over and above its statutory duty, to ensure the financeability of capacity expansion. It seeks to justify its position by simultaneously arguing that financing costs do and do not get passed through to passengers, and pays lip service to '*affordability*', focussing instead on ensuring that HAL's shareholders are remunerated. Nevertheless, Government explicitly recognises that airport costs are passed through to passengers and that affordability requires airport charges to remain flat - a challenge the CAA puts to Arora, but not to HAL in CAP 1782.
5. The CAA signals support for HAL's dividends, through increased future regulated rates of return, regardless of actual (or efficient) WACC and despite the obvious benefits of assuming HAL's demonstrably sustainable higher level of gearing. HAL is absolved of responsibility for financeability, as the CAA is prepared to transfer risk and cost onto passengers, in order to protect dividends, whilst financing capacity expansion, irrespective of inefficiency, inappropriate capital structure or unwise dividend policies.
6. There remains the requirement for rigorous ex-ante scrutiny of forecast capital investment (to ensure allowances are reasonable), as well as ex-post scrutiny of actual capital investment, to ensure passengers benefit from capital investment efficiency and/or over-forecast. HAL failed to justify Category B costs and information provided by HAL was unreliable. In response, the CAA acceded to HAL's request for more time to support its position and rather than learning from HAL's approach to Category B costs, it is planning to weaken incentives for efficient Category C costs.
7. There are strong incentives on airlines both to fill and increase the size of aircraft at LHR, while HAL's revenues are strongly correlated with passenger volume, so there is no countervailing buyer power to HAL's monopoly. Efficiency incentives ought to deliver

desired outcomes most of the time, while customers shouldn't pay for undesired outcomes, so the CAA must apply quantitative measures to HAL's behaviour. Responsibility for financing expansion is HAL's; the CAA's responsibility is to make sure that if it is done, it is done in a way that furthers the reasonable interests of users.

8. Whilst disdainful of Arora's proposals, HAL asks the CAA to put in place subjective and unequal targets, at the same time threatening non-cooperation; however, the CAA must not allow HAL to shut out competition. Neither must it hold Arora to higher standards than it does HAL - and whilst HAL's criticism of Arora's proposals is reflected in its language, it must not be reflected in the CAA's evidence to the DCO process.
9. The challenge of "... *no real increase in charges...*" applies to all potential developers, including HAL and that the CAA has chosen not to develop a regulatory framework that caters to competition is troubling. We disagree with the DfT's reasons for preferring HAL over Arora, consider that the CAA must treat both equally and question the timeliness/relevance of certain '*initial tests*' being applied to Arora.

#### **Approach to financeability**

10. The CAA says that it will: "... *help ensure [HAL] can raise the relatively large amounts of new finance that will be necessary to allow capacity expansion to proceed.*"<sup>1</sup> This is not the duty imposed on the CAA, which is that it: "... *must have regard to the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted...*"<sup>2</sup> So the CAA has no duty to help HAL raise large amounts of finance; it is an economic regulator, not a financial fixer. The CAA's duties do not extend beyond being aware of (and by implication, sensitive to) HAL's ability to finance current operations.
11. In reference to the Civil Aviation Act 2012, the CAA says: "[t]his approach should **also** enable us to satisfy our duty under section 1(3)(a) CAA12 to have regard to the need to ensure that HAL is able to finance its provision of airport operation services at Heathrow (often referred to as the '*financeability duty*')".<sup>3</sup> In recognising that its chosen approach is incremental to its '*financeability duty*', the CAA explicitly recognises that it has assumed a role to ensure the financeability of capacity expansion at Heathrow, which goes beyond its '*financeability duty*'.

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<sup>1</sup> Chapter 1, paragraph 1.1.

<sup>2</sup> The Civil Aviation Act 2012, chapter 1, section 1, paragraph 3(a).

<sup>3</sup> Footnote 8.

12. Notwithstanding the damaging consequences of how the CAA's position affects HAL's behaviour, the CAA segues towards a consumer benefits justification. On one hand, it takes a view that finance costs do not find their way to passengers: "... [helping HAL] raise the relatively large amounts of capital necessary to allow capacity expansion to proceed [...] should deliver benefits to consumers in terms of greater choice, less delay and **lower fares**...". In its very next breath, the CAA argues in the opposite direction: "... [an incentive package would not] inappropriately raise [HAL's] financing costs and, so, **prices to consumers**".<sup>4</sup> The CAA cannot have it both ways: either financing costs are passed through to passengers, or they aren't. They are.
13. The CAA is silent on what it understands by the term "**affordability**", despite saying that it has previously "... described [it's] approach to affordability and financeability...". CAP1782 mentions "**affordability**" just 16 times, in contrast to 118 references to "**financeability**".<sup>5</sup>
14. In our view, something is 'affordable' if it adds (but not if it destroys) value. A customer with a choice would never willingly buy something, if doing so would damage its business. So, in a competitive market, where every incremental consumer is more price-sensitive than the last, no supplier would ever choose to increase unit costs at the same time as unit revenues were decreasing; however, this is what airlines are facing.
15. In contrast, the CAA describes in some detail what it understands by "**financeability**", going so far as to produce a "**financeability framework**", which indicates various factors influencing financeability and their interrelationships.<sup>6</sup> Notwithstanding our view that this is of limited value, it is clear that the CAA is giving more consideration to remunerating HAL's shareholders than it has to protecting consumers.<sup>7</sup>
16. In well-functioning markets, affordability and financeability are the same thing. If customers can't afford something, they won't buy it; and suppliers of goods or services that customers don't buy, are unfinanceable; however, the CAA has created an arbitrary distinction between the two, using this to justify a focus on what matters to HAL's shareholders, whilst paying lip service to what matters to passengers. The CAA is supposed to protect passengers from the abuse of monopoly airports, not to ensure monopoly airports are able to further consolidate their monopoly power.

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<sup>4</sup> Chapter 1, paragraph 1.1.

<sup>5</sup> Paragraphs 8, 1.3, 1.6, 1.8, 1.11, 1.23, 1.35, 1.37, 1.40, 2.3, 2.7, 2.15, 2.28, 4.17. 4.24 & Annex E, paragraph 7.

<sup>6</sup> Paragraph 1.8 & figure 1.

<sup>7</sup> For example, we would argue that 'costs of equity and debt' (item 6) are inputs to financeability; however, in the CAA's view they appear to be outputs of 'risk allocation', 'credit rating', 'incentive parameters and cost allowances' and 'gearing', whilst an input only to a 'financeability check'.

17. In only two references to affordability does the CAA depart from its narrative of providing incentives to HAL. In the first, the CAA says, “... *Arora may be in a position to provide more evidence on the cost, **affordability**, operability and timing [but] the primary onus remains on Arora to show that it can address the issues identified by Arcadis and demonstrate that it can meet our initial tests.*”<sup>8</sup> Then, in an Annex entitled “*Initial Tests for Arora*”, the CAA asks: “... *[w]hat evidence is there that [Arora’s] proposals have a reasonable prospect of being consistent with the **affordability** challenge set by the Secretary of State?*”<sup>9</sup>
18. On 24<sup>th</sup> May 2018 (the eve of a Parliamentary vote on Heathrow expansion), the Secretary of State for Transport, The Rt Hon Chris Grayling MP, gave a speech to industry, in which he said, “*[i]t remains one of my fundamental priorities to deliver the ambition I set in 2016 – to keep airport charges as close as possible to current levels – so price increases are not passed on to airlines, and ultimately consumers.*”<sup>10</sup> This was followed by a Statement to the House of Commons on 5<sup>th</sup> June 2018, in which he said: “*[e]xpansion must also remain **affordable** to consumers. We took a bold step when I asked the industry regulator, the Civil Aviation Authority (CAA), to ensure the scheme remains **affordable** while meeting the needs of current and future passengers.*”<sup>11</sup>
19. It is consequently clear that not only does Government explicitly recognise that airport costs are passed through to passengers, but that affordability requires that airport charges remain flat – a challenge the CAA puts to Arora, but not to HAL.
20. In our view, it would be a mistake for the CAA to “... *assume that HAL’s management has taken all reasonable steps to manage its financeability and taken appropriate mitigating actions.*”<sup>12</sup> HAL relies on the CAA’s commitment to financeability. For example, following the CAA’s support for an iH7 arrangement, to reimburse airlines in H7 (when the CAA has said it would take account of HAL’s financeability in setting a regulated rate of return) for £400m+ benefits HAL will accrue in iH7, in February 2019 HAL issued an extraordinary £500m dividend.<sup>13</sup> The CAA may be aware this attracted a certain amount of media interest, notably an article entitled ‘*BA fury after Heathrow’s shareholders land £500m while the airport continues heaping costs on customers*’, in

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<sup>8</sup> Paragraph 4.24

<sup>9</sup> Annex E, paragraph 7.

<sup>10</sup> <https://www.gov.uk/government/speeches/address-to-airlines-uk-on-heathrow-engagement>

<sup>11</sup> <https://www.gov.uk/government/speeches/proposed-heathrow-expansion>

<sup>12</sup> Paragraph 1.13.

<sup>13</sup> CAP1769 Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements, paragraphs 1.29 & 1.30.

which our CEO refers to not only the dividend in question, but to the £3.5bn in dividends HAL's shareholders have enjoyed since 2012.<sup>14</sup>

21. In this way, the CAA signals support for HAL's dividends, by increasing future regulated rates of return, regardless of HAL's realised WACC, or an assumed efficient WACC, something explicitly recognised in capital markets: *"Heathrow operates under a **predictable and supportive regulatory framework** based on the RAB concept, which encourages investment by allowing recovery of capex costs via tariffs. A fair return over the RAB ensures the business' **profitability and shareholder returns, which grow in line with capex**. Heathrow's profitability, 61.9% S&P Global Ratings-adjusted EBITDA margin in FY2016, is not only **above average for the transportation infrastructure industry but also the highest among rated European airports**. This is the result of the high level of recent investments in the airport's infrastructure, and Heathrow's ability to recover investment costs. It has also been supported by Heathrow's success in increasing its commercial revenues per passenger, in particular from retail and car parking, and its focus on delivering operating efficiencies."*<sup>15</sup>
22. It is all very well for the CAA to say that *"... it will remain the responsibility of HAL's management to decide on its actual financial structure and ensure that its business is financeable..."*; however, the CAA must set a notional WACC which it considers to be efficient.<sup>16</sup> It must inform itself by, amongst other things, looking at HAL's actual capital structure and understanding what equity/debt ratios are achievable, as well as the true, post-tax cost of debt. We are therefore pleased by the CAA's recognition of HAL's levels of debt being sustainably well above Q6 regulatory assumptions, but remind it that the quoted 78.4% is calculated against a 2017 RAB that was some way ahead of depreciated NBV of assets.<sup>17</sup>
23. Cambridge Economic Policy Associates LLP (CEPA) says *"[o]ther things being equal, highly geared financial structures might be expected to be associated with relatively low-risk, stable and predictable cash flows."*<sup>18</sup>
24. This submission will not comment in detail the CAA's 'initial thinking' for financeability testing. In our view, CEPA has pointed to a reasonable methodology and we would

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<sup>14</sup> <https://www.thisismoney.co.uk/money/markets/article-6737763/BA-fury-Heathrows-shareholders-land-500m.html>

<sup>15</sup> S&P Ratings Direct, Heathrow Funding Ltd, 4<sup>th</sup> May 2018.

<sup>16</sup> Paragraph, 1.18.

<sup>17</sup> Paragraph 1.19.

<sup>18</sup> CEPA, Response to CAA consultations on RP3 and H7 WACC, 12<sup>th</sup> April 2019.

expect the CAA to adopt a similar approach, avoiding any inclination to reward excessive dividend-taking with increased regulated rates of return.

25. The CAA says that if, “... *modelling indicates a possible financeability problem we will ensure it also reflects reasonable managing/mitigating actions by HAL (including reducing dividends, considering other steps to limit any increases in gearing and seeking greater efficiencies)*.”<sup>19</sup> In our experience, firms facing financeability problems usually **stop** dividends, would **already** have capital structure controls in place and would **constantly** be seeking efficiencies. It is therefore worrying that the CAA considers these to be necessary only in the case of distress. It goes on to say that if HAL doesn’t solve any financeability problem, it will consider “... *modifying incentive and risk sharing arrangements...*”, “... *making changes to our assumptions on capital structure [and] gearing...*”, “... *reprofiling revenue or regulatory depreciation...*” and “... *[revising] assumptions on the cost of debt and/or equity finance.*”
26. In this way, HAL is absolved of responsibility for its own financeability, as the CAA has confirmed that it is prepared to transfer risk and cost onto passengers, in order to ensure dividends can be paid, whilst financing capacity expansion, irrespective of inefficiency, inappropriate capital structure or unwise dividend policies.
27. Whilst understanding the CAA’s view that, “... *given that depreciation is essentially just re-profiling of revenue cash flows, it does not automatically affect the value of the business...*” this can only be true when the regulated rate of return equals the observed WACC; however, as it is greater, so slower depreciation increases HAL’s enterprise value, because shareholders benefit from the variance over a longer period.<sup>20</sup> Perhaps more importantly, because airlines’ WACC is greater than HAL’s, slower depreciation reduces the NPV of future costs to airlines (without effecting the NPV of revenues to HAL) and in this way, supports airlines’ investment in capacity uptake. For this reason, we encourage the CAA to consider and consult on the merits of unitised depreciation.

### **Incentives for capital expenditure efficiency**

28. We agree with HAL “... *that the introduction of capital efficiency incentives would represent a significant departure from [the CAA’s] current regulatory practice...*”; however, in our view it would be a welcome withdrawal from the existing comfortable arrangement, in which HAL is rewarded at a rate above WACC for everything it does.<sup>21</sup>

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<sup>19</sup> Paragraph 1.36.

<sup>20</sup> Paragraph 1.39.

<sup>21</sup> Paragraph 2.5.

29. Our views on incentives for capital expenditure efficiency are straightforward – and haven't changed since our September 2017 submission to the CAA on this topic.<sup>22</sup>

*“As the CAA points out, both ex-post and ex-ante scrutiny of CAPEX are required. In particular, rigorous ex-ante scrutiny (through an IFS) is absolutely crucial for investment of this scale – and will require much more detailed plans and costings than have so far been provided by HAL. That said; associated difficulties (not least in quantifying uncertain investment) will necessitate complimentary use of ex-post scrutiny, combined with some mechanism to return excess revenues from capital efficiency and/or over-forecast to customers.*

*“[...]*

*“Costs: Incentives and Efficiency Assessment. For clarity, IAG supports both ex-post and ex-ante CAPEX efficiency incentives, but – in light of disincentives on HAL to overspend, should it not share efficiency benefits - is willing to consider ex-post benefits sharing. For this to be effective, CAA ex-post reviews must display rigour that has not previously been in evidence.*

*“Similarly – and notwithstanding difficulties arising from informational asymmetries, ex-ante CAPEX reviews must be rigorous and so we agree with the CAA when ‘[it] expect[s] HAL to provide strong supporting evidence for its forecasts of costs.’ We would say more: that in the absence of such evidence (or quality of evidence), the CAA (in collaboration with stakeholders and the IFS) should set an ex-ante cost allowance, which it sees as reasonable and fair. (This can always be reviewed, ex-post.)*

*“We do not agree with the CAA’s suggestion of the use of an approach which makes assumptions about the chances of outturn CAPEX being higher or lower than a central case. A central case ought to take account of all relevant factors and so, over a portfolio of investments, should be central at the end, as well as at the beginning. As it is described by the CAA, the ‘p80’ value for development CAPEX artificially increases cost estimates, so that 80% of the time, costs would be no higher than the central case. In other words, cost estimates would be artificially increased, in order to create an illusion of capital efficiency!*

*“The CAA is aware of airlines’ concerns that capital efficiency is the regulatory equivalent of over-forecasting, so it would be entirely unreasonable to replace HAL’s hitherto regulatory gaming with an equivalent approach, cemented into regulation.*

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<sup>22</sup> Consultation on Core Elements of the Regulatory Framework to Support Capacity Expansion at Heathrow, IAG response to CAP1541, paragraphs 45 & 66–70.

*“It would be wrong to consider LHR R3 on a project by project basis – for example: project A comes in at +£10m and the CAA makes a +£10m ex-post RAB adjustment, while if project B comes in at -£10m, the CAA shares the benefit between airlines and HAL, by making a -£5m RAB adjustment, so the net effect to the RAB is +£5m. Rather, it must take a portfolio approach; using the same example, there is no damage and nothing to be done to the RAB.”*

30. The CAA will be aware that from a regulatory perspective ‘capital efficiency’ and ‘over-forecast’ look very similar - and so may agree that were airlines to get back 100% of capital underspend and/or over-forecast, it would likely end up being 100% of nothing, because then it would be in HAL’s interests to spend everything. So, from a pragmatic standpoint, there needs to be some kind of ex-post benefits-sharing. A brief commentary with further detail on current and future mechanisms for capital expenditure efficiency is appended.
31. So, in summary, there remains the clear requirement for rigorous ex-ante scrutiny of forecast capital investment (to ensure allowances are reasonable), as well as rigorous ex-post scrutiny of actual capital investment, to ensure passengers benefit from capital investment efficiency and/or over-forecast.
32. We share the CAA’s view that “[t]he significant increase in HAL’s forecast of Category B costs [...] reinforces the importance of ensuring that HAL faces sufficient pressure to keep its costs under control.”<sup>23</sup> Whilst we agree, it would have inspired more confidence in the CAA’s willingness to regulate HAL, had it acted meaningfully. The CAA had previously said that Category B costs were to be limited to £265m; however, it is still allowing HAL spend at a recovery rate of 105% +5.35%pa whilst we await a consultation and determination of how to handle the proposed increase of Cat B spend to £530m. It is not surprising that HAL continues to over-spend. As the CAA summarised:<sup>24</sup>

*“The key findings of PwC’s initial report included:*

- *HAL provided a statement of Category B costs to enable PwC to undertake its review. It also provided a breakdown of these costs by cost category. However, **HAL was unable to provide comprehensive supporting information that reconciled to the statement** and, following a further request from PwC, provided a large number of invoices and other accounting records (including payroll information) in support of its statement;*

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<sup>23</sup> Paragraph 2.15

<sup>24</sup> CAA January 2019, CAP 1752, Independent Planning Cost Review on costs relating to the Heathrow Expansion Programme covering the period 2016 and 2017

- Nonetheless, **PwC was unable to fully reconcile this evidence to the statement of Category B costs provided by HAL, with only 60% of the costs (including operating costs) identified by HAL as Category B costs being supported by evidence;** and
- PwC also noted that **the information provided by HAL included duplicate invoices and referencing/naming inconsistencies,** which made the allocation of invoices to the cost categories particularly challenging.

*“As a result of the significant variance between the Category B costs identified by HAL and the initial total values derived by PwC from the evidence that HAL had provided to support its estimates of costs, **HAL requested that we extend the period of the review and allow it to provide further information. Bearing in mind that this is a new process, we decided to agree to HAL’s request** and we asked PwC to produce a supplementary report that would expand its original assessment to cover this new additional information.”*

33. So, first HAL failed to provide information to support its stated costs and then provided information that supported just 60% of these; however, on further examination it was found that the information provided by HAL was unreliable. In response, the CAA acceded to HAL’s request for more time to support its position.
34. In light of HAL’s lack of financial oversight, the CAA variously states that:
- *“... there would be an opportunity to adjust [the cost baseline] later...”;*<sup>25</sup>
  - *“... because of the need to set a cost baseline at a relatively early stage [...] the regulatory model may need to be implemented with a weaker incentive”;*<sup>26</sup>
  - *“... any adjustments to the cost baseline [...] will need to be considered further...”;*<sup>27</sup>
  - *“... [details of incentive arrangements would need to take account of] how baseline costs should be uplifted to allow for price or cost inflation...”;*<sup>28</sup>
  - *“[i]f we decide to introduce capital efficiency incentives, it will be important that we introduce a cautious and proportionate approach...”*<sup>29</sup>

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<sup>25</sup> Paragraph 2.18

<sup>26</sup> Paragraph 2.19

<sup>27</sup> Paragraph 2.22

<sup>28</sup> Paragraph 2.23

<sup>29</sup> Paragraph 2.24

35. It is not clear that the CAA has learned from HAL's approach to Category B costs. It appears to be planning to weaken incentives for efficient Category C costs, which would go some way towards avoiding further criticism.

### **Promoting economy and efficiency**

36. Whilst recognising the complexities, we support the CAA's proposal to introduce an "... *efficiency condition [to address] how HAL conducts its business, rather than precisely what it delivers...*".<sup>30</sup> The case for this is strengthened by HAL's pointed response to the suggestion, in that it is "... *not necessary, targeted or proportionate.*"<sup>31</sup>
37. The economy and efficiency licence condition must make clear that it applies only to HAL and the provision of its airport services. There cannot be any ambiguity which would allow the misuse of a licence condition to interfere in the operation of other parties. Therefore, in our view, clause B3.2 should be redrafted to read: "*[i]n complying with [Condition B3.1], the Licensee shall seek to secure that the reasonable demands of present and/or future users of air transport services regarding the range, availability, continuity, cost and quality of airport operations services **provided by the Licensee** at the Airport are met.*"
38. Our concerns are around designing a structure that will deliver against the CAA's objectives. Key will doubtless be delivering the desired "... *behavioural focus...*" through quantifiable/measurable outcomes.<sup>32</sup> In the meantime, HAL continues to be unresponsive to airlines' requirements and is insensitive to the commercial pressures under which they operate. It has (and maintains) substantial informational and resource advantages, which airlines cannot match.
39. We understand that "... *an efficiency condition could create an additional risk that HAL might want reflected in the [WACC].*"<sup>33</sup> To be clear, this comment refers to the effect that a perceived increase in risk might have on the regulated rate of return, rather than on HAL's experienced WACC. We know that HAL will take any opportunity to protest that it is somehow '*risky*' and that the CAA should therefore increase its regulated rate of return. Equally, HAL (like other businesses) will be working hard to reduce its experienced WACC – for example by replacing equity with debt, in order to continue remunerating shareholders far above rates commensurate with the risks they bear.

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<sup>30</sup> Paragraphs 3.4 & 3.24

<sup>31</sup> Paragraph 3.6

<sup>32</sup> Paragraph 3.9

<sup>33</sup> Paragraph 3.11

40. HAL's comments about engaging in the drafting of an efficiency condition betray tacit acceptance of its necessity; albeit, with a view to mitigating its effectiveness. Nevertheless, we are pleased to note the CAA's rejection of HAL's protests and recognition that HAL's prior conduct has fallen short of the required behaviours.<sup>34</sup>
41. In particular, we note HAL's suggestion that "... *an efficiency condition would undermine investor confidence...*" and are pleased that the CAA has rejected this premise.<sup>35</sup> What HAL means is that if it is efficient, customers will pay less – and so there will be less money to give to shareholders. In our view, a well-designed efficiency condition should increase investors' confidence that they will receive a fair return; although, we accept that they may be less-confident of benefitting from the kind of exceptional dividends that they have recently enjoyed.
42. It is hard to understand what "... *the commercial pressure that airlines can bring to bear on HAL...*" could effectively be.<sup>36</sup> HAL realises a (broadly) fixed revenue per passenger and once airlines have committed assets to LHR, they **must** set airfares to maximise marginal revenue per ATM. In this way, airlines translate any perceived volume risk an airport might argue it faces into their own revenue risk. So, there is no volume threat available to airlines and if they were to reduce the number of assets deployed at LHR (which is difficult in itself as there are no suitable alternative airports to deploy the assets to), then others may quickly replace them. Moreover, as capacity constraints tighten (constraints on the supply of slots) in the face of increasing demand (for seats), airlines are strongly incentivised to deploy bigger, more efficient assets into LHR – or to trade slots to those who can.<sup>37</sup>
43. The result is that there is robust pressure on airlines both to fill and increase the size of aircraft at LHR, while HAL's revenues are strongly correlated with passenger volume, so there is no countervailing buyer power to HAL's monopoly.
44. We do not consider that output-focussed efficiency measures need slavishly be bound to quantitative outcomes, as the CAA seems to suggest. We agree with the CAA when it says that "... *what can reasonably be expected from HAL is that it approaches the management of airport efficiency and effectively: this does not necessarily mean delivering all the desired outputs and outcomes all of the time.*"<sup>38</sup> We would add that it does mean delivering all the desired outputs and outcomes most of the time; that

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<sup>34</sup> Paragraphs 3.16 – 3.20, 3.23 & 3.27

<sup>35</sup> Paragraph 3.29

<sup>36</sup> Paragraph 3.21

<sup>37</sup> For explanation, see IAG response to CAP1658, appendix, paragraphs 9-11

<sup>38</sup> Paragraph 3.24

customers shouldn't be expected to pay for undesired outputs and outcomes; and that wherever the CAA eventually positions itself on this question, it must apply a quantitative measure to HAL's behaviour.

45. Considering proportionality (as mitigation), the CAA points out that "... *the capital-intensive nature of HAL's activities have parallels in other sectors...*", but should not forget that airlines too are highly operationally geared.<sup>39</sup> Airlines' investment in aircraft (excluding maintenance and other facilities) at LHR is around £32bn, compared to HAL's investment in plant, property and equipment of around £16bn.<sup>40</sup> It is therefore clear that airlines have over twice the capital invested at LHR than does HAL.
46. We do not consider that the CAA should need to "... *attempt to define 'economy or efficiency' [or] effectiveness...*".<sup>41</sup> In simple terms: 'economy' is about procuring the least cost inputs; 'efficiency' is about transforming these into the most valuable outputs; and 'effectiveness' is about making sure those outputs meet customer requirements. We do not understand why the CAA would describe these well-understood terms as "... *fact-specific concepts requiring assessment in the context of the particular issue under consideration.*"<sup>42</sup>
47. The CAA raises an interesting point, when it says "... *we propose to amend the draft efficiency condition to refer to the requirements of users (explicitly referring to both present and future users) and acknowledge the need for HAL to be able to finance its activities at Heathrow, in line with CAA12.*"<sup>43</sup> As previously discussed, the CAA's 'financeability duty' extends no further than HAL's current activities and goes no deeper than 'having regard to' these. So, the CAA owes no financeability duty to future users, only a duty to further their interests once they become future users; however, not to ensure that they do. So, whilst we agree that "... *HAL's approach should represent value for money for users in both the short and long term...*", it is not the CAA's responsibility to replace capital paid out in dividends, by means of an artificially increased regulated rate of return. Specifically, the CAA must not muddle financeability of current activities with that of capacity expansion.

## **Alternative delivery arrangements**

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<sup>39</sup> Paragraph 3.30

<sup>40</sup> Roughly, 166x narrow bodies @ £31m & 292 wide bodies @ £92m; & Heathrow Airport Limited, Annual Report & Accounts 2017.

<sup>41</sup> Paragraph 3.37

<sup>42</sup> Paragraph 3.41

<sup>43</sup> Paragraph 3.38

48. We support the principle of competition throughout all stages of planning, development, construction and operation – and therefore welcome Arora’s involvement in this field.
49. It is interesting to contemplate the contrast between HAL’s performance in terms of sharing information about its own plans and its view that the CAA has a duty to ensure financeability. It states that “... *third party providers should be required to demonstrate **real prospects for viability, financing and rapid development** of expansion proposals [and that] the CAA should set out a **meaningful timeline for testing the credibility** of Arora’s proposals...*” HAL goes on to say that “... *innovations in the regulatory framework should only be introduced if they are in the interests of consumers.*”<sup>44</sup> This is an open-ended ‘get out’ clause, in case Arora is able to prove that it has met whatever subjective and unequal targets HAL is able to persuade the CAA to set.
50. We disagree with HAL’s suggestion that “... *a competitive model would require various regulatory, legal and operational interfaces between HAL and a third party to be created and this could potentially increase the risks of lapses in coordination.*”<sup>45</sup> Coordination between different entities in the aviation sector is commonplace and the only reason for the systemic failure suggested by HAL, would be if HAL chose not to cooperate with other parties. The CAA must not allow HAL to shut out competition and reinforce its monopoly position.
51. Our view remains that the CAA must not hold Arora to higher standards than HAL; especially, because HAL has very significant informational advantages. The CAA must ensure that HAL provides information that is reasonably needed by third parties, in order to further their applications – and it must take decisive steps, where this is not happening.
52. We note that the CAA’s role in the DCO process is “... *as a statutory consultee under PA08...*”<sup>46</sup> and understand this to mean that the CAA will be asked for its views on DCO applications, but will have no direct role in the decision-making process. As the sectoral regulator, it will be highly influential in that decision.
53. We are pleased to note that (in contrast to HAL’s behaviour), the CAA’s technical consultant Arcadis reported that “... *through the review, **Arora engaged constructively, providing it with access to key stakeholders, shared information and evidence to support its proposals.***”<sup>47</sup> Whilst this is a pleasing summary, it is concerning that some of

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<sup>44</sup> Paragraph 4.5

<sup>45</sup> Paragraph 4.6

<sup>46</sup> Paragraph 4.13

<sup>47</sup> Paragraph 4.18

the CAA's subsequent language used in relation to Arora is less enthusiastic, for example: "... Arora's proposals are currently at an early stage of maturity..."; "... [it is not known] whether they would be constant with the aspiration for no real increase in charges..."; and "... Arcadis considered the stated timescales to be 'ambitious' ...".<sup>48</sup>

Taking these points in order: the CAA does not say how the maturity of Arora's proposals compares with that of HAL's, or to what extent HAL's reluctance to share information has hindered Arora; it puts no similar affordability challenge to HAL; and the use of apostrophes around the word 'ambitious' suggests it is used euphemistically. The 'affordability challenge' of "... no real increase in charges..." is one that applies to all potential developers, including HAL.

54. Even more troubling is what the CAA's says about regulation: "... we do not consider it appropriate for the CAA to commit significant resources to considering the regulatory framework before we have understood the Arora's proposals are **credible, plausible and deliverable**."<sup>49</sup> It would be damaging to competition and consumers if the lack of a developed regulatory framework was to flavour the CAA's evidence at DCO hearings.
55. We note that DfT's views, set out in the 'Relationship Framework Document (RFD) between DfT and HAL', in particular: "... [that] HAL is the only credible promotor..."; "... another party would have to acquire land from HAL compulsorily..."; and "... it would require HAL's agreement and collaboration...".<sup>50</sup> Taking these points in turn: we would be surprised if HAL did not use this opportunity for self-promotion; we understand that HAL would equally have to compulsorily acquire land from Arora, so this cannot be a consideration; and HAL again threatens to withhold cooperation, while the DfT seemingly sees this as a legitimate reason to support HAL's proposals over those of potential competitors. We disagree on all counts.
56. The CAA follows its summary of the DfT's position, by saying, "... this does not mean that we will treat Arora and HAL identically [and] HAL will continue to be regulated by the CAA irrespective of the outcome of each DCO process."<sup>51</sup> We recognise entirely the CAA's different approaches to Arora and HAL; however, do not understand the relevance of the CAA's reference to continuing regulation on HAL. If Arora was to be successful in the DCO process, then both would be subject to regulation; if not, then the question would be academic, but until it is answered, conditions should be the same.
57. The CAA has set out a number of 'initial tests', which it applies to Arora's plans – and says: "... there is insufficient detail in Arora's proposals for us to apply our initial tests...";

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<sup>48</sup> Paragraph 4.19

<sup>49</sup> Paragraph 4.20

<sup>50</sup> Paragraph 4.21

<sup>51</sup> Paragraph 4.22

*“... there remains significant work for Arora to do if it is to meet our initial tests...”*; and *“... the primary onus is on Arora to show [...] that it can meet our initial tests.”*<sup>52</sup>

58. The initial tests include such items as *‘safe operation of airspace’*, *‘safe integration with other airports’* and *‘air traffic management’*.<sup>53</sup> We are unclear whether these same tests have been put to HAL, or whether the CAA has exempted HAL (as the incumbent operator) from examination. Nevertheless, we would remind the CAA that *“... [Arora] is no longer proposing to deliver the new runway...”* and so would also question whether certain tests are appropriate at the current stage of development - or relevant.<sup>54</sup>
59. We note the CAA’s guarded encouragement of *‘HAL and Arora working together’*, but consider there is a significant danger of Arora being subsumed into HAL’s supply chain, which in our view would be far less beneficial (if at all) to competition and consumers.<sup>55</sup>

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<sup>52</sup> Paragraphs 4.23 & 4.24

<sup>53</sup> Appendix E, paragraphs 1 & 4

<sup>54</sup> Paragraph 4.11

<sup>55</sup> Paragraph 4.28

## Appendix

A1. IAG expects any capital incentive regime to deliver efficient investment. A mechanism to do this must include the promotion of strong governance and collaborative working with an aim to jointly agree the right investment and ensure that it is delivered efficiently. The current Q6 system is a significant improvement on that followed in Q5 but it still has flaws which can and should be closed.

A2. The current capital approval process has an ex-ante element, in so far as the amount that attracts a return for HAL is fixed until the end of the control period, however given the rigour that goes into developing a business case for a G3 approval and the reviews that happen at sign off by multiple interested stakeholders we would expect a stronger disincentive in place if HAL overspend this amount. Similarly, if HAL underspend this amount we would expect HAL should receive some of the reward for this shared with the airlines. Any such mechanism should have symmetrical risk and incentive sharing between HAL and the airlines unlike the set up today which favours HAL.

A3. One version of this is the G3 approval amount is fixed and this is the amount that enters the RAB. Post G3 the delivery of the asset is entirely within HAL's control and all risk and reward should remain with them. Alternatively, there could be schemes where there is some split between airlines and HAL to be determined.

A4. In addition to the above ex-ante incentive we would also expect an ex-post review in order to do three things, i) sign off that all scope has been delivered as per the G3 approval, ii) assess whether the spend has been efficient (whatever the outcome) iii) inform future business cases around cost, scope, deliverability and milestone expectations. Ex-Post reviews should be conducted on all projects agreed at G3, and they should be completed and reported as projects go live and not just at the end of the control period.

A5. In summary IAG require an incentive scheme that is deliverable and includes both ex-ante assurance and ex-post rigour. We would welcome further discussions with the CAA on this.