

Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable

1. This submission is made by International Consolidated Airlines Group SA (IAG) in response to the CAA's consultation of July 2019 on early costs and the regulatory timetable for capacity expansion at Heathrow (CAP1819). It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling, Aer Lingus and LEVEL.

INTRODUCTION and CONTEXT

2. HAL's confidence that it will be allowed to realise a generous return on whatever it spends is grounded in its belief in a benevolent regulator. HAL's spiralling estimates of early expenditure (now up to £3.3bn) are uncontrolled - and we have no confidence that its management can deliver the expansion on budget.
3. HAL's original £14bn forecast would deliver both the runway and new terminal capacity (T6A or T5XA) by 2026. HAL's new version of £14bn by 2026 only delivers the runway. This change in scope is significant as it reduces the available airport terminal capacity at runway opening, increases the total cost of the original scope by up to £3bn taking it above £17bn, and creates a greater affordability challenge as new passengers start using the runway much later.
4. HAL's confidence in future benign regulation is exemplified by public statements that it is beyond challenge: *"Heathrow expansion is 'a fait accompli' and will be a 'critical part of any new prime minister's agenda', the airport's chief executive has said. John Holland-Kaye said plans to build a third runway were already underway as he warned off Tory leadership frontrunner Boris Johnson from interfering. He refused to reveal when he last discussed the plans with Mr Johnson but insisted the project 'is now happening'."*¹
5. The CAA appears to have adopted a lenient approach to HAL's escalating CAPEX, forgiving inefficiencies in Cat B spend, presiding over ever-increasing cost estimates and an unclear approach to risk, whilst putting both costs and risks onto consumers. This means that customer interests could be subsumed to HAL's shareholder interests.

EXECUTIVE SUMMARY

6. IAG's key messages on overall expansion planning and costs are:
 - Expansion is not a "fait accompli" as described by Heathrow Airport Limited (HAL) CEO John Holland-Kaye – there is significant political, policy, judicial review and planning risk in Heathrow Expansion and there is no guarantee that planning permission will be given. This needs to be recognised in how early expenditure is regulated

¹ <https://www.dailymail.co.uk/news/article-7275969/Heathrow-expansion-fait-accompli-airports-chief-executive-says.html>

- HAL refuses to take any of this risk and wants passenger and airlines to pay for these costs even if their DCO application fails – HAL’s approach exposes passengers to too much risk of having to pay for stranded assets. This is unacceptable and IAG does not support this.
- The total masterplan cost for expansion is now at £32.5bn yet HAL continues to state publicly that the cost is £14bn, whilst reducing the scope of what is included in that number. The CAA must ensure HAL does not continue to mislead both the public and parliament by understating the full costs of expansion.

Early Category C costs (land purchase and construction)

- Early Cat C costs have mushroomed to £2.8bn – this is unacceptable. In order to protect passengers’ interests the CAA must ensure that early Cat C costs are minimised
- HAL must come up with an alternative viable plan that minimises the early Category C costs that passengers are being asked to fund at risk. The CAA must ensure this is the case as passengers rely on them to do this as the regulator of HAL and Heathrow Airport.
- HAL is a highly-leveraged investor, reliant on debt-financing for expansion. Therefore, if the CAA is prepared to allow recovery of any early Cat C costs, then it should be at HAL’s experienced cost of new debt. This would mean investors don’t earn a return on any pre-DCO work and remove the incentives on HAL to spend inefficiently and invest prematurely, thereby offering protection to consumers.
- Furthermore, if the DCO is not successful then the CAA should apply a reduction on the costs HAL can recover
- IAG considers that neither HAL or the CAA has made a clear and compelling case as to why early Category C costs of £2.8bn would be a risk worth taking for possibly delivering new capacity early. HAL’s justification of scarcity rents is entirely flawed as we have described on numerous occasions.

Category B planning costs

- HAL’s forecast for Category B costs has doubled and the CAA proposed cap² on these is a review point for further costs – at the same time, despite clear evidence of HAL’s mismanagement of Category B costs in 2016 and 2017, the CAA is allowing £80m of £82m claimed and HAL can apply for the other £2m at a later date. This is unacceptable and the CAA needs to instigate much stronger control of these costs
- If the CAA is prepared to re-open its Cat B policy and allow recovery of additional Cat B cost over the original £265m cap, then it should be at HAL’s experienced cost of new debt up to a pre-determined ceiling after which HAL must take all the risk itself. Furthermore, since it is re-opening its previous ruling it should consider also applying the cost of new debt rather than the WACC to the £265m itself.
- IAG does not support the proposal for HAL to be allowed to reduce its 15% share of risk on additional Category B costs in the event of DCO failure on a “best endeavours” basis. The CAA must not allow a “best endeavours” concept to reduce HAL’s risk and pass even more risk to passengers and airlines.

Regulatory timetable

- The CAA must set out a regulatory timetable that is based on a reasonable assessment of likely events, rather than unrealistic timelines

² CAP1819, para 1.23 ii)

- If the CAA extends iH7, there is a risk consumer interest could be sacrificed to regulatory convenience. IAG would only consider a further extension year to iH7 if it could clearly be demonstrated as being in the consumer interest.
- Due to the challenges of funding expansion and smoothing prices the CAA may need to review whether there is a case for a longer price control period (with the ability to update regulatory assumptions at intervals) in the order of 10-15 years, or even longer, as opposed to the standard 5-year control period.

Other

- Operational resilience ought to be intrinsic to HAL's plans, which must incorporate robust forecasts of regulatory building blocks; however, the CAA should be assessing this independently, rather than just amending forecasts put forward by HAL. The CAA is setting too much store by HAL's views on CAPEX incentives.
- IAG remains supportive of the concept of terminal competition at Heathrow. The CAA should not assume that HAL will be co-operative on this and should start exploring how regulation could work at Heathrow with multiple terminal providers/owners.

POLICY PROPOSALS FOR CATEGORY B COSTS

Background

7. IAG has previously made clear its opposition to the CAA's policy on Category B planning costs recovery. In particular, on the annual £10m exempt from efficiency testing, the post-DCO 105% plus accumulated indexation cost recovery incentive, and the 85:105% risk allocation plus accumulated indexation between consumers & airlines and HAL, whose 15% risk figure includes a return on capital invested.
8. The huge increase in HAL's Category B cost forecast from £265m (2014 prices) to a latest estimate of more than £500m means the CAA is right to both review its existing policy and assess whether its original policy delivered the anticipated outcomes, i.e. to incentivise HAL to progress expansion and efficiently manage costs. It is clear that this original policy has not been successful.
9. Our concern as outlined below is that the proposed recovery cap is defined as "review point" at £500m+ above which HAL is invited to justify further costs.
10. The CAA also outlines its final decision on HAL's Category B costs for 2016/17 where HAL eventually claimed £82m, following two reviews by the Independent Planning Costs Reviewer who noted the lack of an end-to-end programme plan and were unable to positively conclude that costs were incurred efficiently.
11. In fact as the CAA explains: "[t]he IPCR has reviewed HAL's Category B costs [...] with a view to ensuring that costs have been **correctly classified** [...] and **not double counted** [and it] considered whether there was a clear and consistent baseline, [...] **appropriate governance** [...], [proper

*reporting and] whether information provided was relevant, complete and timely.”³ It went on to say that: “***[i]n each of these areas, the IPCR review highlighted concerns...***” and that: “*[i]n summary, there is **only limited evidence on the efficiency of HAL’s Category B costs** and we have observed the **near doubling of HAL’s estimates** of these costs.*”⁴*

12. Despite this the CAA’s proposal is to allow £80m of costs and to effectively defer the remaining £2m for decision in 2018 or at DCO decision. This does not constitute the level of robust regulation needed to ensure HAL manages expansion costs in the interests of consumers.
13. The key challenge for the CAA’s Category B policy is to be effective in getting HAL to manage its costs effectively and efficiently. Neither the increase in costs above the £265m forecast level nor the CAA’s determination on HAL’s 2016/17 costs indicates that the existing policy and its application is fit for purpose and so it must be reviewed to ensure HAL manages its costs and consumer and airlines do not pay for its mismanagement.

Scope of policy

14. In addition to the policy objectives to strengthen governance arrangements, establish a new recovery cap (or rather a further ceiling or review point) and financing cost allowances for 2020/21 the CAA also needs to focus on having an effective efficiency test. The CAA defines efficiency as “delivering the right outcomes and making informed and robust decisions on scope, cost, time and risk”⁵ with costs being considered efficiently incurred if the programme is set-up to succeed, performance and progress can be measured and managed, and opportunities to improve can be taken.
15. The CAA also says that: “*[e]fficiency is **not necessarily about achieving the lowest cost**; rather it is about delivering the right outcomes and making informed and robust decisions on scope, cost, time and risk. In this context, costs are considered to be efficiently incurred when: the programme which they are attributable to has been set up to succeed in the early planning stages; performance and progress are meaningfully measured to enable management intervention; and an environment is created which positively identifies opportunities to improve.*”⁶. We do not agree with this.
16. We prefer the following definition: “*[e]fficiency is the (often measurable) ability to avoid wasting materials, energy, efforts, money, and time in doing something or in producing a desired result.*”⁷
17. However, using the CAA’s definition of efficiency, it is hard to see how the Category B costs incurred by HAL in 2016/17 can be deemed efficient particularly in the absence of an end-to-end plan to allow management control and determine if deliverables had been achieved. The CAA states that “there is only limited evidence on the efficiency of HAL’s Category B costs and we

³ Ibid, paragraph 1.12

⁴ Ibid, paragraphs 1.13 & 1.17

⁵ CAP1819, footnote 16

⁶ Ibid, paragraph 1.10, footnote 16

⁷ <https://en.wikipedia.org/wiki/Efficiency>

have observed the near doubling of HAL's estimates of these costs"⁸. The CAA should adopt a position of being fair to consumers and not being lenient to HAL. Allowances for the 2016/17 period should make HAL bear responsibility for having incurred costs without management controls and an end-to-end plan in place and ensure that the revised Category B costs policy stops these issues arising again.

Governance and Cost Scrutiny

18. The CAA's description of HAL's existing governance arrangements may reasonably be summarised as *'they are far from good enough and they need to get a lot better'*.⁹ We agree - and whilst not sharing its confidence in HAL's ability to improve, offer the following comments on the CAA's proposals:

- a. *'strengthening reporting requirements'* seems unlikely to achieve greater efficiency on its own, as it amounts only to more frequent reports, accompanied by a commentary – and so simply provides HAL with a vehicle to pre-empt legitimate challenge;
- b. *'increasing cost scrutiny'*. This is proposed to be delivered through a combination of the recovery cap and the continued work of the IPCR to scrutinise costs and make recommendations to the CAA. The IPCR element of this is not well-defined and does not make clear what would be different from today. The IPCR clearly indicated that it was unable to make a determination on efficiency on 2016/17 costs, yet the CAA has determined that those costs should be allowed. In the absence of clear changes to how the IPCR conducts its scrutiny it is the CAA's behaviour that needs to change. The CAA must be prepared to act and disallow costs, where justified. Without that credible threat HAL will not respond to demands for increased cost scrutiny. At the same time if the CAA is not prepared to act on the Category B costs versus the greater sums of Category C or full Expansion costs the CAA's behaviour will not inspire confidence in airlines or consumers that they will be able to properly regulate HAL as it pursues expansion.
- c. *'establishing a recovery cap'* might be a good idea, except that the CAA proposes it will be set at £500m+ (replacing the previous £265m cap) and because **it isn't a cap**, as consumers will be required pay costs in excess of £500m+ if *'the CAA considers that such spending is appropriate'*. We propose (point 21) that any cap must represent a fixed ceiling.

19. Noting the CAA's discussion of HAL's WACC, we do not agree that any of its proposals are suitable.¹⁰ In particular, we would point out that:

- a. the existing Q6 WACC of 5.35% (or indeed a suggested 3.2% - 4.2%) is considerably ahead of HAL's experienced WACC and so long as this persists, HAL will continue to profit at the expense of consumers; and so
- b. whilst agreeing that it is appropriate for the CAA to *'take account of this new information on the cost of capital'* we are concerned that the CAA's comment that *'it is*

⁸ CAP1819, para 1.17

⁹ Ibid, paragraphs 1.21 & 1.22

¹⁰ Ibid, paragraphs 1.24 to 1.26

important to maintain the stability of the regulatory framework and not to act retrospectively' raises questions about whether the CAA will act or not

20. HAL is highly-leveraged, wholly reliant on debt-financing for expansion. Therefore, if the CAA is prepared to allow recovery of any further Category B costs, then it should be at HAL's experienced cost of new debt. That is the only way that the CAA can offer any protection to consumers and remove the incentives on HAL to spend inefficiently and invest prematurely.
21. Additionally, the CAA should consider the size of the recovery cap and set it as a true cap or pre-determined ceiling after which HAL take all the risk themselves (and any such expenditure over this ceiling does not enter any RAB)
22. Furthermore, since it is re-opening its previous policy the CAA should consider also applying the cost of new debt rather than the WACC to the original Category B spend up £265m itself.
23. IAG also notes that the Arora Group is funding all its Category B planning costs itself – unlike HAL whose costs are being paid for by consumers and airlines, which raises serious questions of fairness.

Incentive arrangements

24. As the CAA proposes, HAL should not benefit from the 105% recovery incentive for costs above £265m. However, IAG firmly disagrees with the CAA that if, in the event of a DCO failure, HAL could recover in excess of 85% of its additional Category B costs above £265m if it could prove it had used "best endeavours" to secure the DCO. There should be no "best endeavours" provision to allow for additional cost recovery in the event of DCO failure – the CAA should not be offering HAL greater protection at the expense of consumers and airlines.

2016/2017 Category B costs

25. The CAA proposes that it will allow £80m of Category B costs incurred in 2016 and 2017 whilst allowing HAL to re-apply for costs disallowed now at a later date (in 2018 and at DCO grant) if it wishes. IAG has already made clear its position on HAL's mis-management of these costs in terms of the lack of effective cost control and an integrated plan to allow any sort of cost efficiency test to be applied. Without these IAG cannot see how HAL can argue that these costs were efficiently accrued or how the CAA can subsequently allow them. We would re-iterate that no commercial company would spend £82m in 15 months without any controls on this, which is effectively what HAL has done and the CAA has allowed. Our concern is not that the CAA has permitted this expenditure, rather it is with the CAA's behaviour in allowing this. Expansion costs will run into the billions (£32bn for the whole masterplan) and must be effectively regulated. Yet at the first hurdle, the CAA has let HAL off any basic cost control or programme management. If the CAA cannot regulate effectively on these costs now, why should consumers and airlines have any confidence that it will effectively regulate HAL at a later date when the sums are even greater?

First 10m per year efficiency test

26. One element of the original policy which should be revisited is the exemption for the first £10m incurred every year from the IPCR's efficiency review with these costs being recovered through higher airport charges. Bearing in mind HAL's performance on Category B costs with the forecast doubling, it is not justifiable for any cost to be exempt from review. The CAA should remove this provision as it applies to the original £265m forecast.

EARLY CATEGORY C COSTS

Background

27. IAG notes that any normal business would take the risk on a new investment themselves. In the context of early Category C costs not only are consumers paying for this investment, but they are paying for an investment in expansion that may never actually happen.

28. As with the Category B costs, HAL's forecasts for early Category C costs have also grown substantially over the past 18 months to 2 years from £650m (2014 prices) in April 2018 to a latest forecast of £2.8bn in 2018 prices (£2.4bn in 2014 prices). The CAA is correct to highlight the increasing risk that, under the CAA's existing policy guidelines, HAL could well spend this money and fail to achieve DCO, providing consumers and airlines with no benefits whilst landing them with significantly increased costs.

29. It is not only the early Category C forecasts that have worsened over this period, but the scope of expenditure as well. IAG does not agree with the CAA's characterisation that "HAL's total forecast costs to deliver the new runway and associated capacity by 2026 remain broadly in line with 2017 expectations" despite "certain changes in the scope of the infrastructure it intends to deliver for 2026".¹¹ HAL's original £14bn forecast would deliver both the runway and new terminal capacity (T6A or T5XA) by 2026. HAL's new version of £14bn by 2026 only delivers the runway. This change in scope is highly significant as it reduces the available airport terminal capacity at runway opening, increases the total cost of the original scope by up to £3bn taking it above £17bn, and creates a greater affordability challenge.

Early Category C spending & the consumers interest

30. In July 2016 the CAA said that:

- a. "Category C or construction costs will typically be **incurred after planning permission is given** through the grant of the DCO...";
- b. "... there **may be** some significant expenditure on preliminary works or enabling construction (e.g. property relocations and land acquisition) **before planning permission is given** [which we will call] pre-construction costs..."; but
- c. "[w]e will need to understand [pre-construction costs] in more detail [...] before developing a specific policy [and] plan to **consider the regulatory treatment** [...] shortly

¹¹ Para 7

after the Government location decision, **provided we receive adequate evidence from [HAL]**.¹²

31. Stakeholders were therefore entitled to believe in a default position such that all or the vast majority of construction costs would be incurred after planning permission was granted – and that whilst there was the potential for some early construction costs, these would have to be justified by HAL, before any regulatory treatment was considered.
32. As the CAA makes clear, in April 2018 HAL’s estimate of early Category C costs was approximately £650m and so it: “... stressed the importance of HAL providing further **detailed and robust information** on [forecasts, need and efficiency].”¹³ By Autumn 2018 HAL had provided only: “... **high-level information** [by when forecasts had] increased significantly, suggesting total spending might reach [**£1.6bn**, but with] only **limited information** on the reasons for the increase.” The current position is that the: “... latest estimate for early Category C costs has increased further to [**£2.4bn**] ...”¹⁴
33. The CAA rightly recognises that in the event that a DCO is not granted: “... these costs would be sunk and provide consumers with no benefit...” What it does not explain is why it feels it appropriate to pass such costs onto consumers, rather than saying that it wants to: “... understand the broad programme of early Category C costs that will be in the best interest of consumers.”¹⁵ In addition to the original £672m, we understand that HAL’s proposed increases to early Category C expenditure comprise:
- a. £923m scope increase and nominal adjustment (2014 to 2018 prices);
 - b. £1,052m increased acquisition costs; and
 - c. £221m increased early construction costs.¹⁶
34. It is unclear how these massive additional cost estimates have accrued – or how the CAA could think that it is reasonable to pass them on to consumers; not least, in light of its explicit recognition that they will not benefit consumers, should a DCO not be granted. The CAA must see that in allowing HAL (but not other developers) to recover Category B or early Category C costs in the absence of a DCO, it is creating a serious distortion of competition.
35. The CAA continues to refer to HAL’s scarcity rent argument as put forward by Frontier Economics. HAL’s justification of scarcity rents is entirely flawed as we have described on numerous occasions. We have provided clear explanation of this, supported by compelling evidence, none of which has been refuted by the CAA; yet, which seems to be ignored. In particular, the CAA states that:
- a. “HAL has provided evidence prepared by Frontier Economics...”;
 - b. “... some landing slots at [LHR] trade for very significant sums in the secondary market...”;

¹² CAP1435, paragraphs 3.8 to 3.10

¹³ CAP1819, paragraph 2.2

¹⁴ Ibid, paragraph 2.3

¹⁵ Ibid, paragraph 2.4

¹⁶ Ibid, figure 5

- c. “[s]ome of this evidence is contested by airlines”; and
- d. “... some of the estimates in the Frontier analysis may overestimate the impact...”¹⁷

36. Unless it is to justify early Category C costs, it is impossible to rationalise why, in the face of criticism from its own consultant and explicit recognition that Frontier has ‘overestimated’, the CAA continues to support HAL’s discredited conclusions. Meanwhile, compelling evidence from airlines, which the CAA has neither refuted nor responded to in a meaningful way, is ignored.
37. As described above IAG therefore does not consider that HAL or the CAA has made a clear and compelling case to date as to why early Category C costs of £2.8bn would be risk worth taking for possibly delivering new capacity 12-24 months early, i.e. the additional benefits generated by and to existing and new passengers would need to exceed that £2.8bn cost within the earlier time period that the new capacity is delivered.
38. Despite HAL’s assertion that Heathrow expansion is a “fait accompli”¹⁸ there are significant political and planning risks that the project may never proceed and if HAL’s current proposals progress there is a substantial risk that the consumer will be left to pay sunk costs of over £3bn (early Category C plus Category B costs).
39. In addition, a situation could arise whereby there are two competing DCO’s from HAL and the Arora Group. There could be a risk that assets are stranded in the event that the Planning Inspector favours one scheme, or elements of one scheme, versus another. The CAA should consider this in its assessment of early costs risk as well.
40. IAG believes that HAL must therefore identify a viable Expansion Plan that minimises early Category C costs consistent with delivering a runway in line with the 2030 deadline in the Airports National Policy Statement (including delivery timeline risk), thereby reducing pre-DCO costs significantly and protecting the consumer from the substantial risks of costs associated with stranded assets. The CAA itself has expressed the view that early Category C costs should be in the hundreds of millions rather than the £2.8bn currently envisaged by HAL.
41. As passengers rely on the CAA to be an effective regulator of HAL and Heathrow Airport we look to it to ensure these early Category C costs are minimised.
42. Not only should HAL be bringing forward a viable plan, both in terms of costs and timelines, but there should also be a clear plan as to how these costs could be mitigated to the maximum extent possible if expansion does not proceed.

Category B and Early Category C regulation

43. The CAA says that: “[w]e could, in principle, devise regulatory arrangements that allocated the risks of failure to get a DCO to HAL but, in practice, this would require HAL’s investors to be

¹⁷ Ibid, paragraphs 2.11 & 2.12

¹⁸ <https://www.itv.com/news/london/2019-07-23/heathrow-third-runway-will-be-critical-for-new-pm-says-airport-boss/>

*compensated for the risks HAL would face [and that this] risk might be hard to quantify [and therefore] price accurately, [but would regardless] lead to higher airport charges [and so] simply allocating risks to HAL does not offer a solution...*¹⁹ We disagree. If the CAA were to ‘allocate the risk to HAL’ at the experienced cost of new debt for early Category C costs, then it would protect consumers and remove the current incentives on HAL to spend inefficiently and invest prematurely. This would also be in line with our suggestion on Category B costs earlier.

44. In line with the suggested policy for Cat B costs there should also be a ceiling on early Cat C costs (in line with the revised minimal Cat C spend plan) and a limit to how much of these costs are recoverable if the DCO fails
45. It is extraordinary that after all HAL’s acknowledged inefficiency and escalating costs, the CAA should say that: *“[its own] quantitative assessment of the costs and benefits [of Category C costs] may not yield clear conclusions [so we] have asked HAL to investigate these issues...”*²⁰ It is the CAA’s job to scrutinise HAL’s expenditure and so it must avoid delegating this task to HAL, allowing it to subjectively review its own outputs. We do not share the CAA expectation that: *“...HAL [will] be pragmatic in its assessment...”*²¹

Recognising Category C costs through the licence

46. IAG gives guarded support to the proposed modification to the airport licence to incorporate the broad programme of revised Category C costs that will be agreed by HAL and airlines and to formalise the governance arrangements that will also be agreed by HAL and the airlines. As the CAA outlines, a high-level description of the early Category C spending in order to set a “baseline” to manage change and variation would be beneficial. IAG’s expectation is that this will mirror the governance principles and objectives the CAA has already set out in CAP1819 and in earlier consultations including CAP1658 (April 2018). However, the governance must follow the Q6 principles and give the airlines a meaningful role in the process with the ability to ‘veto’ spend if necessary and not follow the current R3 engagement model where the airline voice has largely been overridden by HAL. A model where HAL consistently escalates matters to the CAA and gets judgements in its favour is not acceptable. Ideally the CAA will be able to affect the licence modification by the end of 2019.
47. The CAA states that when it proposes the Category C cost licence modification that both HAL and the airlines would be able to appeal the CAA’s decision to bring forward that proposal to the CMA. However, the CAA notes that any such appeal would lead to a delay of around six months before the CMA could determine an appeal. In this scenario HAL would effectively be disputing the licence modification formalising the Category C forecast plan it has already agreed with airlines and the CAA, which is counter-intuitive. However, the CAA says if that happens it would consider still allowing early Category C costs to be incurred during such an appeal, if there was “a particularly strong and compelling case that such spending would be in the interests of consumers”.²² IAG does not see the need for such guidance; an appeal should lead to the

¹⁹ Ibid, paragraph 2.14

²⁰ Ibid, paragraph 2.16

²¹ Ibid, paragraph 2.17

²² CAP1819, para 2.42

suspension of early Category C spending, as it would demonstrate that HAL itself does not have confidence in its own costs and plan and the airlines should have governance arrangements that allow a measure of control on Category C spending, including during an appeal to the CMA. As such we are not convinced by the need for any further guidance being provided during an appeal to the CMA.

TIMETABLE AND BUSINESS PLAN GUIDANCE

Background

48. HAL was last subject to a full regulatory review process in 2013, pending the start of Q6 in 2014. By the time that Constructive Engagement starts to review HAL's H7 business plan in 2020 it will be over 7 years since any substantive review of HAL's business has been undertaken. Over that period HAL has benefited from stronger than forecast passenger growth (and a WACC above today's prevailing levels) and is now looking to undertake expansion. In light of this, it is imperative for both consumers and airlines that HAL's business plan is subject to airline consultation, scrutiny and challenge and that the CAA has the opportunity to reset the regulatory controls on HAL.

49. In this section IAG highlights its views on several regulatory policy issues

Regulatory timetable

50. IAG agrees with the CAA's assessment that a 2026 runway opening date is no longer likely and that HAL should develop alternative expansion scenarios that could see the runway opening at any point between 2027 to 2030 with minimised Cat C costs. A later runway opening date means that initial runway construction would not be completed by the end of the 5-year H7 regulatory period which could run from 2022-2026 inclusive. As the CAA notes, another challenge will be that construction costs assumed in the H7 price control review are likely to be less mature. This is already a challenge however, as the DCO decision is now assumed to be made in late 2021 which would be after a CAA H7 price control determination in mid-2021.

Initial Business Plan and Final Business Plan Timing

51. It seems that with expansion (before the granting of planning permission or the commencement of construction) currently being forecast between 2026 and 2030, notwithstanding that the latter date was specified in the NPS, this may be optimistic. We therefore agree with the CAA that: *"... there would be a number of advantages in retaining our current timetable for HAL to provide an initial business plan ("IBP") at the end of 2019 and the CAA making price proposals in 2021, rather than delaying..."*²³

52. IAG wants the opportunity to have the fullest review possible through the Constructive Engagement process and the earlier that HAL can publish the IBP the better that is to allow IAG

²³ Ibid, paragraph 3.8

and other airlines to scrutinise, challenge and agree changes to the plan – so retaining the IBP in December 2019 supports this.

53. We are nevertheless concerned that HAL's proposed IBP for December 2019 will not take account of feedback from its statutory consultation (which is due to conclude in September 2019) and disagree that: "[t]here may be case for HAL submitting its FBP alongside its DCO application in 2020." It seems to us that this would make challenges to the IBP too easily dismissible and challenges to the FBP, unrealistic
54. An FBP in mid-2020 would mean reducing the time allowed for airlines to conduct the full 6-month Constructive Engagement period that we have previously had in Q5 (2008-2013) and Q6 (2014-2019). Expansion timescales must not be used as a means of reducing the time airlines have to challenge HAL's business plan and to conduct a full review of its existing business-as-usual activities. That is meant to happen every 5 years, yet it is now 7 years since that has been done. Curtailing Constructive Engagement would disadvantage consumers and penalise airlines. Time savings should not be solely focused on airline and consumer engagement either. If time pressures are building, then the CAA should also be reviewing the time it has allowed itself to conduct the H7 regulatory review and take its share of that challenge as well. Therefore, we think that the FBP must be later than mid-2020 and there must be a suitable gap between the IBP and FBP to allow a full 6-month Constructive Engagement period.
55. Given the uncertainty around timescales and bearing in mind the need for adequate Constructive Engagement the CAA must set out a regulatory timetable that is based on a reasonable assessment of likely events, rather than unrealistic timelines - and which provides opportunities for stakeholders to give appropriate consideration to HAL's plans.

H7 proposals in 2021

56. Notwithstanding the dates for publication of the IBP and FBP and Constructive Engagement timescales it is clear that the CAA's preferred approach to align the H7 regulatory decision with the Expansion DCO decision is under increasing pressure. The planned DCO decision has now moved back to late 2021. Even assuming a best-case scenario of the first week of October for a DCO decision that only allows a further delay of around 10 weeks before it slips back into 2022. That clearly has implications for the H7 price control decision as the CAA may be having to take decisions based on cost and plan information that could change and will not take account of further conditions and additional costs that maybe made by the Planning Inspector or the Secretary of State for Transport.
57. In recognising the CAA's objective in seeking: "*broad alignment between the timetable for our work to develop the regulatory framework and the wider programme for capacity expansion...*", it is increasingly clear that the latter is slipping. As the CAA puts it: "*[t]he wider timetable for expansion is clearly under a degree of pressure...*" Meanwhile, consumers continue to be subject

to a regulatory rate of return some considerable margin ahead of HAL's experienced WACC, whilst not benefiting (as the CAA points out) from: "...*efficiencies and other gains...*".²⁴

58. This uncertainty raises the questions as to whether there is a case for further extension of iH7. If the CAA extends iH7, there is a risk that the consumer interest is being sacrificed to regulatory convenience given the current position on WACC and passenger forecasts. IAG would only consider a further extension year to iH7 if it could clearly be demonstrated as being in the consumer interest.

H7 interim price control review and length

59. A wider question for H7 is what the length the control period should be. The CAA assumes five years between 2022 and 2026 but also indicates it is open to a longer period proposing a 6, 7- or 8-year length as well. IAG believes this is a critical question bearing in mind the IAG, airlines and Government ambition to keep prices flat in real terms. As a general principle, we support the use of regulatory tools and techniques that protect consumers from uncertainty. We would therefore support an extended H7 control period, provided this was mapped onto capital programmes, as the CAA suggests.²⁵ This could address the high up-front costs of expansion through a longer control period that allows airport charges for expansion to be smoothed and made more predictable, with the ability to adjust that at specified intervals in a more substantial way than we are currently able to. This could allow for a much longer regulatory period in the order of 10-15 years or longer that covers the period over which both new runway, airfield and terminal capacity is delivered.

Business Plan Guidance

60. We agree that HAL's FBP should be: "... *high-quality, clear, robust, and well justified by supporting evidence...*"; however, '*confirmation*' as to whether or not it is '*affordable*' is not a matter for HAL's board.²⁶ Whilst we are more cautious than the CAA in its expectation that 'Constructive Engagement' will deliver various benefits:

- we agree that the CAA should attach greater weight to published plans than to those provided on a confidential basis;
- we agree that HAL should work more closely with stakeholders;
- we feel strongly that operational resilience over the transition ought to be intrinsic to HAL's plans;
- we feel strongly that whilst HAL must provide robust forecasts of regulatory building blocks (in particular, OPEX, depreciation, other revenues and traffic forecasts), setting these is actually the job of the CAA - and so we would like to see the CAA doing this independently, rather than just amending figures put forward by HAL;

²⁴ Ibid, paragraphs 3.5, 3.6 & 3.8

²⁵ Ibid, paragraphs 3.9 & 3.10

²⁶ Ibid, Paragraph 3.17: affordability is a question for customers – see our response to CAP1812 for full explanation

- we are concerned that the CAA is putting too much store by HAL's views on CAPEX incentives – again, this is a job for the CAA;
- we agree with the CAA that it should not consider a plan high-quality if airlines and other stakeholders do not broadly support it; and
- we support the CAA's statement on how HAL should detail out the H7 business plan costs and other revenue building blocks for both current operations and Expansion is welcomed²⁷ as it acknowledges the complexity inherent in H7 with different traffic forecasts depending on different airport capacity scenarios, e.g. 480k ATM's vs 505k ATM's "early growth" versus R3 opening

Constructive Engagement & Enhanced Engagement

61. IAG agrees with the CAA that Constructive Engagement should "be focussed on HAL's business plan, and the investment and services to be delivered by HAL in the next regulatory period...and encompass both HAL's existing activities and capacity expansion".²⁸ Regulation of HAL should be solely focussed on how HAL impacts the consumer interest and should not be extended to encompass airlines that are in commercial competition with each other.
62. CAP1819 is undecided as to whether Constructive Engagement (for the H7 price control review) and Enhanced Engagement (for Expansion engagement and consultation) should run alongside each other or whether Enhanced Engagement should subsume Constructive Engagement and deliver its objectives as part of Expansion. IAG would prefer the two remain separate from each other though clearly Expansion will form a core part of the H7 business plan. IAG will work to update either the Q6 Capital Governance protocol and/or the Enhanced Engagement protocol to ensure that the objectives of Constructive Engagement are fully delivered.

Terminal competition at Heathrow

63. In our response to CAP1782, we said:
- *"[w]e 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";* and
 - *"[e]ven 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.**' 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."*²⁹

²⁷ CAP1819, para 3.20 bullet 4

²⁸ CAP1819, para 3.21 bullets 3 & 4

²⁹

[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/International%20Consolidated%20Airlines%20Group%20\(IAG\).pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/International%20Consolidated%20Airlines%20Group%20(IAG).pdf)

64. We are unaware that the CAA has yet addressed these points and so it seems to us that our concern was well-placed. IAG remains supportive of the concept of terminal competition at Heathrow. The CAA should not assume that HAL will be co-operative on this and should start exploring how regulation could work at Heathrow with multiple terminal providers/owners.