London (Heathrow) Airline Consultative Committee

Response to the CAA's Consultation on the Economic Regulation at Heathrow from January 2020: Proposals for the Interim H7 Price Control (February 2019)

CAA CAP 1769

30th April 2019

Introduction

The Airline Operators' Committee and the London Airline Consultative Committee (LACC) welcome the opportunity to respond to the CAA's Consultation on the Economic Regulation at Heathrow from January 2020: Proposals for the Interim H7 Price Control (CAA CAP 1769).

Before making our comments on the CAA's consultation paper, it must be understood that the AOC and LACC are not airlines. Rather they are representative bodies who work on behalf of their members. As such, we do not have the option of accepting or rejecting the 'Commercial Deal', as that is offered only to our members. It is properly for each of individual member airline to decide whether the 'Commercial Deal' is in their commercial interests, and we make no comment in this regard at all. Rather our comments are limited to the more strategic and general issues contained in CAP 1769.

Comments on the Purpose of Regulation

In our response to CAP 1722, we stated that we were surprised that the CAA saw merit in a commercial deal approach. The CAA accepts that HAL has SMP and that it should be subject to ex ante regulation i.e. price control. In other words the CAA regulatory position is that HAL has monopoly power, the ability to exploit that market power to the detriment of airlines and their passengers, and that the risk of HAL doing so is both so likely and so detrimental that it warrants the imposition of price controls. It is a tenet of economics that negotiations with those who hold monopoly power over you do not lead to competitive outcomes. Consequently, we were surprised that the CAA would propose such an approach as it seems to run counter to the very purpose of economic regulation.

Comments on the strength of the CAA Assessment

In our response to CAP 1722, we supported the CAA's view that any deal should be in the passengers' interests. We also said that we expected the CAA's assessment to be robust, rigorous and objective. We are disappointed that the CAA's assessment in CAP 1769 appears to be somewhat short of our expectations.

CAP 1769, has the feel of a paper where the CAA has perhaps taken a policy position to approve the 'Commercial Deal' and worked backwards with the analysis. In order to assess the passenger interest, the CAA put forward three scenarios: the 'Commercial Deal'; the CAA's proposal in CAP 1658; and work from CEPA on what the control should be if the current building block performance was projected forward (although we note that CEPA use only a partial WACC revision, rather than the latest PwC figures for a 2R HAL).

The CAA argue that there is no material difference between their limited offer in CAP 1769 (approx £150mpa) and the 'Commercial Deal'. However the CEPA estimate is for around £300mpa – significantly above the Commercial Deal. In the light of this evidence from their own consultants, the CAA seem to argue that the 'Commercial Deal' is still in the passengers' interests for two reasons:

i. that there are longer term advantages to a deal – we are unclear what these advantages are, and indeed at the April LACC, the CAA representative was clear that there was little (or no) evidence to suggest these benefits would actually be realised ;
ii. that the CEPA figure, if adopted would be subject to a regulatory process and that HAL would have the chance to submit further information and so the difference between the CEPA estimate and the 'Commercial Deal' is *'likely to come down significantly' (CAA CAP 1769).*

We are especially concerned by this last comment. It appears that without seeing any evidence, the CAA has pre-judged the outcome of a potential consultation, and pre-judged it in favour of the monopoly company it is supposed to regulate. We note that HAL has already had the opportunity to submit its evidence to the CAA and CEPA, and that CEPA's evidence is presumably based on that data and discussion with HAL. The airlines, did not submit data to the CEPA work, and may have new information for the CAA, which could potentially counter the HAL information.

Of course, it may be that our inference from the CAA's text is incorrect. If this is the case, we would welcome written confirmation from the CAA stating clearly what was meant.

The airline community is concerned that, from the evidence presented in CAP 1769, the CAA may have fallen short of an objective analysis of the passengers' interests. In discounting the evidence from its own consultants, the CAA appears to be relying on two key assumptions:

i. that there are potentially wider (but unquantified) benefits to a 'commercial' deal; and
ii. the assumption that the CEPA numbers are too high, and that HAL will be able to present new evidence that would reduce difference between the CEPA numbers and the CAA's offer in CAP 1658.

We do not believe that these assumptions, either individually or taken together, are a particularly satisfactory basis for the CAA's decision.

Comments on enforcement

In our response to CAP 1722, we highlighted our concern that any commercial deal could undermine the CAA's ability to enforce economic regulation at LHR. We note that the CAA has failed to address this point in CAP 1769, and we are concerned that this is the case.

The airline community believes that the 'Commercial Deal' should be enforced through the licence rather than the Courts. We believe that this is the right approach for two reasons: it would ensure that the CAA remained the authority for enforcing economic regulation of HAL, and did not undermine the CAA's role; and second, we do not believe that the 'Commercial Deal' is a normal commercial deal between competitive parties. Rather it is a regulatory accommodation driven by a unique set of circumstances and so should be

primarily enforced through the economic regulatory mechanisms i.e. HAL's licence. If the licence needs to be amended to facilitate this the CAA should propose these changes.

Comments on what happens to those who don't sign

We understand that the CAA's proposal, should the 'Commercial Deal' go ahead, is that the default position for airlines who do not sign up to the deal would be that they receive the 'Commercial Deal' without the scope for outperformance payments.

We would ask the CAA to reconsider this position. Given that HAL has SMP, it seems to us that the default position for those airlines who do not sign up to a deal, would be a regulated settlement delivered by the CAA. However, we would ask that the CAA recognise airlines strong time preference for cash, and amend its proposal in CAP 1658, so that airlines that do not sign the 'Commercial Deal' are given the repayment over four years, as with the 'Commercial Deal'. In addition, as the repayment can be recalculated now, that the airlines who do not sign should be notified what their repayments will be in each of the four years now, so that they can plan. We see no reason why the airlines cannot be repaid their monies within at least 4 years as HAL will already have the money from the airport charges levied on the airlines, and they have already agreed these terms as part of the 'commercial deal'. This option should be available to all airlines, including existing signatories to the commercial arrangements, who should be able to consider both the 'commercial deal' and the CAA option and choose between the two.

Comments on the Deal and Future Regulatory Arrangements

The airlines at LHR, both collectively and individually have always been clear with both HAL and the CAA, that any commercial deal sets absolutely no regulatory precedent. Rather it is a unique response to a unique set of circumstances. In fact, it should be noted by all parties that a major contribution to these circumstances has been the proposal from the CAA that the airlines be repaid their rebate due through amending HAL's RAB. A proposal in which it would take a large number of years for the airlines to get their money back. Indeed, it could be that a different set of airlines would be benefitting in the future from the charges paid in iH7 by the airlines currently using Heathrow Airport.

Economic theory and evidence tells us that bi-lateral negotiations where one party holds SMP over the other do not lead to optimal outcomes for consumers. Indeed it is the very purpose of economic regulation to protect the consumer from the exercise of market power. In the presence of SMP, the data strongly suggests that effective regulation delivers the best outcomes for consumers.

That the airlines would consider a commercial deal with HAL, and indeed a deal which appears to deliver less money to them than the CAA's proposal (and significantly less if the CEPA numbers are used) does not mean that HAL has set aside its SMP, or herald a new chapter in HAL-airline relations. Rather it is a signal of the airlines lack of confidence in the CAA to effectively constrain HAL's

SMP on behalf of consumers and enforce a regulatory settlement, especially in the context of our desire to deliver an affordable, deliverable and operable expanded LHR.

Regulation of the Service Quality provided by HAL

The CAA states the SQRB would remain fixed throughout 2020 and 2021. This is welcome as we agree with the CAA that "*it is important for HAL to demonstrate that it is acting in the consumer interest over the iH7 period and that it continues to deliver on service quality, including a resilient airport operation"*.[1] Although we would note that by the end of 2021 the Q6 standards will have been unchanged for nearly 8 years. However, it is likely that HAL could achieve higher levels of performance in some areas and doing so would be in the interests of passengers. Specific areas of the SQRB in which the airline community thinks standards could be improved are set out below:

- **Security queue standards** – HAL has been funded by the CAA throughout Q6 to deliver a performance standard of 99% of passengers waiting less than 10 minutes. This has not so far been delivered by HAL. The position of the airlines on this has been set out many times. Therefore, it is not repeated here except to highlight again that HAL achieving security queue standards at the level required of them by CAA for Q6 is in the interests of passengers. Significant progress has been made towards a system of measuring the performance of HAL security queues. HRS has been successfully implemented in T2 security and could be used across the airport. HAL also believe that a product offered by XOVIS could also provide effective measurement of security queues. However, we think it would be in the interests of passengers for the Q6 incentive on HAL from the CAA for delivery of the better performance standard to be re-instated by the CAA for the iH7 period. This is not because the airlines wish to receive the rebates. It is because evidence has shown that HAL responds to the incentives placed on it by the CAA through economic regulation.

- **Control posts –** the performance of HAL on control posts has been a 'mixed bag'. Some control posts perform well and other are continually failing the standard set for HAL by the CAA. This needs to be addressed urgently by the CAA. Especially since high standards of control post performance directly impacts the operational resilience of the airport. The aggregation of the control posts into groups for performance measurement has incentivised an improvement in performance. However, we would note that some control posts consistently fail but the performance of other control posts in the group keep the group performance above the SQRB standard. An opportunity exists for the CAA to promote the interests of all consumers by requiring all control posts to pass the SQRB standard for HAL to avoid paying a rebate. This should be easily achievable by HAL has they have already been funded to provide the control post standard across the campus.

[1] CAP 1769 Paragraph 1.26

- **Areas measured by the QSM** – HAL has made substantial improvements in the four areas of its performance in the SQRB which are measured through the QSM. These areas being: Wayfinding, Flight Information, Cleanliness and Departure Lounge Seat Availability. The CAA established an improved target standard for HAL in Q6. In addition to this the CAA established a gap from the point of achieving the standard to the performance level at which HAL could earn bonuses. HAL has now reached the level of consistently earning bonuses for the Wayfinding element. It would be in the interests of passengers for the target performance standards in these areas to increased. Also, we don't think it is appropriate for HAL to earn bonuses so the performance target in iH7 should simply be high enough to incentivise HAL to achieve the standard rather than pay rebates.

The CAA suggests elements of the Outcomes in OBR could be tracked in iH7 to determine their suitability and possible performance levels. This is not appropriate for at least two reasons. Firstly, HAL and the airlines will not have agreed, and the CAA will not have established, a list of possible Outcomes by the start of 2020. Secondly, if HAL thinks its target performance standards in H7 will be based on its performance in iH7, it will be incentivised to underperform in iH7 so any actual target standards in H7 will not be a stretch for it.

S Factor calculation

The airline community would like to challenge the approach taken in Q5+1 and Q6+1 to increase the S factor allowance simply by inflating the control period amount. The purpose of the S-Factor is to disincentivise HAL from investing in new security initiatives without challenging the scope of new directives and/or delivering on new directives as efficiently as possible. The airline community believes the concept of the S factor deadband amount to be time based. A longer control period has more opportunity for new security initiatives and therefore requires an increased deadband amount.

This perceived logic of adjusting Q6 at the beginning of the period seems at odds with the logic used at the end. Q6 was originally 5 years and the S factor was £20m, the final Q6 was 4.75 years and the S factor was reduced to £19m. There are 20 quarters in a five year period and reducing to 19 quarters seemed to suggest an annual S factor allowance of £4m.

Based on this, we would have assumed the S-Factor amount in Q6+1 would have increased by £4m to a total of £23m. The airline community understands that for Q6+1 the S-Factor was increased to £20m based on £19m being inflated by £1m. There is an argument that the S-Factor should be inflated to account for inflation and then applied based on time. So in the extra year for Q6+1 the S factor would be increased by £4.2m (£20m/4.75). The airline community accepts that the Q6+1 decision has already been taken and is not seeking to overturn it.

However, the airline community position for IH7 is that the additional two years should increase the S-Factor by either £4m or £4.2m (if inflated) per annum. Taking the total S factor in Q6/IH7 to £28m or £28.4m. It is important for the S-

Factor to be increased in this way for it to retain its intended incentive properties on HAL in the interests of consumers.

Proposed Licence Changes

The document includes a statement that a change to the licence may be required "*including hold baggage screening to the list of other regulated charges, if HAL decides to charge for this through this mechanism; and".* The airline community position is that there is no basis for the Hold Baggage Screening activity being an ORC and should be funded through Airport charges. It is not simply a case of HAL taking a decision.

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