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Civil Aviation Authority
United Kingdom

CAA Consultation on the Shortlist of Future Regulatory Models – Heathrow (CAP3251)

We commend the CAA for recognizing the existence of the deficiencies in the current framework applicable to Heathrow, and the need for a new framework to create value for all stakeholders. Heathrow is one of the largest and most constrained airports in the world, serving both the UK and international markets as a connection point. It clearly has significant market power and the current model clearly has shortcomings, some of which the CAA has pointed out in this consultation document. We are writing to express our support for this reform and make some recommendations based on our international experience.

Given the limited time provided by the CAA to comment on over 300 pages of documentation, this response will concentrate on our overarching views on the shortlisted options and some aspects which we consider need further consideration. We will follow up further with the UK CAA and in any case encourage the CAA to maintain an open dialogue we have seen thus far as you refine the target model. As often, success will be determined by the details as much as the overarching model.

There is a need for change

On the case for change, we strongly support the need for significant change to the framework. We maintain our position that the CAA must maintain affordability as its core objective, aligned both with the mandate to protect consumers and with the strategic objectives of the UK government to promote aviation.

Affordability is essential

Affordable charges are essential. Whether Heathrow is the first, second or third most expensive airport – what matters is whether consumers and users receive the appropriate infrastructure and services at a competitive (lowest possible) price, respecting the ICAO principles, notably cost-relatedness. Even airports that have far lower charges than Heathrow may still be inefficient, excessively profitable or delivering poor value for consumers. Capex and opex scrutiny as well as the introduction of competitive pressure by other means must continue to be at the core of the model.

Reform is for the whole airport

The call for reform is not limited to expansion; shortcomings for existing infrastructure are why the industry is concerned about the impact of expansion, but it does not mean the current, two runway environment does not need reform. Consumers, and users, seek efficient, affordable and appropriate quality infrastructure and services at Heathrow – irrespective of the terminal or runway used. In all cases, the CAA must ensure it scrutinizes all proposals from Heathrow Airport Limited (HAL) or any other provider of airport services and challenges them – seeking input from users as needed but also acting if users are not able to challenge each proposal. Respectfully, while HAL is ultimately responsible for the current situation through its choices – the CAA also bears some share of responsibility for not stepping in earlier to curtail the abuse of market power.

Airport roles & responsibilities: Ownership & Regulation

Responding to significant market power means calling into question not just the regulatory model – but the roles and responsibilities in the airport when it comes to ownership and operation. In our previous submission, we emphasized that the challenges at Heathrow are not purely linked to regulation. They are also consequences of State choices regarding ownership and operating models. We encourage the CAA to refer to our publication, Airport Ownership and Regulation Guidance.

The choice of the United Kingdom to completely privatize airports and grant airport-level licenses to operate has consequences. As recognized when BAA was broken up, assigning a single operator for airport services comes with challenges. IATA does not have a preference for a single ownership model, and it is not the CAA's place to make investment or divestment decisions on behalf of the UK government. It is the responsibility of the CAA to review whether the roles and responsibilities at the airport – notably due to ownership/operating model – are appropriate and aligned with the objective of protecting consumers.

In many countries, when contracts or concession agreements expire, the government is afforded an opportunity to revise the ownership and regulatory model. The current license approach, linked to fully private ownership of the land and assets, does not provide such an opportunity. The license is "monolithic" and assigns most roles and responsibilities to a single entity. IATA finds that the CAA is too quick to dismiss potential challenges to the current roles and responsibilities at the airport. If alternative providers mount challenges to the existing ownership and operation roles at the airport – the CAA should ensure that HAL considers reasonable challenges. The incumbent must provide sufficient transparency to allow the CAA and airlines to assess value for money and allow potential challengers to put forward proposals to do better.

Consequently, in addition to changes in the regulatory model, the CAA should consider revising how the licenses for Heathrow are currently structured and possibilities to grant different licenses to HAL or alternative operators. By way of comparison, other sectors in the UK have embraced competition and private sector participation in specific parts of the value chain and retained some aspect of public ownership or control in others. While the CAA might not decide who owns/operates infrastructure, the CAA should recognize that it may be beneficial to review whether users and consumers are best served through a single airport license or not. IATA's view is that it is valid to periodically review whether the current ownership, operating and licensing model is suitable.

On the shortlist

We applaud the CAA's choice to reject light-touch, "price benchmarking" and similar alternative models that fail consumers. Several countries including Austria, Hungary, and Portugal have opted to set charges in a regulatory framework based on "benchmarks" while others like the Netherlands requires the use of benchmarking as part of their charges setting process. Inevitably, price benchmarking regulation fails consumers as the needs of every single airport are unique. We also strongly support the CAA's rejection of alternative models such as light-touch frameworks. IATA has been vocal that these types of frameworks do not work in markets such as Australia, where airports operate in a for-profit framework where there is obvious significant market power present.

The CAA must expediently fix the current capital governance framework

We support the first package of reviewing capital governance and incentives, focusing on the elements in the process which produce meaningful impact on the outcomes. In some cases, this means strengthening governance – and in other cases some simplification. Given the scale and failings to date, it is imperative that sharper incentives are applied. Broadly speaking, greater user involvement earlier in the process on strategic decision making, should reduce the level of disagreement further down the planning process, so that later discussions can focus on delivery efficiency. The measures should also strengthen the consequences of poorly consulted, designed, or delivered capex. Airlines are accountable for their investment decisions and bear the consequences of the market for poor choices. Airports should also face consequences of inefficiency in delivery.

In most airports with some form of user involvement in capex projects, the most common issue is late involvement of users in the process once strategic decisions have been taken either without user input or without fully informing users. The most common outcome is then a "take it or leave it" presentation project options to the users, examples of which we have seen at Heathrow, limiting the scope for discussion and dialogue to find a mutually beneficial option. Whilst Heathrow does have a very extensive consultation process in comparison to other airports, the underlying fundamental failings of information asymmetry, true independent assurance, and lack of consequences for governance failings remain. We do believe that earlier involvement in strategic planning by the airlines, sharper incentives with true accountability for business cases and delivery, as well as more direct intervention by the CAA is necessary.

The CAA should not support long-term determinations

We oppose proposals for longer-term price controls or long-term fixing of underlying parameters. Embarking on a major expansion project requires a degree of regulatory certainty, which does not mean locking in all parameters or the cost of capital. Megaprojects are not an excuse to shift risk to airlines, and in IATA's position on economic regulation, we outline that charges should be set in a 3–5-year framework, allowing for resetting of parameters or transfers of efficiency gains.

Some will argue that the forthcoming expansion of Heathrow has different characteristics to the BAU work. For some work, the expansion has characteristics similar to a "greenfield" airport project. In many such projects, there is no longer term agreement in place regarding charges and no initial revenue for the airport before opening. What reassures investors is stability as to the overall framework, so that if parameters change, they change within a known structure and are managed by an independent regulator. There is merit in providing clarity on the regulatory framework that will apply to certain aspects of expansion, including for a short period after assets are delivered. The clarity must reassure investors and the airport operator – but ultimately should serve to protect the interests of users and consumers. By way of example, in France, Italy, and India, the methodology for determining the cost of capital is set out in guidelines which are meant to be stable for the foreseeable future. Investors are not guaranteed a return; however they know what the consequences of market movements will be. We would strongly advocate against "hard coding" parameters as is seen in the Netherlands and Switzerland where a highly formulaic approach is applied. The return on capital should be proportionate to the risk, and when too many parameters are set in stone – there is no possibility to adjust for shifts in the risk-reward paradigm.

We are surprised to read that the CAA is considering a price determination or a cost of capital determination in the longer term. We do not see this as favorable to consumers or users. Setting either parameter in the long term will prevent users and consumers from benefiting from period transfers of efficiencies. Furthermore, while airlines are likely never going to be able to "reopen" a long-term determination faced with very different market conditions, it is likely that an airport in difficulty would manage to do so. IATA has strongly opposed the proposed 8-year Economic Regulation Contract being discussed in Paris and after six years the airline community in Munich have changed their views on the current long-term agreement. Even longer periods – linked to expansion – are dangerous as IATA has outlined in our publication on Balanced Concessions.

The CAA must stop abusing current consumers to the benefit of future consumers

As with greenfield airports, we strongly oppose the use of pre-funding as this is not what competitive firms do. Charging incumbent airlines for current studies for future work is unfair, as airlines advance that funding based on their higher cost of capital while the potential airport operator or developer faces lower risk. We would, in line with the idea of a longer-term framework, such as different RABs with different logics, to isolate project and construction costs which have different risk profiles and timelines during the expansion phase. Rather than pre-funding, costs should be capitalized in the RAB along with a reasonable return – and only be included in charges once delivery is complete. Under the current “early cost” framework, today’s consumers must pay for future infrastructure which is unfair and more expensive for consumers and users whose capital costs are higher than an airport operator at Heathrow.

The CAA should retain alternative ownership and operating frameworks

IATA supports regulatory interventions that reproduce the effects of a competitive market. The government mandated the UK CAA to protect consumers and seek efficiency by reproducing the effects of a competitive market on the regulated entity. However the system must push for more signals from the market on what efficiency really means. This must come through revising how the CAA regulates today, notably on capital expenditure. This can be complemented by the introduction of competitive pressures through tenders or mandates to parties other than the incumbent. Be it designing, building or operating part or all of the airport, there is merit in looking at whether adding new players can effectively challenge the incumbent operator. If other operators could at least propose to take over existing functions or infrastructure, the incumbent would be encouraged to defend its ability to deliver efficiently, and if it fails, other operators could propose to step in. We encourage the CAA to look at IATA’s publications on ownership and regulation notably on management and service contract models, exercising caution not to replicate the failings of many long-term concession agreements globally.

The CAA is too quick to dismiss alternative ownership and operating frameworks based on perceived complexity. It may be conceptually simpler to have a single monolithic operator – but the need for coordination and interfaces should not be the only reason to discard options. As very visible in the energy, telecom and water sectors – multiple actors can be introduced and work extremely well in some areas of the value chain. This does not mean, however, that all infrastructure and services should be deregulated. Even with different operators providing different services, Heathrow is extremely constrained and has market power so even multiple operators will still have to be regulated.

The identification of the point of separation between actors in the value chain is key to making this work. The use of the term “direct competition” between terminals likely has multiple interpretations. There are a handful of cases of multi-operator airports, but many operate on slightly different models. Consequently, understanding whether such a model could work at Heathrow requires further detail on ownership, charging models, transition plans and service levels. IATA’s view is that a focus on better regulation, notably of capital investments, should be a priority, however the CAA is too quick to discard multi-operator frameworks for new and existing terminals or different airport services. A fully competitive market for airport services will likely never exist at Heathrow, if only due to capacity constraints, switching costs, and provider entry/exit costs. However solid regulation does not prevent some multi-operator scenarios. The CAA could still retain options including multiple candidates for a development consent order, mandating a specific procurement exercise for design, build <u>or</u> operation of assets, or changes to the license to potentially grant entry to new operators. All of this is without prejudice to the historical operator of Heathrow to bid on the work, but we do see value in retaining the option.

Conclusion

In conclusion, IATA believes the shortlisted options are a good basis to reform Heathrow, but encourages the CAA, considering the current framework, to maximize the extent to which the incumbent is challenged on their ability to design, build or operate new or existing infrastructure. The aim of regulation is to replicate the pressure of a competitive market. Greater regulatory scrutiny and enhanced capex governance ensures that the airport delivers what the market needs efficiently starting with an aligned strategy. Providing framework clarity for specific megaproject items to encourage investment can protect users from excess charges, without guaranteeing yields or returns. Exploring how to restructure the license or to allow multiple operators in some areas could yield better outcomes than a single monopoly.

We look forward to exchanging further with your authority in the coming months to find the best model for the industry.