

Economic regulation of capacity expansion at Heathrow

Technical information note on the CAA's approach to dealing with licensing issues raised by potential alternative developers of new capacity at Heathrow Airport

The purpose of this note in the context of the CAA's role

This note is being published by the CAA in the context of the possibility, raised by stakeholders, that capacity expansion at Heathrow might be developed by more than one party.¹ At present, it appears to us that the most likely circumstances in which this could arise are either where HAL and a third party come to an agreement on the development of different areas of Heathrow airport, or where a third party makes a successful application for development consent.

Bearing this in mind, this technical information note seeks to provide initial information on these issues.

Given:

- the limited information we have about any proposals that might be brought forward;
- the uncertainties about the precise mechanics for the delivery of future capacity expansion at Heathrow; and
- how parties might propose that any interface between their intended proposals and the proposals being prepared by Heathrow Airport Limited (HAL) should be managed,

any indicative clarification that the CAA can provide at this initial stage of the process is necessarily subject to a number of caveats. It should also be noted that any decisions that the CAA makes in relation to these issues in the future will be made in accordance with its primary statutory duty under the Civil Aviation Act 2012 (the "Act") to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services.²

The caveats referred to above are as follows:

- At present, not only do we have limited information on potential alternative proposals, but HAL's proposals are also continuing to evolve, not least in the light of its

¹ See, for example, the response of the Arora Group to [CAP 1541 Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow](#), ("CAP 1541"); [CAP 1610 Regulation of capacity expansion at Heathrow: policy update and consultation](#) ("CAP 1610") and [CAP 1658 Economic regulation of capacity expansion at Heathrow: Policy update and consultation](#) ("CAP 1658").

² See section 1(1) of the Act. We often refer to these users by using the shorthand of "consumers".

engagement with airlines and wider public consultation. Both of these factors affect the clarity that we can provide at this early stage of the process. We would expect the detail of our response to these issues, and our ability to provide a greater degree of certainty, to improve as more detailed and firm information becomes available over time, for example, when plans for public consultation on alternative proposals are developed. We would expect that, once it has reached an appropriate level of maturity and prior to the CAA making any final decision(s), the CAA's approach will be subject to public consultation. As we have already noted in our CAP1658 Consultation, it will remain too early in the process to reach a definitive view on the precise form of regulation until significantly more information becomes available to us.

- The interaction between any alternative proposals and those being developed by HAL through two Development Consent Order (DCO) applications could be relatively novel. Responses that address those interactions are not entirely within the CAA's remit. All decisions to grant development consent will be made by the Secretary of State or a nominated Minister.
- Whilst it is clear that the Act envisages the possibility of there being more than one airport operator at any given airport, there are a number of ways in which such a situation could be implemented. The consequence of this is that a variety of different structures could be used to regulate such operators in an appropriate and proportionate manner. It is not yet clear how the precise details in any successful DCO application would interact with the various mechanisms for economic regulation set out in the Act.
- We note that stakeholders have already made arguments that competition should not be limited to the delivery of expansion, but should also include allowing subsequent terminal ownership and operation. HAL has contested these matters.
- In our CAP1658 Consultation, we noted that it was too early in the process to reach a definitive view on the precise form of regulation until significantly more information becomes available to us so that we can carry out a more detailed assessment of the interests of airport users on this issue.
- As part of that process, we may receive (and will need to consider appropriately) representations from a wide range of stakeholders before we can reach any final view on the matters discussed in this note. We cannot pre-empt that process (and our duties of proper consultation) by adopting a definitive position now.
- We have consistently said that capacity expansion in the south east of England is in the best interests of consumers, since, without the timely delivery of capacity expansion, consumers will experience higher fares, less choice and greater delays. In this context, in the discharge of our statutory duties, we are concerned with (among other things) both the timely and efficient delivery of capacity expansion and in promoting wider competition in airport operation services in the light of our regulatory duties in the Act.
- In performing its statutory duties, the CAA will need to exercise its expert regulatory judgment and make appropriate economic and policy choices in the manner that it considers will further such of the interests of users as it thinks best.
- In any event, the CAA cannot fetter its discretion as to the particular approach it might adopt if presented with more than one operator of different areas within Heathrow airport. This is because, among other things, we would need to consider which approach was most appropriate and proportionate once we have much more clarity and certainty about the final factual situation and form of the overall development of capacity expansion.

Nonetheless, we recognise the importance of the issues that may arise if there is to be more than one operator of different areas within Heathrow airport and of clarity regarding the exercise of our regulatory powers in circumstances where development proposals are being put forward by parties other than HAL.

In the light of the above context and caveats, any clarificatory guidance (including in this note) that the CAA can volunteer at this early stage is necessarily indicative and provisional. It will likely develop as circumstances evolve and as stakeholders engage with us as part of the ongoing process. We will also need to consider any representations from HAL, airlines and other interested stakeholders so that we can, in line with our wider regulatory duties in the Act and as part of best regulatory practice, develop an appropriate evidence base to support any decisions that further the interests of consumers that the CAA makes in due course through the capacity expansion programme as a whole.

It should be noted that this information note is not intended to give legal advice to any party on any aspect of regulatory treatment of capacity expansion. The CAA is not in a position to provide legal advice to any party and will assume that any stakeholder seeking to bring forward alternative proposals for the development of new capacity will instruct its own legal advisors. Moreover, the CAA is unable to provide detailed comments on the impact of particular proposals at this very early stage of their formulation because the development of any regulatory structures to accommodate any proposals, should a promoter decide to proceed with them, will, necessarily, be a complex and iterative process and will need to take account of very significant amounts of evidence which naturally remains to be prepared and/or provided to the CAA.

The issues covered by this technical information note

The CAA has noted, in both CAP 1610 and CAP 1658 that, while the Act does not contain explicit powers for the CAA to force divestment of assets, it is flexible enough to accommodate a wide range of commercial structures at Heathrow. This note seeks to provide clarity in relation to the CAA's regulatory powers and proposed approach in the event that, either by agreement with HAL, or through the planning process and any land or other rights acquired under it, an alternative operator is likely to have, or has, overall responsibility for a particular area of Heathrow airport alongside other areas operated by HAL.

This note covers the following four areas:

- whether the CAA has statutory powers to support, facilitate and regulate the development of alternative delivery and ownership mechanisms;
- whether the CAA can impose licence conditions on HAL that would require it to enter agreements with the independent operator of an independently owned terminal to facilitate the integration/operation of a new terminal with the airport;
- whether the CAA can license a new participant without first conducting a new Market Power Determination (MPD) at Heathrow and that if a party other than HAL were to obtain a DCO whether it would require a licence under the Act before it could levy airport charges; and
- how the CAA will engage with PINS in relation to a third party DCO application.

These are addressed in turn below.

1. Alternative operators

A key reform introduced by the Act was to enable one or more operator to manage different “areas” that form part of the same airport. Each “area” may comprise land, buildings or structures used for the purposes of providing airport operation services, as defined in the Act.³ There may be multiple operators with overall responsibility for the management of discrete areas.⁴ Alternatively, there may equally be two or more joint operators within one area.⁵

Overall responsibility is not confined to ownership of the land or building itself, but comprises the ability to control the types, prices and quality of services provided in the area, access to the area and development of the area.⁶ As such, there is a wide range of possible mechanisms that might be used by alternative operators (including owner-occupier, leasing and cooperation models but also contractual arrangements such as access arrangements, assignment and sub-contracting).

In circumstances where there are (or are likely to be) multiple operators at a particular airport, the CAA has been conferred regulatory and licensing powers over such operators, which it will exercise in accordance with the general duties, regulatory principles and objectives set out in (inter alia) section 1(1) to (4) of the Act.

³ See sections 66 to 68 of the Act.

⁴ Section 9(2) of the Act provides that the Secretary of State may issue guidelines regarding the precise circumstances in which persons are to be regarded as having overall responsibility for the management of an airport area.

⁵ Section 70 of the Act.

⁶ Section 9(4) of the Act.

2. Power to modify HAL's licence to facilitate a successful third-party scheme

At present, HAL is the sole operator of Heathrow Airport⁷ and is subject to the licence conditions imposed by the CAA following its Market Power Determination in 2014. While the CAA has power to modify HAL's licence to impose specific conditions that might compel HAL to enter into commercial arrangements with third parties, any change to HAL's licence to include an obligation to enter into arrangements with third parties would need to be based on robust evidence, be necessary or expedient having regard to the CAA's duties and require the CAA to follow the procedure for modification of HAL's licence set out in the Act. Given the present lack of detail we have on all potential promoters' schemes and how they might be integrated together at some undefined point in future, it would appear premature to seek to make any assumptions at this time on the merits of any such condition, or the possible terms to be provided, in the absence of significantly more detailed and firm proposals.

In any event, the CAA's ability to modify any licence (including HAL's) is subject to various legal safeguards, including the statutory and procedural safeguards already incorporated into the Act, reinforced (where appropriate) by judicial review and appeals to the Competition and Markets Authority (CMA). That said, in principle, section 21 of the Act permits the CAA, where it considers it necessary or expedient, to make provision in HAL's licence for the accommodation of an alternative operator which had been successful in obtaining a DCO to develop part of Heathrow airport, by requiring it to enter into contractual agreements or other arrangements for the delivery of capacity expansion. As indicated above, the CAA's exercise of its discretion in that regard would be conducted in line with its general duties and regulatory objectives as set out in section 1 of the Act as well as the requirements of sections 18 to 23 of the Act.

In the event that there were to be compelling evidence that the inclusion of a licence condition requiring HAL to enter into contractual agreements or other arrangements with a third party would be necessary or expedient having regard to the CAA's duties to further users' interests and/or necessary or appropriate to promote competition, then the flexibility allowed by the Act could, in principle, be used to support the implementation of such arrangements provided the CAA considered that to be a necessary and proportionate intervention to further the interests of consumers.

We consider that this flexibility could extend to requiring HAL to enter into contractual agreements or arrangements with the developer and operator of new terminal capacity at Heathrow in circumstances where such intervention was necessary and proportionate to prevent abuse of market power or to further the CAA's statutory duties. That could also, in principle, extend to appropriate arrangements to integrate the new capacity into the operation of the airport as a whole, provided that it was considered to be necessary and proportionate.

The development of any such licence conditions and arrangements would be subject to the general caveats identified above and would need to be proportionate and consistent with the CAA's duty to promote the interests of consumers, having regard to all relevant factors including financing. Factors of particular relevance might include the results of careful consultation (with HAL, airlines and other stakeholders) and analysis of relevant information and other evidence.

⁷ Excluding the fuel facilities as defined in [CAP 1136: Heathrow Airport Operator Determination](#).

3. Powers to licence an alternative terminal operator

This section deals with the approach the CAA could take to licensing a party acquiring responsibility for a particular area of Heathrow airport alongside other areas operated by HAL, and whether there is any need for the CAA to conduct a separate Market Power Determination (MPD) or whether the existing MPD conducted in 2014 can continue in effect until it is superseded.

For the reasons and general caveats set out above, we cannot, at this stage, reach any firm view on what our regulatory approach might be regarding licensing because that decision will depend on the factual circumstances and the CAA's assessment of them, and the exercise of its regulatory judgment as to the need for a licence at the relevant time. As such, it is too early for any third party to make any assumption over whether it would need a licence in order to levy charges at any new terminal it might develop.

At this early stage, the factual scenario is too uncertain and subject to many variables and commercial choices by third parties so it would be premature and inappropriate for us to narrow the available regulatory options without a much fuller picture of all the relevant circumstances. Furthermore, as a matter of public law, the CAA cannot fetter its discretion in this regard.

Nonetheless, the CAA can offer the following indicative guidance:

- the Act sets out an iterative process, involving various stages of and procedures for the CAA's assessment of how best to regulate a particular airport operator;
- first, the CAA could make an operator determination as to whether a third-party developer did, or did not, have overall responsibility for the management of the particular area of Heathrow airport.⁸ The CAA can make that determination in advance where it is likely that the third party will be treated as having such responsibility.⁹ At this early stage in the planning process, this prospect is too uncertain for the CAA to be able to progress such a determination.
- next, the CAA would need to consider whether to make a market power determination pursuant to s.7 of the Act. Whilst there is an existing MPD in respect of Heathrow, that determination dates from 2014, relates to a single operator and does not consider the new areas to be developed as part of the expansion. While the CAA has no existing plans to carry out an MPD, we cannot rule out, at the appropriate time, needing to consider whether there has been a material change of circumstances and/or whether it is appropriate to make a new MPD to supersede the old one. The exercise of its discretion in that regard would depend on the prevailing circumstances at the relevant time, which cannot be predicted with certainty at this stage;
- if the CAA determined that it was minded to carry out a new MPD, it would need to carry out the market power test for the relevant area(s) by reference to the three cumulative tests applied in relation to the relevant operator(s) as set out in section 6 of the Act.
- on completion of the MPD, assuming it was resolved in an affirmative decision that the benefits of regulating the relevant operator(s) by means of a licence outweighed any adverse effects, the CAA would then have to exercise its regulatory judgment to determine the terms and conditions of any licence. The CAA would need to consider

⁸ Section 10 of the Act.

⁹ Section 12 of the Act.

what terms would be necessary or expedient to be included in that licence to address the specific risks of abuse presented by that particular alternative operator's market power and/or to further its regulatory objectives in accordance with its statutory and public law duties. This would include considering what obligations it might contain in relation to pricing and service quality (amongst others) and whether to enforce them through a "traditional" licence controls or in the form of licence backed commitments, or some other arrangement.

The decisions the CAA might reach regarding the timing and conduct of any new MPD, let alone whether to grant a licence to the operator of a new independently owned terminal at Heathrow, raise significant and fundamental issues for the licensing regime for Heathrow airport (or parts of it). As such, it would not be appropriate for us at this stage to fetter the discretion of the CAA by confirming whether or not it would necessarily grant a licence to any particular third party. Granting a licence to an alternative operator is merely one of several potential tools of economic regulation that the CAA might consider using, depending on the available factual and economic evidence, regulatory considerations and views of all interested stakeholders expressed at the relevant time.

At this early stage of the process, it is premature for the CAA to comment on any of those aspects, since important details regarding the development of distinct areas, the addition of alternative operators, and the precise model for any such integrated management are unknown. Similarly, until those details have been finalised (or have reached a sufficiently certain stage for the CAA to intervene in advance),¹⁰ the CAA would not be able to decide on the need for a new MPD, assess the conditions of competition in the relevant market or resolve the costs and benefits of any hypothetical licence.

¹⁰ We note that the Act contains provisions that allow for some flexibility regarding the timing of any Operator Determination, MPD or licence grant. For example, section 12 and section 16 taken together permit an advance MPD and/or the anticipatory grant of a licence if it is "likely" to be needed.

4. Engagement with the Planning Inspectorate

This section clarifies at what stage of the DCO process the CAA would engage with a third-party promoter and the Planning Inspectorate on the grant and potential terms of any licence.

The CAA is a statutory consultee as part of the planning process. As such, we have already been engaging with the Planning Inspectorate from an early stage in relation to the DCO process being conducted by HAL. This has had the benefit of enabling us to help the Planning Inspectorate with understanding the various roles and duties of the CAA, including in relation to its economic regulation powers. Just as we are engaging with the Planning Inspectorate as part of HAL's DCO planning process, we would also expect to engage with it in relation to any application involving any third-party promoter in a similar manner from an early stage. However, we would note that such engagement is likely to be largely driven by the Planning Inspectorate in the context of the issues which are relevant to its process and decision making, rather than being driven by CAA.

Similarly, we would appreciate open and constructive dialogue with the regulatory team of any third-party promoter as it develops its plans and proposals so that we can assess the impact that they might have on our regulatory approach. This will enable us to coordinate with that promoter, HAL, the Planning Inspectorate and other interested stakeholders on the need for, nature of and timing of any regulatory action including collation and delivery to us of necessary evidence to put the CAA in a position to conduct any determinations (as necessary) in a transparent, consistent and efficient manner.

Next steps

We will discuss this note with interested parties and will make any further comments that are necessary in the light of those discussions in our next consultation, which is due to be published in October.