

# Economic regulation of capacity expansion at Heathrow: policy update and consultation - CAP 1722

## Heathrow's response

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## 1. Executive summary

1. Expanding Heathrow is a once in a generation opportunity. The Department for Transport (DfT) estimates that expanding Heathrow will generate £68 billion<sup>1</sup> in benefit for consumers through lower fares and new flights driven by increased competition and choice from airlines operating from an expanded Heathrow. The CAA, the airlines and Heathrow need to focus on this long-term consumer prize. If we develop the right plan, with the right regulatory framework underpinning it, we will provide what consumers want. We will also secure a sustainable future for our businesses, boost the aviation industry, and build global links for the whole of the UK.
2. The delivery challenge cannot be underestimated. Heathrow is being challenged to bring in a new runway by 2026, with consent achieved by 2021, while maintaining airport charges close to 2016 levels in real terms. As with any major infrastructure project, this requires extensive planning, iteration and engagement. Heathrow is working to deliver one of the most complex planning applications and construction programmes in the UK. Furthermore, this is while continuing to operate a busy hub airport where we must deliver every day for today's passengers. At times, unforeseen situations will require adjustments to the programme. Throughout these challenges, we as an industry need to remain focused on consumers. We must provide the leadership to ensure consumer needs in the round are driving our plans. The CAA has a pivotal role in keeping us concentrated on long-term balance not just immediate issues.
3. The CAA's latest consultation provides some initial work assessing consumer benefits of expansion. Establishing this evidence is essential to create an appropriate regulatory framework for expansion. As a matter of principle, it enables the CAA to make regulatory decisions in a quantified way, consistent with its primary duty. At a practical level, it helps with important decisions. These include the balance of investment before the DCO to accelerate potential new capacity versus the risk of investing in the face of uncertainty. They will also include decisions on the speed and nature of capacity build as the runway opens. We therefore encourage the CAA to further develop work in this area.
4. The CAA also gives an extensive discussion of the regulatory timetable. There will never be perfect alignment between the regulatory timetable and statutory DCO process. We ask the CAA to pragmatically settle on a timetable to deliver a regulatory framework ensuring an affordable and financeable expansion. We do not believe a further iH7 extension is needed. We now expect a commercial alternative to be feasible for the iH7 period. The CAA should focus primarily on the wider regulatory framework. We also believe that, given the scale of H7, a full Final Business Plan (FBP) in 2020 is required. This allows Heathrow to incorporate consumer, airline and other stakeholder views on its Initial Business Plan (IBP).
5. Heathrow and airlines have a joint objective to provide an optimal service proposition in terms of price and quality that appeals to consumers. We are thus hopeful there is real scope for achieving a commercial deal to supplement H7 regulation. We have actively worked with airlines to pursue a commercial deal for the iH7 period. We welcome the CAA's support for an industry led agreement. We believe this is best supported by a clear timetable for defining the regulatory framework. This will be reinforced by allowing sufficient time for commercial discussions to happen once the masterplan and business cases are better understood.

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<sup>1</sup> NPV of economic benefit in NPV terms 2014p, 60 years – DfT, Updated Appraisal Report Airport Capacity in the South East, October

6. Heathrow is still concerned by the assertion that a general licence condition to ensure efficiency and economy is required. We consider the case unproven at best based on the latest arguments from the CAA. The CAA's stated rationale for introducing it is muddled. Equally unclear are the specific objectives that the condition aims to achieve or the risks it is trying to mitigate. We offer some suggestions in this response and would like to engage with the CAA in more detail the wording of any proposed licence condition.
7. The CAA must make progress on solidifying the regulatory framework for expansion. There is an increasing danger of generating unnecessary uncertainty by open-ended pursuit of untested alternative regulatory structures. We have responded constructively to the exploration of alternative delivery mechanisms (ADMs). We will be providing the further evidence on ADMs requested by the CAA. We have also engaged constructively on ex-ante incentives. Heathrow would ask the CAA to outline clear milestones to bring speculative work on alternative regulation to a conclusion. This helps ensure no delay to the H7 timetable. It is also vital for financing the largest private transport project in the country since prolonged uncertainty will impact the cost and availability of finance. Financing must not be taken for granted, as it often seems to be. In addition, we call on the CAA to provide robust, quantified analysis on how any proposals for alternative forms of regulation are in the consumer interest.
8. We acknowledge the CAA's confirmation that any surface access capital contributions made in line with CAA's surface access principles will be recovered through the RAB. We also acknowledge the principle that any surface access operational costs and revenues will be considered through single till. We support the broad continuity in regulation of surface access, including the user pays principle. We ask the CAA to set a final policy as soon as practicable in 2019 given the imminence of government decisions on Western Rail.
9. It is good commercial practice for Heathrow to consult with and listen closely to its airline customers irrespective of any regulatory requirements. At the same time, the Civil Aviation Act 2012 (CAA12) requires the CAA to make decisions in the interests of consumers. Airlines are not a substitute for consumers. In parts of CAP1722, the CAA appears to focus on protecting airline community interests<sup>2</sup>. This is inconsistent with the CAA's primary duty.
10. Throughout 2019 the CAA needs to focus on the fundamental elements of the regulatory framework for Heathrow Expansion. It needs to do so on a systematic and logical basis. For example, it needs to make a formal decision on pre-DCO category C costs in January. It should provide meaningful insight on its approach to capital incentives and how it affects affordability and financeability by March. In the first half of the year, it also needs to develop robust work in its approach to defining the risks and risk premium associated with expansion. In doing so it must explain how it will deal with issues of longevity and stability for investment.
11. Heathrow's response is structured around the CAP1722 chapters. We are happy to engage with the CAA on any areas contained within this response.

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<sup>2</sup> For example, "... work on commercial and regulatory arrangements that would protect airlines and consumers..." Para CAP1722, page 42, paragraph 3.26

## 2. The overall timetable and the interim price control

### iH7

12. An industry led commercial approach for iH7, and potentially beyond, is an opportunity. It could generate good outcomes for consumers as well as airlines and the airport. Heathrow recognises the CAA's support for a commercial deal for iH7 in previous consultations. We agree with the advantages a commercial deal could provide, as outlined by the CAA in CAP1722.
13. We therefore urge the CAA to adopt a straightforward and wholistic approach to assessing that a commercial deal is consistent with its duties. The CAA should avoid an additional burdensome consultation and review process that delays agreements and decisions being made.
14. We note and support the CAA's statement that if a commercial deal is assessed to be in the interests of consumers it would not need to undertake the iH7 price control as currently envisaged. Likewise, we agree with the need to make appropriate changes to Heathrow's licence to reflect the terms of the commercial agreement.
15. We are not convinced by the CAA's proposed approach to re-opening the calculation of the WACC if iH7 needed to be extended further. The CAA should carefully consider how reopening the WACC calculation would be consistent with a) its proportionality principle for extending the current price control and b) its intention to avoid unnecessary complexity and significant distraction from the full H7 price control.
16. We also note that the Q6 WACC did not envisage or reflect the substantial investments or increased risk profile now triggered by Heathrow's expansion. These need to be carefully considered by the CAA in assessing WACC for any further iH7 extension. We are concerned with the CAA's assertion of Heathrow having a WACC for "Business as Usual" activities. There is just one Heathrow WACC. There is one Heathrow financing platform. Heathrow's inherent risk comes from a single site operation and recovery methodology as defined by the single till. 2020, 2021 and 2022 see significant capital expenditure on expansion within that integrated business. The CAA must properly consider how to reflect that increased risk in addition to reviewing the market driven parameters of the WACC.

### H7 timetable

17. We have good confidence in our revised timeline for the delivery of expansion. We believe that the current regulatory timetable works with a two-year iH7 period (i.e. to end 2021). However, the CAA needs to accept that there will never be perfect alignment between the regulatory and statutory planning processes. It needs to ensure that there is flexibility in the H7 regulatory framework should there be any change to the timetable. This would be more helpful than further deliberating over more extensions to the iH7 period.
18. Recurring debate regarding the timetable for H7 risks detracting attention from the real task at hand. Namely, establishing the appropriate regulatory framework to facilitate the delivery of consumer benefits from new capacity in the 2020s.
19. Our preferred timetable for the H7 decision therefore maintains a 2022 H7 start and contains clear milestones for both the IBP and the FBP:
  - a. IBP – End 2019

- b. FBP – Mid 2020
- c. Initial Proposals – End 2020
- d. Final Proposals – Mid 2021

20. We view the FBP as an essential milestone in the process. It would ensure that we can develop, discuss and adapt our plans in line with stakeholders' views through constructive engagement (CE) following publication of Heathrow's IBP. We believe this in particular as:
- a. Absent a clear milestone for the FBP, the CE process would be undermined as there would not be a formal opportunity to reflect stakeholders' feedback on the IBP.
  - b. Under an outcomes based regulatory framework, Heathrow's IBP will be a fully integrated plan based on extensive consumer engagement and research. This means that any changes to Heathrow's plans following consumer and stakeholder feedback need to be considered in the round. Therefore, a fully (re)integrated FBP is required.
21. We note the CAA's concerns in providing definitive dates for the back end of the H7 decision. We agree changes to initial milestones could trigger changes to subsequent dates. Some flexibility should be acceptable to all involved. Having said that, it is important the CAA defines key milestones in the timetable so we all can plan and allocate resources accordingly. Flexibility could be introduced by confirming say the quarter of a year intended but fixing an exact date for later milestones (i.e. FBP or Initial Proposals) later in the process or expressing them as approximate months following previous milestones.

## 2019 consultations

22. At the end of 2019, Heathrow will publish its IBP for H7. The plan will outline, amongst other things, the outcomes that will be achieved, passenger service levels, the investment plan and the key choices associated with them.
23. The CAA needs to solidify the regulatory framework for expansion ahead of Heathrow's IBP. For Heathrow to develop a robust business plan in the interest of consumers, we need to understand the foundations of the regulatory framework for that plan. It is counter to best regulatory practice to mandate the publication of the regulatee's business plan without having fully defined the regulatory framework. This need not quantify all variables for example, but the principles and structures need to be clear and settled.
24. Heathrow considers that significant information, thinking and decision-making is thus required from the CAA ahead of the publication of our IBP. We outline below the most pressing areas for developing the regulatory framework for H7 and beyond:
- a. A decision on Pre-DCO category C costs and Surface Access policy as soon as practicably possible. Regulatory certainty is essential to ensure that the Heathrow Expansion timetable is not delayed in 2019.
  - b. Defining and assessing risk and reward. The CAA has stated that expansion will change Heathrow's risk profile. The CAA needs to explain how the expansion risk premium will be quantified. The March 2019 policy consultation should consider important questions including:
    - i. the approach to defining and quantifying risk;

- ii. how the CAA will provide stability and certainty over the construction and early operational phase of expansion (10 to 15 years); and
  - iii. how the wider incentives framework links logically to the cost of capital and risk premium and how trade-offs could be made.
- c. Financeability. Taking financing for granted would be a huge mistake. Financeability requires a balanced regulatory framework as a base. The CAA should set an A- target credit rating for H7. It can then work from there to ensure cost effective financing. Heathrow needs to better understand the CAA's approach to financing as soon as possible. The March policy consultation therefore needs to discuss financeability.
- d. Incentives. The CAA should provide better insight on capital investment incentives. Big changes to incentives would make for a riskier regulatory framework against a backdrop of a fundamentally riskier investment. Changes to incentives will change the basis of Heathrow's regulatory framework and therefore the basis of Heathrow's operating model and IBP. This uncertainty needs to be resolved as soon as possible through 2019.

### 3. Promoting economy and efficiency

25. This chapter should be read alongside Appendix A, Heathrow's review of the CAA's rationale for introducing a licence condition to promote economy and efficiency.

#### Requirement for the condition

26. A new licence condition is not justified. Heathrow's track record of responding to regulatory and wider market incentives demonstrates this clearly. Heathrow's performance has improved over the last decade in every single metric; investment, operational expenditure and commercial efficiency, service quality results, passenger numbers, safety and resilience.
27. We do not agree with the CAA's assertion that a condition is necessary to address concerns around economy and efficiency. The CAA has provided no examples of when such a condition was previously required, or where the current regime did not provide sufficient protection. The CAA has failed to provide any evidence as to why an additional licence condition is necessary and proportionate for the CAA to fulfil its statutory duties. It has not even provided evidence that the incentives currently incorporated in the regulatory framework are not enough to ensure economy and efficiency. Further, we do not agree that incentives weaken over time within a price control or that they are, even theoretically, less strong throughout the iH7 period. Again, no evidence is provided to support this assertion.
28. The CAA's application of economic regulation covers every aspect of Heathrow's business. For example, Heathrow is incentivised to run the airport efficiently with powerful commercial mechanisms and targets for rationalising operational expenditure and generating commercial revenue. Heathrow is incentivised to grow passenger volumes year on year, while providing defined service levels for passengers. In addition, Heathrow has clear incentives to deliver capital investment, category B costs and pre-DCO category C costs efficiently, since a failure to do so would result in Heathrow not being able to fully recover the invested amounts.
29. Furthermore, the CAA's powers and their application through regulatory policy is flexible enough to adapt to unforeseen circumstances in the interest of consumers. This is demonstrated by decisions the CAA has taken over the Q6 period, e.g. category B costs policy, extension to the Q6 price control.

30. Heathrow's licence already incorporates a number of mechanisms via which the CAA can ensure it is operating in an economic and efficient manner. Two very significant and wide-ranging licence conditions cover:
- a. Procurement of capital projects; and
  - b. Operational resilience, with a licence condition which ensures the availability and continuity of airport services in a timely, efficient and economical manner.

These two licence conditions give the CAA enough flexibility to investigate any concerns. They also overlap and potentially contradict the discussed licence condition.

31. Although this document provides the CAA's most in-depth discussion of a potential licence condition to date, it continues to fail to provide real clarity on the CAA's objectives for the introduction of a general licence condition. It remains unclear to us what the CAA's specific concerns are, in particular when they are not based on specific examples or experience. A justification based on "other regulators have it" is simply not enough and is not consistent with Better Regulation principles.
32. Regarding the CAA's question as to when the condition should be introduced, based on the reasons above, we do not see the need for introducing any such licence condition in 2019 nor at the beginning of H7.

### Specific wording of the licence

33. As set out above, a condition of the type currently articulated in the CAA's consultation document is neither justified nor proportionate. We request that the CAA carefully considers all of the concerns articulated in Appendix A. Additionally, and without prejudice to those concerns, we believe the CAA needs to consider the specifics outlined in the following paragraphs which we would expect to see included in any consideration of economy and efficiency requirements on Heathrow.
34. Although not persuaded by the need for a general licence condition, we are strongly of the view that, should any such condition be contemplated, the wording must be clear and properly reflect the CAA's duties. Any such licence condition must be able to stand the test of time over multiple regulatory periods. It would need to be targeted in its intent and application such that it would not expose Heathrow to the risk of open ended interpretation of the licence itself, undermining essential regulatory certainty.
35. We note the CAA's discussion that any general licence condition should focus on *how* a business such as Heathrow delivers, not on *what* specifics are delivered. We also understand the aim of any condition is not focused exclusively on expansion. Both of these factors are important for any possible wording and would have to be consistently applied in drafting.
36. Heathrow operates within a competitive environment, facing strong competition from both UK and international airports. Airline users have significant power and ability to constrain any actions of Heathrow. Heathrow is also entirely privately financed and run. In this context it is only appropriate that the CAA reflects this competitive environment in any condition monitoring economy and efficiency, such that Heathrow's actions are measured against wider commercial best practice for private businesses.

37. We do not agree with the CAA's decision to remove the previously proposed reference to users' reasonable requirements<sup>3</sup>. The inclusion of this statement is essential to ensure clarity. Absent this statement, it is open to interpretation as to whose requirements the operation, maintenance, enhancement etc. of the airport should meet. Any ambiguity as to the definition of users can be addressed through reference to the definition in CAA12. This would better reflect the CAA's primary duty.
38. The proposed wording of the condition fails to recognise the CAA's duty to licence holders to ensure that they can finance the provision of airport operator services. Condition 1 of Network Rail's licence specifically makes reference to ensuring that the licence holder has regard to its ability to finance its activities when carrying out its general duty. We would expect the CAA to have similar regard. The CAA must ensure it is not overlooking its wider duties and that the licence condition does not have the unintended consequence of forcing Heathrow to take action which could impact its financeability.
39. In its proposed wording, the CAA's main areas of focus of the condition remain expansion related issues. The suggested 'focus areas' concentrate on what Heathrow is delivering, such as the development of a DCO application, rather than how Heathrow should behave. This reinforces the lack of clarity around the CAA's assessment for the need of the condition. We would urge the CAA to consider this in any further consultation on the matter and remove the concept of periodically updated 'focus areas' of such nature.
40. Apart from being contradictory to the CAA's intent of focusing on the how rather than the what, the focus areas fail to provide any meaningful guidance. This is explicit in the CAA's document, footnote to paragraph 2.17.3.

*Compliance with these requirements shall be without prejudice to the general nature of the obligation set out in condition [ ], and compliance with these requirements shall not, be sufficient to exhaust the licensee's general duty under that condition."*

41. This caveat exacerbates, rather than improves, the vagueness of the proposed obligation and therefore undermines any clarification provided. This reinforces our view that areas of focus should be removed from any potential licence condition.
42. Should the CAA seek further input on a licence condition, despite the lack of a convincing, evidenced and clear rationale outlined above, we would urge it to address these issues in any potential drafting<sup>4</sup> as well producing an adequate justification. We would also urge the CAA to engage closely with Heathrow on any such work.

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<sup>3</sup> CAA, CAP1658, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, April 2018, para 3.36

<sup>4</sup> For example, and without prejudice to and notwithstanding the points made on any such general condition lacking justification, there would be a need for the CAA to address such points with a form more consistent with the CAA's duties under CAA 12 such as:

*1.1 The Licensee shall conduct its business in an economical and efficient manner as would a private business in line with commercial best practice to secure the operation, maintenance and appropriate enhancement of Heathrow Airport in line with the reasonable requirements of users\*.*

#### 4. Alternative delivery arrangements

43. The CAA is seeking feedback on its broad approach to alternative delivery arrangements. This includes its focus on understanding more about Arora Group's proposals, and the next steps identified for whether it should commit further resources to develop the regulatory framework to take account of DCO applications from competing parties.
44. It is time to exercise common sense to make expansion happen. Regulatory certainty is indispensable if the largest privately financed transport infrastructure project in Europe is to happen. Following NPS designation and after three years of work on expansion regulation, the CAA needs to make urgent progress on the H7 regulatory framework. It should also require any potential competing approaches to robustly demonstrate real prospects for viability, financing and rapid development, not delaying the existing development process.
45. The current regulatory framework has facilitated the transformation of Heathrow into the best rated European hub by passengers. Heathrow has consistently argued that the CAA should build on the strengths of the current regulatory framework. It should introduce regulatory innovations only when they can be unequivocally proven to be in the interest of consumers. The CAA should embed this principle in any work or analysis regarding the investigation of ADMs. .
46. The CAA's decision-making is governed by its primary duty to consumers. It should be grounded on sound and robust information and analysis. This applies equally to ADMs.
47. Consistent with statute, the CAA should consider why Arora did not put forward its scheme to the Airport Commission, thus giving itself a fair chance to be assessed against other credible promoters. Given where we are in the process, the CAA should question itself whether committing significant public resources and time for a scheme that appears to lack the credibility, feasibility and maturity of Heathrow's own proposals is in the interest of consumers.
48. The CAA has no power to split Heathrow airport to allow for third party delivery<sup>5</sup>. It is for the Planning Inspectorate, not for the CAA, to consider the merits of alternative DCO applications. Notwithstanding these points, Heathrow has the following comments regarding the questions outlined by the CAA:
- a. The CAA outlines potential next steps for better understanding the credibility of Arora's proposal. It nevertheless does not provide any meaningful timeline for when these actions would happen, nor does it outline when it would stop any work on a regulatory framework for such a scheme. This is precisely because of lack of meaningful progress of Arora's scheme. There is a clear risk of delaying decision making on H7 until a conclusion on the Arora's scheme credibility is reached. This would be a situation that is simply not acceptable for consumers. The CAA should remedy this by outlining a firm and appropriate timeline for a conclusion on the credibility of Arora's scheme.

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*1.2 The licence holder shall not be required to take any actions in complying with Condition 1.1 which might reasonably be expected to have any adverse impact on the ability of the licence holder to finance its licensed activities*

*1.3 In complying with condition 1.1. the licence holder is expected to carry out appropriate engagement with consumers and other stakeholders, in a fair and proportionate manner*

\* Users as defined in the CAA12.

<sup>5</sup> CAA-H7-200 Response to CAA's Technical Note

- b. The CAA aims to define an expansion regulatory framework that ensures an affordable and financeable expansion. Heathrow shares that objective. Heathrow believes that this is best achieved by providing certainty on the regulatory process. Further work on potential radical changes to the regulatory framework late in the regulatory process puts at risk that objective. In addition to future uncertainty, it risks undermining the decisions made so far on H7. This would significantly reduce trust in the regulatory process, in turn harming the financeability and thus affordability of expansion.
  - c. New and untested regulatory structures would also inevitably generate uncertainty, complexity, cost and delay in themselves. The CAA must consider this in its decision making. The example of TTT and other such structures suggest 5 -10 years of delay is not unfeasible. In Heathrow's case such a delay would cost consumers billions in lost benefit.
49. Given the lack of progress and meaningful information provided by stakeholders regarding the "BuildCo" option, we agree with the CAA's intention to not investigate it further.
50. The CAA supports Heathrow's Innovation Partners process. It nevertheless states that Heathrow has not met all the criteria in relation to alternative commercial and delivery arrangements by rejecting separate terminal delivery and/ or operation<sup>6</sup>. The CAA's investigation of alternative commercial and delivery models is nevertheless predicated on furthering the interest of consumers, as described in CAP1658 "*we will need assurance from all relevant parties that any approach to alternative delivery of capacity expansion will not undermine the ability for the expansion programme as a whole to be efficiently commercially financed and delivered in a timely way in the interests of consumers*"<sup>7</sup>.
51. Alongside Heathrow's response to the CAA's consultation, we provide a report from Frontier economics<sup>8</sup>. It provides evidence of why separate terminal operations appear not to be in the best interest of consumers and therefore evidences why no further consideration is required. The main points of the report are summarised below:
- a. Introducing competition should not be viewed as an outcome in its own right. Rather, competition is a means to help achieve positive outcomes for passengers, current and future. The CAA needs to define what success means in terms of the outcomes that competition would generate and then assess how changes to the current framework would lead to a better outcome for consumers. Frontier defines these outcomes at four different levels; design, build, finance and operation.
  - b. From a design perspective, the recommendation and subsequent decision to expand Heathrow was largely based on the fact that it is a hub airport. A new entrant, if it was responsible for one single terminal only, could have an incentive to design its terminal in isolation and without regard for the rest of the airport, negatively impacting the hub nature of Heathrow. Heathrow on the other hand would have an incentive to design a terminal which is well integrated into the rest of the airport as a system. In addition, Heathrow already has processes which are embedded within its regulatory framework which sees that airlines, passengers and independent experts are all involved in the design and construction phases of new terminals.

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<sup>6</sup> CAA, CAP1722, October 2018, para 3.18

<sup>7</sup> CAA, CAP1658, April 2018, para 3.18

<sup>8</sup> Annex 1, Frontier Economics, Economic Regulation of Terminal Expansion, December 2018

- c. From a build / construction perspective, Frontier argues two fundamental points:
  - i. Heathrow commissions infrastructure but does not actually build it itself. All large construction projects are put out to tender introducing significant competition at this part of the value chain through the procurement process. This would hold constant for a new entrant too. Therefore, there does not appear to be different incentives on the part of Heathrow or an alternative party regarding efficient delivery of investment.
  - ii. In addition, Heathrow is already subject to significant regulatory controls to ensure that expansion is delivered efficiently.
- d. From a cost of financing perspective, based on recent experience, cost savings incurred from the third-party tenders of large projects are not solely due to lower financing costs, but also the favourable structure of the regulatory regime (e.g. a Government guarantee for TTT).
- e. From an operational perspective, there is significant evidence that suggests that the introduction of a third-party could lead to a loss of co-ordination and resilience at an airport level, impacting the operation of the integrated hub. This was indeed one of the main findings of the Begg report<sup>9</sup>. The key recommendation of the report was the need for increased centralisation of operations and decision-making in times of crisis.
- f. From a regulatory perspective, third-party terminal ownership and operation would necessitate a more complex and untested regulatory regime in order to set access prices for airport infrastructure, leading to increased uncertainty and regulatory burden.
- g. From a competition perspective, it is unclear whether there would be sufficient terminal capacity to effectively introduce competition at a terminal level. This means any theoretical potential benefits envisaged from competition at this point in the value chain are unlikely to be realised in practice in the market.

52. We would like to engage with the CAA on the contents of the Frontier report.

## 5. Surface access policy

### Policy confirmation

- 53. It is imperative that the CAA makes a final decision on its surface access policy in its March consultation. This will ensure that Heathrow can consult effectively on a strategy that meets the CAA's policy in our June 2019 airport expansion consultation and that we engage with our statutory stakeholders on a clear and consistent basis.
- 54. An appropriate surface access strategy is key to the delivery of expansion. It allows us to meet NPS targets on mode share and pledges on the levels of airport related traffic. These are needed to give Heathrow the licence to grow. Without improved surface access we thus risk the delivery of expansion. We also know that surface access options are a key determinant of airport choice and experience for consumers. Yet building surface access choices that meet

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<sup>9</sup> The Heathrow Winter Resilience Enquiry, chaired by Professor David Begg

consumer's needs is a very long lead time project. It is therefore important that we have clarity of policy in the CAA's March document to ensure that this strategy can be fully delivered.

55. As the CAA is aware, we are in particular facing time pressure in regard to the Western Rail scheme. Absent important input from the CAA, we cannot move at the required pace, and risk delaying delivery of an important piece of infrastructure for consumers to access Heathrow.

### Policy principles

56. We continue to support the CAA's surface access policy in principle and the application of user pays. We support the CAA view that airport users should only bear the efficient costs of projects needed for the efficient operation of the airport or to support obtaining planning consent. We agree that there is no benefit to airport users bearing any further costs.

57. Although we provide a fuller commentary on the CAA's draft policy in Appendix B, our main comments on the CAA's policy are set out below:

- a. In applying its policy, the CAA should ensure it views surface access investment through the lens of its statutory duties.
  - i. Firstly, in line with its primary duty to consumers, the CAA should ensure that its policy encourages the provision of surface access options that meet the requirements of consumers, both in terms of the infrastructure itself and the service levels provided.
  - ii. Secondly, the policy should be in line with its secondary duty to secure that licence holders are able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport.
  - iii. Thirdly, the policy should be explicitly in support of its statutory duty to ensure that licence holders are able to finance their airport operation services.
- b. The CAA's clarification of its role in regard to surface access set out in its document should be made explicit in the policy.
- c. Although we agree with the CAA's statement that non-airport users should not subsidise infrastructure which is primarily for the purpose of connecting the airport to the wider transport network, care should be taken to ensure that airport users are not forced to pay more than they experience in benefits. It is therefore important that the CAA's policy explicitly acknowledges that other parties, aside from airport users or the Government, in particular local authorities and businesses, also benefit from the enhanced public transport connections which serve the airport. It is important that these wider benefits are understood and identifying them becomes a formal part of the policy to ensure that airport users are not paying for benefits which accrue elsewhere.
- d. The CAA's takes a holistic view of surface access strategy including the principle of ensuring that surface access contributions provide benefits to users over time. It is important that the CAA's policy therefore allows for spend which may be required to not preclude providing of future surface access infrastructure. Within a long-term strategy, it may be that schemes are not required until a future point, corresponding with the timeline for passenger growth when they provide most benefit to users. The CAA should recognise the efficient additional spend needed to ensure that these

projects are not precluded and that providing earlier infrastructure does not make future infrastructure unnecessarily complicated or costly.

- e. The CAA must make clear in its policy that decisions on the level of costs that can be recovered from direct users of the surface access facilities are often outside of Heathrow's control. For example, on rail schemes, fares for services may be set by external bodies and revenue from direct track access charging is determined by ORR.
58. We acknowledge the CAA's confirmation that any capital contributions made in line with these principles will be recovered through the RAB. We also acknowledge that any operational costs and revenues will be taken into account through the single till calculations used to set the price control. This creates a positive incentive to ensure that airports invest in surface access projects where these have clear benefits to airport users. This is particularly important in the context of expansion where the delivery of the right surface access schemes will allow for the delivery of new capacity, providing the biggest benefit for consumers.
59. We acknowledge the CAA's confirmation of the importance of a holistic assessment of surface access interventions. It is important that our surface access strategy is viewed holistically to ensure that the most efficient mix of infrastructure and policy measures is implemented.
60. We are supportive of the CAA's proposal to leverage the analysis of other specialist bodies when reviewing our strategy and cost efficiency of any proposed surface access schemes. We are working with surface access stakeholders, including DfT, Highways England and TfL to try to reach alignment on modelling approaches and inputs.

### The DCO process

61. We acknowledge the CAA's clarification in its document that its role is not to determine whether the surface access strategy will meet the targets set out in the NPS. The DCO examination process will test different aspects of our strategy and use of different levers to meet the NPS targets. It will assess both our 'Assessment Surface Access Case' (showing our worst-case scenario, without reliance on uncommitted schemes such as Western and Southern Rail) and the 'Expected Surface Access Case' (reflecting our 'expected' scenario, including Western and Southern Rail). It is important that the CAA realises that a worst-case assessment scenario does not represent our expected surface access strategy, which utilises committed and uncommitted schemes to optimise consumer benefit.
62. Our surface access strategy is being developed using robust transport modelling and consumer engagement to identify the right surface access schemes and incentives to change consumer and colleague behaviour in order to meet the NPS targets. The strategy is being built in layers, to ensure it is cost-efficient and identifies only the schemes which are valuable to consumers and have the biggest impact on the NPS targets:
- a. Infrastructure and new services: identifying where we can maximise existing and committed public transport schemes and deliver new infrastructure or services for passengers and colleagues to drive behaviours
  - b. Policies and incentives: transport subsidies and HR policies to encourage behavioural change
  - c. Restraint measures: parking and access management and pricing

63. The strategy needs to be viewed holistically, as different combinations of infrastructure intervention, policies and restraint measures will impact behaviours differently and, consequently, have a different impact on our ability to meet our NPS targets.

## **6. Consumer benefit of Heathrow Expansion**

64. Heathrow is fully committed to working towards meeting the Secretary of State's challenges. Expanding Heathrow at close to 2016 charges in real terms, with a new runway taking flights from 2026 and "spades in the ground" by 2022. But these challenges must not be underestimated. They would represent global benchmarks and outstanding outcomes.

65. Heathrow has consistently argued that it is important to establish early in the expansion process the real wins for consumers. This is why Heathrow has been calling on the CAA to quantify the consumer benefit of expansion.

66. Heathrow believes that quantifying the consumer benefits of expansion is a crucial policy tool for the CAA. It is fully compatible with long-established policy principles of incentivising efficient delivery of investment or efficient operation of the airport.

67. The FTI report provided alongside the CAA's October document is a positive step to quantifying the benefit of expansion for consumers. The CAA now needs to continue with this work and come to a clear policy position on the consumer benefit of expansion and how this should be used to facilitate important decisions around the right balance of investment, such as:

- a. Decisions on pre-DCO category C that impact the timing of delivery of new capacity by potentially years and thus represent material consumer benefit; and
- b. Decisions on the speed of release of capacity and slots that affect airline choice and service from Heathrow and thus also have huge implications for consumer benefit.

68. Absent this clear policy direction based on quantified value, the CAA will be unable to test for the ultimate benefit of expansion i.e., more competitive airfares and greater choices for consumers. It is only in this context that the CAA can make regulatory decisions that are in the interest of consumers and in line with its primary duty.

69. We welcome the findings of this report, recognising that scarcity rents exist at Heathrow. FTI recognises the important contribution made by Frontier Economics in estimating scarcity rents at Heathrow, noting the validity of their econometric analysis. However, FTI points out some potential shortcomings in Frontier's analysis and makes a number of recommendations on further work to be carried out in order to improve the accuracy of the analysis.

70. In line with FTI's recommendations, we have asked Frontier Economics to carry out additional analysis, intended to provide:

- a. More definitive evidence that the fare premium at Heathrow is a consequence of lack of capacity;
- b. More robust estimates of the value of the premium, based on a wider sample of evidence; and

- c. Projected future values of the congestion premium up to and beyond the opening of a new runway.

71. Airlines' views expressed on this topic are neither consistent with economic theory nor reflect the reality experienced by consumers. This is clear from the work carried out by FTI and its commentary on the response to the Frontier report provided by IAG. FTI points out critical inconsistencies in IAG's rationale which simultaneously argue that:

- a. Scarcity rents do not exist because they are competed away by airlines' ability to switch their slots to serving more profitable routes; and
- b. Scarcity rents accrue to Heathrow rather than to airlines because of its higher market value compared to IAG.

72. FTI dismisses both arguments asserting that IAG hasn't provided any strong evidence on the absence of a congestion premium at Heathrow.

73. We call on the CAA to base development of the regulatory framework for Expansion on sound economic principles supported by thorough analysis. The FTI report acknowledges the existence of scarcity rents and provides the basis for further work in this area to formally establish the consumer benefits of expansion in a more meaningful way.

## 7. Appendix A: Review of the CAA's rationale for an economy & efficiency licence condition

### Summary

1. The CAA proposes to introduce a new licence condition that would require Heathrow Airport Limited ('Heathrow') to "*conduct its business in an economical and efficient manner so as to secure the (i) operation and maintenance and (ii) timely enhancement and development of Heathrow airport*" (the 'Proposed Licence Condition'). This appendix outlines why the Proposed Licence Condition is misconceived and should not be brought into effect.
2. First, the Proposed Licence Condition is wholly unjustified. The CAA claims it would provide the CAA with a more "flexible" means to investigate Heathrow's behaviour in "real time". However, the CAA fails to explain why the current system of economic regulation does not provide sufficient tools to guarantee the economic and efficient development of Heathrow Airport. In fact, the existing regulatory regime – including the quinquennial price controls, existing licence conditions and statutory provisions allowing for timely intervention by the CAA where required – is entirely fit for purpose. The CAA has failed to articulate a convincing justification for introducing such a fundamental and detrimental change to Heathrow's licence.
3. Second, the CAA can only impose new licence conditions in accordance with its statutory powers. In imposing an unjustified and unnecessary burden on Heathrow, in a manner which is lacking transparency, unaccountable and disproportionate, the CAA is acting in breach of both its statutory duties and the principles of Better Regulation.
4. Third, the Proposed Licence Condition would unnecessarily undermine investor confidence at a critical time for the development of Heathrow Airport. This would jeopardise Heathrow's ability to finance its operations, in further breach of the CAA's statutory duties.
5. The CAA should therefore abandon its proposal to introduce the Proposed Licence Condition and instead focus on working with Heathrow within the existing regulatory framework.

### Existing regulatory framework

6. Under the CAA12, the CAA has a primary statutory duty to "*further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services*" (section 1(1), CAA12). In doing so, the CAA must have regard to its secondary duties, including that regulatory activities are carried out in a way which is transparent, accountable, proportionate and consistent, and targeted only at cases where action is needed (sections 1(3) and (4), CAA12) and the need for each holder of a licence to be able to finance its provision of airport operation services in the area for which the licence is granted (section 1(3), CAA12).
7. Importantly, the CAA is also under a duty, by virtue of section 73(2A) of the Regulatory Enforcement and Sanctions Act 2008, not to impose or maintain unnecessary burdens while performing its duties (section 104, CAA12).

### Price controls

8. The CAA conducts quinquennial price control reviews. For Heathrow, the current control period (referred to as Q6) started on 1 April 2014 and was originally scheduled to run until 31 December 2018. Following the UK Government's 2016 decision to support Heathrow expansion, the CAA extended the current Q6 regulatory period by one year, until 31 December 2019. In addition, to ensure that the price control period remains aligned with the process of expansion, the CAA has since decided to further extend the Q6 period by two additional years, until 31 December 2021 (and potentially until 31 December 2022) (the

Interim Period).<sup>10</sup> The CAA is currently consulting on the licence to be used for this Interim Period. The CAA has suggested that the Proposed Licence Condition could be introduced at the start of the Interim Period, i.e. from the beginning of 2020.<sup>11</sup>

9. For Heathrow and the CAA, price controls are part of a regulated system that stands as a proxy for full market competition. The CAA is under a duty to ensure that Heathrow provides airport operation services economically and efficiently.<sup>12</sup> To date, the price control incentives have proved to be an effective mechanism to ensure Heathrow's performance.<sup>13</sup> The CAA has not provided a single example or piece of evidence to illustrate otherwise.

### There is no justification for the imposition of the Proposed Licence Condition

10. The CAA has not clearly articulated its concerns with the current regulatory regime. It is therefore unclear what it is seeking to achieve through the Proposed Licence Condition. The CAA merely asserts that in order to satisfy its objectives it needs to design "*incentives covering the whole of HAL's activities*".<sup>14</sup> This is clearly insufficient.
11. To the extent that the CAA has specific concerns, these must be identified and evidenced. The CAA must then assess whether it has sufficient tools under the existing regulatory framework to address these concerns. It is not permissible for the CAA to introduce a vague and far-reaching general licence condition to address a vague and unspecified concern. In particular, this breaches the CAA's duty to uphold the principle that "*regulatory activities should be targeted only at cases in which action is needed*."<sup>15</sup>

### The current regulatory framework already confers adequate powers on the CAA to ensure economy and efficiency

12. The CAA makes the unsubstantiated claim that the approach of setting price control incentives for Heathrow that it has adopted up to now cannot ensure that Heathrow is incentivised to behave in an economical and efficient manner in relation to all aspects of its business.<sup>16</sup> In particular, it states that designing such incentives would require "*a level of detailed information being provided to the CAA, and a degree of foresight by the CAA, which are not realistic in the development of any price control*".<sup>17</sup>
13. The CAA has not provided any evidence for these assertions. Nor has the CAA demonstrated that in the past it lacked effective powers to ensure efficiency by Heathrow or that Heathrow has lacked commercial and regulatory incentives to act in the consumers' interest. In fact, there is no deficiency in the current regulatory regime. The existing price control mechanism

<sup>10</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, para 14-15. HAL is due to submit its business plan for H7 in Q4 2019.

<sup>11</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, para 18.

<sup>12</sup> CAA12, section 1(3)(c).

<sup>13</sup> HAL, Response to CAP 1658, July 2018, para 68-71.

<sup>14</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 8.

<sup>15</sup> CAA12, sections 1(3)(g) and 1(4)(b).

<sup>16</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 8.

<sup>17</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 9.

and the CAA's powers to enforce licence conditions under the CAA12 are extensive and ensure that Heathrow operates in an economical and efficient manner.

- a. First, when the new system of regulation under CAA12 came into force in 2014, the CAA itself highlighted the flexibility and breadth of its powers stating that the "*new powers also mean we can be much more flexible – under the old system, if something went wrong and passengers lost out, we would have to wait until the end of the price cap period to make any change, potentially five years. The new licence regime will give us the power to make much more rapid changes to licence conditions, to stop passengers suffering*". Accordingly, as the CAA has itself stated, the statutory regime is designed to allow for timely intervention if necessary.
- b. Second, the CAA has more than adequate existing powers to monitor capex expenditure and incentivise efficiency. For example:
  - i. Specifying upfront capital expenditure triggers and financial incentives related to Heathrow meeting certain delivery milestones on time.<sup>18</sup>
  - ii. As stated by the CAA at the time Heathrow's licence was granted, "*to ensure that the Q6 capital programme is delivered efficiently*"<sup>19</sup> the CAA introduced a split between early-stage, or 'development' capex, and 'core' capex, which is incurred once the project has been designed and approved by the airlines and HAL's management. This mechanism allows Heathrow and the airlines flexibility over the capex programme, while ensuring that Heathrow does not recover revenue for projects that it does not undertake.
  - iii. The Independent Fund Surveyor (IFS) – an industry expert jointly appointed by Heathrow and the airlines with a duty of care to the CAA – established in 2013 to scrutinise all major decisions made on key projects and to give a real-time opinion that capital is being used effectively to deliver the outcomes of the project's business case.<sup>20</sup>
  - iv. More recent provisions relating to the recovery of Category B (planning) and Category C (construction) costs to incentivise an efficient and focused Development Consent Order and efficient delivery of expansion. In addition, the CAA introduced the role of an Independent Planning Costs Reviewer (in addition to the role of the IFS) to ensure that costs are efficient.<sup>21</sup>
- c. Third, the current form of RPI-X price cap regulation for HAL is underpinned by quality of service regulation and a RAB. As the CAA notes, "*[t]he RAB is well understood by stakeholders and debt providers and has a long track record of successful use in UK*

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<sup>18</sup> CAA, CAP 1510, *Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable*, January 2017, para 4.20.

<sup>19</sup> CAA, CAP 1103, *Economic regulation at Heathrow from April 2014: final proposals*, October 2013, para 12.

<sup>20</sup> CAA, CAP 1151, *Economic regulation at Heathrow from April 2014: Notice granting the licence*, February 2014, para D38.

<sup>21</sup> CAA, CAP 1658, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, April 2018, para 6.18; CAA12, section 22.

*airport regulation*".<sup>22</sup> Given the success of the RAB in airport regulation, the CAA should be cautious about undermining this model.

- d. Fourth, there are already adequate and more targeted provisions within Heathrow's licence to ensure efficiency. For instance:
  - i. The latest version of the licence contains a condition that Heathrow shall, so far as is reasonably practicable, secure the procurement of capital projects in an efficient and economical manner.<sup>23</sup> By 1 February each year, Heathrow is also required to publish a report identifying instances where significant capital investment work has not been procured in line with the Procurement Code of Practice.
  - ii. Heathrow's licence also contains a condition to ensure its operational resilience to further the interests of users of air transport services in accordance with best practice and in a timely, efficient and economical manner.<sup>24</sup>

No evidence is provided by the CAA which suggests that these provisions are inadequate or that the CAA has been unable, in practice, to apply them effectively.

- e. Fifth, as stated in the National Policy Statement (NPS), in relation to the examination and determination of an application for development consent, the CAA is also a statutory consultee and will advise the Examining Authority in considering whether any impediments to the applicant's development proposals, including cost-efficiency and sustainability.<sup>25</sup>

14. In addition to the forward-looking mechanisms in the price control, the CAA also currently has ex-post review powers which it can use as part of the price control. The CAA claims that ex post reviews are "*most suitable for protecting the interests of consumers by disallowing inefficient costs rather than dealing with broader issues*".<sup>26</sup> However, the CAA fails to specify which "broader issues" it is aiming to address through the use of its Proposed Licence Condition. The CAA also states that ex-post reviews would not provide timely protection to consumers as the CAA would have to wait until the next price control review. However:

- a. The CAA themselves acknowledged in an earlier consultation that ex-post reviews "*provide an incentive on HAL to deliver efficiently given the knowledge that it faces a financial consequence of not having certain expenditure remunerated in the RAB if it is found to be inefficient*".<sup>27</sup>
- b. In the upcoming period, the CAA has an Interim Period starting at the beginning of 2020 and the beginning of the subsequent price control period starting soon thereafter

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<sup>22</sup> CAA, CAP 1510, *Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable*, January 2017, para 5.14.

<sup>23</sup> Heathrow licence, Condition C3.

<sup>24</sup> Heathrow licence, Condition D2.

<sup>25</sup> Department for Transport, *Airports National Policy Statement: new runway capacity and infrastructure at airports in the South East of England*, June 2018, para 4.39-4.40.

<sup>26</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 10.

<sup>27</sup> CAA, CAP 1510, *Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable*, January 2017, para 4.23.

(either until the start of 2022 or 2023). Therefore, in the coming years there will be a timely opportunity for the CAA to make price control decisions without a significant time lag.

- c. The CAA also has the ability under its powers in CAA12 to reopen or terminate early a price control under its licence modification powers and has indeed used these powers already to e.g. extend the length of the Q6 price control.<sup>28</sup>

15. In any event, the introduction of the Proposed Licence Condition would not provide the CAA with any more certainty over Heathrow's capex expenditure than the current regulatory framework. On the contrary, the condition would create considerable regulatory uncertainty and Heathrow would not be aware of whether or not it is acting in compliance with the condition. The Proposed Licence Condition is therefore not in line with the CAA's statutory duties and breaches the statutory requirement to avoid imposing unnecessary burdens.

### Breach of Principles of Better Regulation

16. The CAA argues that the introduction of the Proposed Licence Condition would be in line with the better regulation principles.<sup>29</sup> In supporting its position, the CAA has overly relied on justifications relating to the process of making this Proposed Licence Modification rather than the consequences. For example, when explaining that the condition is transparent and accountable, the CAA claims the consultation process and appeal mechanism under CAA12 indicate that these principles are satisfied.<sup>30</sup> However these procedural requirements should be a given. The key issue is whether the outcome of the Proposed Licence Condition would meet the principles of better regulation. On the substance, the CAA's proposal does not satisfy any limb of the five principles of better regulation.

### The Proposed Licence Condition is not necessary

17. As explained above, the CAA already has far reaching powers under CAA12 and a licence condition should only be used as a last resort. A more flexible, proportionate intervention is possible by using the CAA's existing powers. The CAA's focus should be on creating a balanced package of price control incentives for the next price control rather than in creating an all-encompassing power with no specific desired outcomes.

18. The CAA also presents contradictory justifications for its proposal. The CAA stated that it wants to achieve oversight "*with or without expansion*".<sup>31</sup> This position is inconsistent with its claim that the expansion plans have led to a change in circumstances since the licence was granted in 2014 and that the licence condition is therefore "*necessary and proportionate*" to address these issues.<sup>32</sup> This inconsistency adds to the lack of clarity as to why this far-reaching condition is considered necessary, particularly at the early stages of Heathrow's capacity expansion.

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<sup>28</sup> CAA12, section 22.

<sup>29</sup> See discussion of the five principles in CAA, CAP 1722, October 2018, Appendix B, para 18-27.

<sup>30</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 21.

<sup>31</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, para 2.14.

<sup>32</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 13-14.

19. When the (then) Secretary of State for Transport, Justine Greening, introduced the CAA12 Bill to Parliament, she said that the result would be that “*future regulatory intervention will be directed only at areas in which it is strictly necessary*”.<sup>33</sup> It was clear that they did not intend for the CAA to introduce unnecessary regulatory intervention. Accordingly, good regulatory practice and ongoing government policy require that only necessary changes or interventions are made. Since the CAA has not explained why the proposed change is necessary, the test is not met by the Proposed Licence Condition.

### **The Proposed Licence Condition is disproportionate**

20. As explained above, no legitimate reasons have been given by the CAA to introduce the Proposed Licence Condition. In any case, the proposals are entirely disproportionate to any conceivable risk. Remedies should be appropriate to the risk posed, with costs identified and minimised.<sup>34</sup>

- a. **The Proposed Licence Condition is neither suitable nor appropriate.** The CAA claims that the Proposed Licence Condition is needed to set expectations.<sup>35</sup> However, the 2014 licence and price control already established expectations as to the manner in which Heathrow carries out its business as can be seen by Heathrow’s track record thus far. The CAA seeks to justify changes on the basis that other regulated sectors have overarching obligations. The mere fact that other regulated sectors may have such obligations does not explain why the CAA requires the introduction of the Proposed Licence Condition or how it would be in line with the CAA’s statutory duties.
- b. **The objective could be achieved by a less onerous and proportionate method.** The CAA has not shown why the existing regulatory tools are not appropriate to regulate the conduct of Heathrow in a proportionate manner. No examples are given as to when the CAA in the past has become aware of certain matters relating to Heathrow’s conduct and was not able to take timely action. Absent such a risk it is not necessary to introduce the Proposed Licence Condition.
- c. **The Proposed Licence Condition’s burden is disproportionate to its benefits.** The CAA claims that it should not be unduly onerous for Heathrow to comply with the condition. On the contrary, the introduction of a vague and all-encompassing licence condition on Heathrow creates a burden which is disproportionate to any theoretical benefits currently evidenced. With regard to the benefits, it also remains unclear which particular benefits the CAA hopes to achieve with the Proposed Licence Condition particularly since there are no signs that Heathrow will not continue to perform as efficiently and economically as it has in the past. Therefore, the burden imposed far outweighs the unsubstantiated benefits of the Proposed Licence Condition.

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<sup>33</sup> House of Commons, Oral Answers to Questions, Column 566, 30 January 2012, available via <https://publications.parliament.uk/pa/cm201212/cmhansrd/cm120130/debtext/120130-0001.htm#12013011000001>.

<sup>34</sup> House of Commons, Select Committee on Transport, Thirteenth Report, *Performance of the CAA*, para 80, available via <https://publications.parliament.uk/pa/cm200506/cmselect/cmtran/809/80906.htm>.

<sup>35</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 11: “we consider that it is necessary for the CAA to consider the use of a licence condition which sets overall expectations for the way HAL conducts its business.”

21. For these reasons, the Proposed Licence Condition is a disproportionate measure to impose upon Heathrow.

#### The Proposed Licence Condition is not accountable

22. Since the scope and meaning of the Proposed Licence Condition is vague and unclear, it will be difficult for Heathrow to understand whether it is in compliance with the condition at any particular point in time. This is particularly important since the CAA has powers under CAA12 to impose penalties for breach of a licence condition.<sup>36</sup> This lack of transparency would create unnecessary levels of regulatory uncertainty and breach Heathrow's rights of defence.
23. The CAA now suggests it will publish a non-exhaustive list of "focus areas". This list is also extremely broad.<sup>37</sup> In any event, the proposed clarification suggests the provision will still state that "[c]ompliance with these requirements shall be **without prejudice to the general nature of the obligation** set out in condition [ ], and compliance with these requirements shall not, be sufficient to exhaust the licensee's duty under that condition". This caveat exacerbates, rather than improves, the vagueness of the proposed obligations and therefore undermines any clarification provided.

#### The Proposed Licence Condition is not targeted

24. Regulation should be focused on tackling targeted matters.<sup>38</sup> However, the objective that the Proposed Licence Condition is intended to deal with is not clear. The requirement that Heathrow acts in an "economical and efficient manner" is not defined and there is no materiality threshold so the provision could be used in a wide variety of circumstances.
25. The CAA states that it wants to achieve "*direct regulatory oversight over broad aspects of HAL's conduct with or without expansion and [provide] a basis for intervention if unforeseen conduct by HAL causes detriment to consumer*".<sup>39</sup> These powers are clearly excessive and aimed at preventing unspecified conduct by Heathrow for which there is no evidence that Heathrow has undertaken in the past or reason why Heathrow is likely to engage in 'unforeseen conduct' in the future. This means that Heathrow is both unaware of the conduct it should seek to avoid and how it is able to satisfy compliance with the Proposed Licence Condition.

<sup>36</sup> CAA12, section 31 and 39.

<sup>37</sup> CAA, CAP 1722, p. 30, footnote 24: "For example, the condition could read as follows: '*In complying with its duty under condition [ ], the licensee shall (a) plan any application for development consent it makes under the Planning Act 2008 with due regard for the requirements of the Airports National Policy Statement; (b) design any new capacity to be economical and efficient in relation to both the cost of delivery and the ongoing costs for the licensee and its customers of operating and using that new capacity; and (c) engage with airlines and other stakeholders to deliver their needs, including providing timely and accurate information. Compliance with these requirements shall be without prejudice to the general nature of the obligation set out in condition [ ], and compliance with these requirements shall not, be sufficient to exhaust the licensee's general duty under that condition.*'"

<sup>38</sup> Better Regulation Task Force, *Principles of Good Regulation*, available via <https://webarchive.nationalarchives.gov.uk/20100407173247/http://archive.cabinetoffice.gov.uk/brc/upload/assets/www.brc.gov.uk/principlesleaflet.pdf>.

<sup>39</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, para 2.14.

26. Furthermore, the CAA states that the condition “*should evolve over time*” and be amended “*in the light of HAL’s anticipated activities*” and “*other developments*”.<sup>40</sup> The CAA states that this ensures that the condition will be targeted but, in fact, the effect of such an unclear and ill-defined obligation would be the opposite. Not only is it not clear how it will be used in the present, but it is also uncertain how it will be used in the future – thereby creating an ongoing environment of regulatory uncertainty.

### **The Proposed Licence Condition is not consistent**

27. The CAA compares the Proposed Licence Condition to a number of examples in other regulated industries. However, the obligations that are suitable for e.g. the licences of Network Rail and National Grid or in gas, electricity and water legislation are not necessarily appropriate for the economic regulation of airports.

28. These industries have very different characteristics from the airports industry and it would not be appropriate or effective to transplant the regulatory framework from one industry to another. The airports regulatory regime needs to be tailored to the specific conditions of the airports industry.

29. The CAA commissioned a First Economics study to compare regulatory practice in other regulated industries in the UK. The report flagged that “*what was right for one sector need not necessarily be right for airports*”.<sup>41</sup> In particular, First Economics differentiated airports from energy and water in particular for the following reasons:

- a. the energy networks and water and sewerage networks are, for the most part, natural monopolies, whereas the scope for competition between airports impacts on the regulation of both Heathrow and Gatwick airports (to different degrees);
- b. the CAA has previously had success with processes of ‘constructive engagement’ and commercial negotiation between airports and airlines that have no parallel in energy and water. Indeed, there are numerous examples of Heathrow responding to constructive engagement with airlines, for example, the smooth operation of the core development in Q6; successful resolution of resilience issues such as winter resilience in 2011; the 2017 PRM review and Heathrow’s recent acceptance of a very demanding stretch target on ORC baggage charges is clear evidence of this working.
- c. the task of maintaining and upgrading network assets can be quite different from the challenges that an airport faces for new investments such as runways. Possibly as a consequence, as far as First Economics could identify there has not to date been the ‘capex bias’ at airports that commentators perceived in the energy and water sectors.<sup>42</sup>

30. The CAA would therefore first have to demonstrate why a particular characteristic of another regulated sector is considered to be equivalent to airports. It has not done so.

31. Indeed, CAA12 is a quite recent piece of primary legislation. Parliament, when drafting CAA12, had the examples cited by the CAA available to it but did not include a statutory duty

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<sup>40</sup> CAA, CAP 1722, *Economic regulation of capacity expansion at Heathrow: policy update and consultation*, October 2018, Appendix B, para 25.

<sup>41</sup> First Economics, *A review of recent UK price review innovations: a report prepared for the CAA*, September 2015, para 4: see [link](#).

<sup>42</sup> First Economics, *A review of recent UK price review innovations: a report prepared for the CAA*, September 2015, para 3.2.

on airport operators to develop an efficient and economical business model. Accordingly, since Parliament did include such a duty on licence holders in the legislation for the water, gas transportation and electricity distribution and transmission industries, it must be taken to have consciously decided not to do so for airports.<sup>43</sup> The CAA should not step outside its proper role by introducing duties that Parliament did not envisage.

### The Proposed Licence Condition would undermine investor confidence

32. The regulatory uncertainty created by the Proposed Licence Condition poses a fundamental threat to investor confidence and therefore to Heathrow's financeability. This is especially true of any proposals which are specific to what activities Heathrow should carry out rather than how it might go about them. Any implication of a compulsion to invest simply unsupported in a privately financed regulatory model. Without sustainable investment, the development of Heathrow Airport will be in jeopardy.
33. This is also a clear breach of the CAA's duty to have regard to "*the need to secure that [HAL] is able to finance its provision of airport operation services [...]*".<sup>44</sup> The imposition of an onerous and unjustified delivery obligation would raise concerns for both debt and equity holders. Furthermore, it could ultimately end up frustrating the CAA's primary duty to "*further the interests of users of air transport services.*" The CAA itself states: "*In assessing users' interests, the CAA must balance the interests of present users in lower airport charges with the interests of future users in HAL's ability to continue to be able to invest in modern infrastructure and services in a timely manner*".<sup>45</sup>
34. A clear and transparent regulatory framework is necessary to attract further investment. Especially at this important time of expansion for Heathrow, investment is needed to ensure that the supply of Heathrow's services remains fit for purpose and policy objectives are met.

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<sup>43</sup> See Water Industry Act 1991, section 37; Gas Act 1986, section 9; Electricity Act 1989, section 9.

<sup>44</sup> CAA12, section 1(3)(a).

<sup>45</sup> CAA, CAP 1151, *Economic regulation at Heathrow from April 2014: Notice granting the licence*, February 2014, para 1.23.

## 8. Appendix B: Heathrow mark-up of CAA draft surface access policy

1. The role of the CAA and therefore this policy, is not to determine whether HAL's surface access strategy will comply with targets set out in any NPS.
2. This policy sets out the criteria against which the CAA would expect HAL to bring forward evidence in support of any proposal to allow surface access costs associated with capacity expansion or to enhance the efficient operation of the airport to be funded from airport charges.
3. Criteria (a) and (b) define the total surface access costs that should be considered for funding (or part funding) from airport charges. Criterion (c) apportions costs between direct charges to users of surface access and the residual costs to be borne more widely (including by Government) and by airport users<sup>46</sup> in general through airport charges. Criterion (d) apportions this residual between the airport charges and other funding providers (including Government and other beneficiaries and their representative bodies).
4. The criteria are:

**(a) Overall cost benefit:** airport operators should be able to demonstrate that surface access projects, (considered individually, or as part of a long-term surface access strategy, and jointly with any airport development that they enable) would be likely to deliver benefits in excess of costs from the point of view of airport users over time. In this assessment, the relevant costs may include the costs of measures required to meet the reasonable needs of consumers in regard to surface access and:

- support the obtaining of planning permission
- enhance the efficient operation of the airport
- meet relevant government transport policy
- bring the investments forward to enable them to meet the timescales for the anticipated increase in demand for surface access brought about by expansion of the airport, and
- not preclude the provision of potential future surface access schemes required for the above reasons
- take into account journeys made by airport staff; made in relation to cargo operations; and made in relation to providers of airport operation services at the airport.

**(b) Cost efficiency minimisation:** the airport operator ~~can~~ should demonstrate that there is a need for the surface access investment, based on the efficient operation of the airport and/or the likely requirements to support the obtaining of planning permission ~~secure planning approval~~ for airport expansion, and that the surface access strategy and individual projects as a whole are not over specified or costed and provide the right outcomes for consumers in regard to service levels. The costs of airport access projects should be measured against a base case which includes planned future upgrades by Government to road and rail infrastructure which would be made ~~absent any further airport growth~~ assuming that the surface access demand arising from the airport is at a level which arises from its current capability. These costs may include the costs of allowing for ~~compensating~~ – or otherwise accommodating on capacity elsewhere – existing non-airport traffic which would be displaced by additional airport demand; ~~a new airport surface access links;~~

<sup>46</sup> Users is defined as per the definition in the Civil Aviation Act 2012 meaning present and future passengers and those with a right in property carried by the service (i.e. cargo owners)

**(c) Direct users' contributions attribution /user pays principle:** the airport operator should take reasonable steps to ensure that the direct users of surface access facilities defray the costs to be recovered through airport charges to the maximum extent practicable, through the application of direct charges for the use of such surface access, subject to the decisions of the expert sector regulator. Direct charges from one mode of surface access ~~should~~ may be used to offset the costs of another where this would support measures to encourage modal shift from car to public transport which may be required for the efficient operation of the airport and /or to support the obtaining of planning permission ~~secure planning consent~~ for to airport expansion; and

**(d) Users' reasonable interests:** the proportion of net surface access costs borne by the airport operator (after direct users have contributed through direct ~~road or rail~~ charges) should be based on the relative benefits derived by airport users versus non-airport users of the surface access projects required to support airport ~~expansion~~ growth (with airport users not cross-subsidising other users but funding at least the incremental costs of infrastructure that has the sole purpose of connecting the airport to the wider transport network). The relevant costs are compared to the base case of surface access investments which would be supplied by Government ~~in the absence of airport expansion~~ assuming that the surface access demand arising from the airport is at a level which arises from its current capability.

5. Consistent with the above approach, ~~efficiently incurred~~ capital elements of the airport operator's ~~residual efficient~~ costs would be added to the Regulatory Asset Base (RAB) and, similarly, any ongoing operating cost and revenues from the surface access projects would be taken into account in the single till calculations used to set the airport operators price control. ~~added to the airport operator's operating expenditure in subsequent price controls.~~
6. The airport operator should demonstrate that its strategy and individual projects comply with these criteria through the use of quantitative techniques including:
  - *Overall cost benefit criterion:* evidence should be based on the same economic appraisal methodology as used by public transport agencies in assessing road and rail investments;
  - *Cost minimisation:* as with other capital expenditure costs associated with airport development, we would expect to scrutinise (with assistance from technical consultants) the scale and costs of surface access projects with the aim of encouraging efficient levels of investment. In addition, where the airport operator is co-funding a surface access project with other transport agencies, we would expect relevant comparator data from other projects funded by other transport agencies to be used to demonstrate the cost efficiency of the airport surface access project;
  - *Direct users' ~~contribution cost~~ attribution:* we would expect airport operators to demonstrate that they had assessed a full range of technically feasible options for placing as much of the surface access costs as possible on the direct users of these transport facilities, taking into account the regulatory regimes and decisions of the expert sector regulator. Evidence on users' responsiveness to charging on surface access, and the impact on overall demand for journeys to and from the airport across all transport modes, should inform the proposals for direct users' cost attribution. Where encouraging modal shift towards public transport is likely to be a planning requirement on the airport operator, evidence on the scope for generating surpluses from road schemes to co-fund public transport services should be presented;
  - *Additional benefits enjoyed by users:* evidence should be based on the relative net present value of benefits to:

- i. airport users who are also direct users of the new surface access infrastructure; and
- ii. “background” non-airport users of the new surface access
- iii. Other bodies benefitting from the wider economic benefits of the services

Benefits would be measured according to standard transport appraisal methodology in terms of generalised cost savings in surface travel (net of any direct charges for fares/tolls) or through calculation of the wider economic benefits of schemes. ~~Calculations of wider benefits to the economy more broadly are likely to be more tentative but may influence the approach taken by Government and airport operators in negotiating relative shares of surface access costs.~~

- We would also expect airport operators to demonstrate that they had actively sought the views of consumers to understand their surface access requirements, both in terms of provision of infrastructure and service levels. ~~airlines’ and other users’ views on surface access options and costs. Airport operators should also engage with airlines and other stakeholders on surface access projects and costs.~~ Where consensus had been reached between airport operators and airlines through such engagement, we would expect to attach significant weight to this evidence in reaching our own view on the inclusion of the proposed surface access costs within the RAB. It would not, however, be appropriate for airlines to have a veto over surface access projects being allowed into regulatory consideration for purposes of setting the price cap, because the interest of passenger as a distinct group are likely to be underrepresented by airlines on their own, and the beneficiaries of growth will include airlines not currently serving the airport.