

Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements CAP1769 Heathrow's response

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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^[1] in benefit for consumers through lower fares and new flights driven by increased competition and choice from airlines operating from an expanded Heathrow.
2. The first and potentially the most complex steps to expanding Heathrow in a timely, financeable and affordable manner are already underway, and will develop throughout the iH7 period.
3. The preceding regulatory period, Q6 has seen record levels of passenger volumes and passenger satisfaction at Heathrow, unprecedented progress on Heathrow Expansion, and healthy financial results for both airlines and Heathrow. It is in this context that the airline community and Heathrow have come together to sign a commercial deal for the iH7 period that furthers the interest of consumers.
4. The iH7 commercial deal demonstrates that Heathrow and the airline community can work together for the greater good of our industry and consumers. It is also a testament to the flexibility that the current regulatory framework provides for stakeholders to find innovative ways of doing business. This deal will:
 - a. Enable Heathrow and the airline community to continue to together focus on developing an expansion programme that is affordable and financeable, minimising the diversion of resources to long and complex regulatory decisions.
 - b. More than ever align airport and airlines incentives to maximise load factors and passenger volumes at Heathrow. This is of significant value as it generates the same dynamics at Heathrow as at other non-regulated airports, providing the basis for an affordable and financeable expansion programme.
 - c. The deal is also a significant step to potentially achieving a longer commercial deal for the H7 period.
5. This deal also demonstrates Heathrow's ambition, as outlined in its discussions and responses to the CAA, of working towards a more commercial environment, moving away from the potential constraints and at times unintended consequences that the regulatory framework may generate. It also aligns with the CAA's support for Heathrow and the airline community to engage in commercial discussions. The CAA therefore should take comfort from the outcome achieved by industry, and the number of Heathrow airlines that have already signed this commercial agreement.
6. Heathrow is supportive of the CAA's minded to decision and considers that this deal is the best possible result for industry, and particularly for consumers for the iH7 period. The CAA should therefore, in the interest of consumers, now formalise the deal through changes to Heathrow's licence, avoiding any disruption to the normal operation of the airport, the expansion programme or the deal itself. Heathrow extends an offer to engage with the CAA to work through the required changes to Heathrow's licence.

^[1] NPV of economic benefit in NPV terms 2014p, 60 years – DfT, Updated Appraisal Report Airport Capacity in the South East, October

Assessment of the commercial arrangement

7. Heathrow has consistently argued that investigating a commercial deal is in the interest of consumers. We have acted accordingly, and working alongside our airline customers, have signed a commercial deal that aims to further the interest of consumers and meet the commercial requirements of the airlines and Heathrow.
8. Heathrow therefore welcomes the CAA's minded to decision to support the commercial deal. Heathrow supports the CAA's proposal to reflect the deal within Heathrow's licence.
9. The context in which this commercial deal has been negotiated and subsequently signed provides even more relevance as:
 - a. The deal has been signed in the context of the Q6 price control period, a period in which Heathrow's airport charges have reduced for six consecutive years, passenger volumes and service quality scores are at record levels and Heathrow has made meaningful progress in delivering an expanded airport. The price and service conditions are reflected in the commercial agreement. In addition, significant cash rebates have been offered to airlines in return for determined passenger volumes.
 - b. The deal has been signed amid starting the process to deliver Heathrow Expansion. A deal of this nature provides the perfect first step for pursuing a further commercial agreement for developing expansion under commercial terms.
10. With this context in mind, Heathrow recognises the benefits that the commercial deal provides for consumers as described by the CAA, and outlines additional benefits below:
 - a. The deal provides full alignment between Heathrow's and airline commercial incentives to increase passenger volumes and to optimise aircraft utilisation before new air transport movement capacity is possible at Heathrow. This enables Heathrow and airlines to work together to make the best use of existing facilities by improving processes and infrastructure.
 - b. By potentially unlocking terminal capacity in the near term, the deal will help increase passenger numbers ahead of the delivery of an expanded Heathrow, supporting Heathrow to deliver an expansion programme that is affordable for consumers and airlines, and financeable for investors.
 - c. The deal enables Heathrow, the airline community and the CAA to focus on the most pressing issues regarding capacity expansion. Optimising the resources allocated to regulatory related issues, the deal enables progressing the expansion programme at the desired speed. The deal enables regulatory decision making to be proportionate and targeted.
 - d. By bringing forward rebates in comparison to the iH7 regulatory process (as the alternative), airlines will have greater flexibility in how to invest those amounts allowing airlines to offer a greater choice of fares, services and destinations.
 - e. By providing earlier stability and predictability of revenue generation for Heathrow the deal will support efficient and cost-effective financing of the day-to-day business and for early investment in expanding terminal capacity.

- f. By ensuring that all airlines operating at Heathrow can access identical terms and incentives, the deal supports a fair and competitive basis for commercial competition at Heathrow, to the benefit of consumers.
 - g. The deal demonstrates the value and flexibility of the current regulatory framework, in which alternative commercial arrangements can co-exist, providing the safety of the regulatory backstop in the interest of consumers, airlines and investors.
11. Regarding Service Quality provision, Heathrow agrees with the CAA that the iH7 period provides a good opportunity to start measuring potential elements of the service proposition under an Outcome Based Regulation (OBR) framework. Nevertheless, in order to implement the OBR framework, Heathrow has designed an incremental process grounded in consumer and airline engagement. This process will gradually define the outcomes, targets, measures and incentives for the H7 framework. It is therefore important that in intending to shadow track any potential measures of the future H7 OBR we do not pre-empt the results of the process we embarked on two years ago. Heathrow will discuss with relevant stakeholders, namely the Consumer Challenge Board (CCB) and the airline community, the opportunity to shadow track any potential measures of the H7 framework at the appropriate governance meetings.
12. Heathrow considers that the only relevant counterfactual to assess whether the commercial deal furthers the interest of consumers is Scenario 1 in Table 1.1, a scenario that has been developed by the CAA, not by a third party.
13. Heathrow concurs with the CAA's interpretation of CEPA's analysis, that it can only represent an "initial estimate". We therefore do not intend to pass detailed comments on the initial analysis performed by CEPA. Heathrow also agrees with the CAA that the difference between Scenario 2 in Table 1.1 and the headline price would have reduced significantly since:
- a. Heathrow has not had the time to fully engage with the initial findings provided by CEPA on any of the building blocks.
 - b. CEPA's analysis does not include incremental cost elements for enabling expansion to take place. Therefore, it is not representative of the underlying economics of Heathrow throughout the iH7 period.
 - c. The iH7 period will see the full effect of a very uncertain Brexit outcome. CEPA's analysis takes a view on what the outcome may be but there is no certainty that CEPA's views will be more accurate than for example Heathrow's or the CAA's view regarding the impact of Brexit on passenger volumes or exchange rates.
14. While we do not aim to discuss CEPA's findings in detail, there are a number of statements that need to be addressed as they are a misrepresentation of the process and the nature of the regulatory arrangements Heathrow is subject to. These relate to capital expenditure.
15. CEPA asserts that *"CEPA considers that HAL's approach to capex for the iH7 submission is a significant departure from the current regulatory approach. CEPA states that HAL assumes that the capex plan should evolve over the course of the control period which is not the case for previous price controls"*. This is not correct, or a fair representation of the approach taken by Heathrow for the following reasons.
- a. Heathrow has followed CAA's guidance on the steps to take for the iH7 price control review. The CAA from the very outset did specify that the level of granularity that it

would expect was not the same as it would expect for a “normal” price review. In addition, the CAA did not allow for a period of formal constructive engagement either where significant progress and agreement regarding the Q6 portfolio was achieved between Heathrow and the airlines. CEPA cannot assess Heathrow’s approach/performance relative to other price controls without having due regard to the CAA’s guidance for iH7.

- b. In addition, Heathrow has followed established governance and has been consistent with the Q6+1 process. Heathrow operates a portfolio in which business cases progress throughout the price control. The portfolio has a set of clear objectives that govern it. These were jointly agreed between Heathrow and the airline community. Against the initial costs envelope for different programmes of the portfolio Heathrow develops business cases and seeks airlines agreement to develop them. In addition, there is an established governance framework. In this framework, there is a specific forum, the Future Portfolio Group (FPG) attended by Heathrow and airline representatives, whose full focus is to jointly work on the pipelines of projects for the Q6+1 and iH7 period. In this group therefore, significant engagement has taken place for the business cases outside of the Q6 years.
16. CEPA asserts that *“CEPA suggests that under the current capex governance process HAL might respond to cost pressure in the capex programme by de-scoping certain projects rather than focusing on efficient delivery of the programme. There is also a risk that HAL prioritises projects that are not the highest priority for users (such as those that produce opex savings) over projects that produce greater benefits for airport users”*. Heathrow has consistently rebutted these assertions for the following reasons:
- a. CEPA has simply no basis to suggest this and it is not based on any relevant data or analysis. Heathrow has constant dialogue with airlines through the established governance. The scope of all business cases is clearly defined at G3 and are delivered by Heathrow as agreed with the airline community. Regarding prioritisation of projects, CEPA again has no basis to assert this. Business cases are developed to meet the objectives of the Q6 portfolio plan and airlines have the opportunity to engage in this process from the very beginning. Moreover, the particular example outlined by CEPA demonstrates CEPA’s lack of understanding of the current framework since opex savings are passed on to consumers in subsequent price controls, supporting affordability. It is very concerning that consultants provide opinions without the required supporting evidence.
17. In paragraph C.6 the CAA states that Heathrow suggested that the CAA’s policy on pre-DCO category C costs precludes noise insulation costs to be treated as expansion costs. It is important to note that as submitted to the CAA in the 25th March 2019, *Noise insulation requirements for an expanded Heathrow*¹, we contend that noise insulation is treated as pre-DCO category C as these are costs required to expand the airport. We would like to extend an invitation to the CAA to further discuss this paper.
18. The CAA states that the rebates associated to the iH7 commercial deal should not be considered as part of the revenue requirement for H7. This has always been Heathrow’s position, we therefore agree with the CAA.

¹ CAA-H7-220

19. The CAA also discusses that reprofiling of charges may be required to support financeability or affordability. Heathrow agrees that there are mechanisms that could potentially be useful to meet these objectives. Nevertheless, these mechanisms tend not to affect the NPVs of a potential price control decision. Therefore, if for example the CAA finds in its assessment a problem with financeability, it should first reassess whether its analysis/determination reflects the underlying economics of the investment on expansion. Also, for the avoidance of doubt we would like to highlight that reprofiling should not imply that the iH7 commercial deal rebates are recovered through H7's price allowance.

Changes to Heathrow's Licence

20. We agree with the licence changes outlined by the CAA in Table 2.1, except for extending the licence condition relating to the rates revaluation impact:
 - a. The rationale for this condition was to moderate consumers' and Heathrow's exposure to the impact of the business rates revaluation in Heathrow's allowed revenue requirement. The revaluation took place and the impact on Heathrow's operational expenditure is now known. Therefore, this is not needed.
 - b. In addition, in the context of the agreed commercial deal the underlying economics of the agreements already reflect an assumption of the business rates that Heathrow would pay over 2020 and 2021. Operating this regulatory mechanism is therefore inconsistent with the deal signed by Heathrow and the airline community and would represent an unnecessary regulatory adjustment since the baseline of the business rates (including the impact of the revaluation process) is already factored in the terms of the agreement.
21. Heathrow is also supportive of introducing a new licence condition/s in C1 to reflect the commercial deal for the iH7 period. Heathrow would like to extensively engage with the CAA in this area to ensure that a practical amendment to the licence is found ahead of the CAA formally consulting on the licence condition in July.