

Stephen Gifford
Consumer & Markets Group
Civil Aviation Authority
CAA House, 45-59 Kingsway
London WC2B 6TE

Sent by email to: economicregulation@caa.co.uk

2nd March 2018

Re. Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP 1610)

Introduction

1. This submission is made by International Consolidated Airlines Group SA (IAG) in response to the CAA's consultation of December 2017 on core elements of the regulatory framework to support capacity expansion at Heathrow (CAP 1610). It represents the views of IAG and its subsidiary airlines: British Airways, Iberia Airways, Vueling, Aer Lingus and LEVEL.
2. This submission will set out the key issues regarding capacity expansion at LHR, before going on to address a number of other points arising from CAP 1610.
3. The Heathrow airline community has retained the services of Cambridge Economic Policy Associates (CEPA) to advise on the cost of capital. The joint response to this CAA consultation from the Airline Operator's Committee (AOC) and the IATA London (Heathrow) Airlines Consultative Committee (LACC) includes this CEPA report and IAG asks the CAA to give due consideration to the points raised in relation to CAP 1610.

Executive Summary

4. IAG believes that the key issues the CAA must address in its proposed approach to expansion regulation are:
 - The CAA must introduce a process whereby individual assets can be tracked once they enter the RAB;
 - The CAA has the powers to introduce competition at Heathrow and it should use these powers to do so. If the CAA believes these powers are not adequate to ensure third party competition then the CAA should review its ability to mandate the introduction of competition into Heathrow expansion and ensure it has those powers even if this requires additional short legislation;
 - New regulatory concepts for expansion, such as Ofwat's Thames Tideway model or a hypothecated RAB for new terminals, should be fully considered and developed;
 - Leading on from the preliminary assessment of cost of capital CAA should share further analysis and continue to monitor and have regard to market developments in this area;
 - Early construction costs incurred should not be admitted to the RAB prior to DCO and IAG proposes an alternative to ensure that HAL bears this risk with regard to final DCO determination;

- Airport charges for expansion should be less than or equal to than the level of charges as at the end of the current CAA Q6 settlement period;
- There must be a decrease in the price path for airport charges as part of an updated charges settlement for Q6+2 as shown by the CAA's own modelling¹; and
- H7 should start in 2021 following Q6+2 and independent of a DCO decision for expansion, under IAG's preferred pricing mechanism.

Emerging Themes – Core regulatory framework

RAB & Single Till

5. The current RAB process does not allocate values to individual assets once they enter the RAB – this creates a lack of transparency and potentially distrust, particularly if there is a focus on an individual asset (e.g. Heathrow Express). Furthermore, it is possible if third parties become involved at Heathrow in future that there might be an opportunity for HAL to sell parts of the infrastructure. The CAA should:
 - a. Support IAG's request for HAL to *hypothecate the current RAB to specific parts of the LHR campus* (as they did in 2011)
 - b. For H7 establish a process whereby individual assets can be tracked once they enter the RAB
 - c. Use this methodology to estimate value of historical assets in the RAB if a particular issue arises (e.g. the value of HEx should HAL sell it)
 - d. Change the methodology for removing assets from the RAB if they are written off before fully depreciated such that HAL no longer continue to receive a return for a written off asset.

Third party competition and facilitation

6. IAG calls for third parties to be able to design, build and run commercial facilities such as terminals at Heathrow to improve competition and ensure value for money for the consumer.
7. The CAA states that the regulatory regime under the Civil Aviation Act 2012 (CAA12) is flexible enough to accommodate a wide range of commercial structures at Heathrow. However it does not believe that it has the power, directly or indirectly, to compel HAL into a particular commercial solution to promote competition. (Although airlines do have the power to appeal to the CMA if they believe any recommended settlement is unfair and decide to challenge the CAA's decision). The CAA's existing powers in respect of HAL's licence could be used to facilitate the delivery of parts of the capacity expansion by another provider. CAA has the powers to "facilitate" competition by amending HAL's licence to enable third party providers to connect and integrate into Heathrow. Furthermore IAG argues that the CAA also has the power to impose conditions to require competitive arrangements. IAG is willing to engage directly with the CAA on this particular issue.
8. It is vital that the CAA utilises its existing powers under the CAA12 to facilitate and where necessary enforce competition. If, contrary to IAG's view, the CAA do not believe they have the

¹ Fig 6.1

necessary powers and mechanisms to act in consumers' interests and be able to force this if required, then it is essential that these powers are given to the CAA in order for them to meet their duties under the CAA12

9. IAG has grave concerns about the effectiveness of the CAA's duty to the consumer and policy of encouraging third party competition if the CAA do not themselves consider that they have the power to compel HAL. The CAA, in that circumstance, must identify what further powers and mechanisms it needs to compel HAL to enter into particular commercial solutions to promote competitiveness – even if this requires a further short piece of legislation. IAG would be happy to contribute to any discussion on this.
10. In the IAG response to CAP 1541, various ways were suggested to introduce competition. The CAA has responded that even “where other legal means might be found” this is not a practicable solution. This is because, they would have lengthy procedures and uncertain outcomes and any delay ‘would also have significant costs to consumers in terms of less choice, poorer service levels and higher fares.’² We dispute this statement. It is surely better that if the expansion of Heathrow is to go ahead, that it is affordable, and is the most efficient design delivered by the most efficient company. It is our view that any potential delay for additional legislation would be small (as HAL would continue to work to its timetable), and that the benefits of third party engagement are potentially large. Consumers should not have to pay additional costs because of the lack of competition in the design, build and operation of airport facilities. The CAA should share its detailed view on the costs of potential delays to inform decision-making in this regard.
11. IAG is exploring ways in which regulation can be utilised and if necessary amended to support third party terminal design/build and operation and has contracted experts to advise on this. More detailed plans will be shared later³. In advance of that the CAA should further explore the following concepts.
12. The first is the concept of a “hypothecated RAB” within the wider RAB whereby certain elements (e.g. a new terminal) could be placed in the hypothecated RAB with returns from this hypothecated RAB going to the third party (which might have a different WACC to the rest of the RAB). Airport charges would still be averaged over the whole of the RAB ensuring the gains of competition were available to all airlines. This concept could be used to allow different elements of expansion to be monitored within the overall RAB, for instance a western campus expansion RAB.
13. The second is a BuildCo approach to facilitate and provide third party competition, which has been put forward by the wider airline community. This would work by establishing a separate company – BuildCo – which would build and deliver expansion. Stakes in BuildCo would be available to HAL, airlines and any other third parties who want to invest in expansion. Once built the expansion assets could be sold to HAL at a fixed price, or to a third party, or to HAL with rights to operate sold to a third party.
14. This type of approach was used by Ofwat to facilitate construction of the Thames Tideway project. Benefits would include a fixed price for expansion removing risk from HAL, giving third parties - and potentially airlines - the ability engage in expansion and so take advantage of their expertise

² Para 1.12

³ Consistent with CAA's requirements outlined in CAP 1610 para 1.16

whether in financing, construction or operation. This type of approach has allowed Ofwat to deliver the Thames Tideway project at lower cost than originally anticipated and could do the same at Heathrow as well. This is one approach that would provide a viable alternative and the CAA must look at a range of such options to understand what alternatives there are to delivering expansion for the consumer.

15. The CAA was right to express both its commitment to transparency⁴, and its statement that HAL must demonstrate how it has engaged with potential third party providers, and that it must demonstrate why its own approach provides better services for consumers⁵. However the CAA does not explain how it expects this to be demonstrated and how it will monitor and enforce this going forward? IAG would envisage a role for the Independent Fund Surveyor in this process. Simply leaving it to HAL will be insufficient, as it has an incentive to stifle competition and has a significant informational advantage over potential third party providers.
16. The CAA's determination of efficiency is a concern. The CAA has existing powers to disallow inefficient capital expenditure which, in IAG's experience, are not used sufficiently when it is clearly appropriate to do so. Going forward into expansion the CAA will need to consider how it uses such powers to assess competing expansion proposals and effectively polices expansion expenditure.
17. The CAA proposal to introduce a new licence condition to require HAL to further consumer interests by exploring competitive and commercial opportunities is supported and the CAA should develop this further. However any such condition should "require" competition not merely "refer" to it being important and have a clear monitoring and enforcement regime in respect of it.
18. Competition mechanisms should be introduced for all elements of expansion from financing, to design, construction and operation if they lower the cost for consumers. To support a level playing field for all third party providers and to ensure transparency IAG believe that studies undertaken by HAL and its contractors that are covered by Category B costs – which airlines will be paying for – should be available to third parties. Since airlines are paying for this work they must have access to the results of the work and should be able to share them with potential third parties of their choice.
19. IAG would also support HAL using competition for provision of new equity that could support HAL's financing for expansion.

Emerging Themes - Affordability

20. IAG continues to stress the point that affordability and financeability are closely linked and that the more affordable an expansion plan is then the more financeable it ought to be.
21. To be clear IAG has never supported the position that "airport charges are maintained as closely as practicable to current levels during and after...expansion"⁶. The use of the term "closely" is too vague.

⁴ Para 1.17

⁵ Para 1.18

⁶ Para 1.21

22. IAG's position is that expansion costs should be less than or equal to the level of airport charges at the end of the Q6 period, i.e. the price path and end point that HAL and airlines are all committed to under the CAA's current Q6 regulatory settlement.
23. In addition to the above the airport charges level for Q6+2 and any further extension should be calculated separately based on an update of key inputs available to determine the actual level of charge for that year. See paras 46-48 below.
24. Despite the CAA's proposals on the use of regulatory depreciation, to re-imburse airlines for paying in advance for expansion, we do not support using depreciation in this way. The consumer should pay the appropriate level of charges in advance of expansion and not pay a higher charge in order to "prime" expansion. We strongly believe that consumers are entitled to retain their money now than have the promise of it being returned to them at some point in the future. It is wrong for the customer of today to be funding the customer of the future.

Cost of Capital

25. IAG agrees with the initial assessment provided by PwC to the CAA on the preliminary ranges for the cost of capital. Since the Q6 price determination in 2013 there has been a significant downward pressure and reduction in cost of capital and this is clearly reflected in PwC's assessment. IAG is aware that the CAA will continue to review other regulators cost of capital decisions and we fully expect the CAA to be consistent with the trend of these determinations. IAG is concerned about the non-committal language used by the CAA around the PwC WACC assessment work in CAP 1610. For the avoidance of doubt we fully anticipate the final H7 WACC for expansion being in line with the wider market and other UK regulated settlements.
26. The CAA says that further work on the cost of capital, including their own assessment of risks and regulatory incentives could lead to a different, potentially higher WACC range than PwC have initially indicated. The CAA must not follow a course of placing regulatory incentives on HAL that increase the cost of capital. The CAA must make available their own continuing analysis on WACC⁷ for review by airlines and other stakeholders as well.
27. On cost of debt IAG accepts the CAA's argument that expansion will be primarily funded by new debt which is cheaper than at current levels (0.15-0.65% new debt vs 1.8% embedded debt costs) and that the proportion of new debt incurred by HAL will increase substantially from 12.5% to 60% for expansion.
28. The CAA will also need to address how risk is incorporated into expansion costs – is it purely within the WACC or is it implicit within HAL's cost estimates as well? With the size of expansion this will be a key issue to address.
29. The final determination is anticipated to be made in the H7 price control review which is due in 2019-20 depending on a further extension to Q6. There is an issue here with the DCO decision only being taken subsequent to this, which means the full cost and scope of expansion is unknown

⁷ Para 2.4

at the point in time when the H7 price determination is made. What is the CAA's position on this and the challenges this brings?

30. The CAA state they are "consulting a group of senior expert advisors on our approach to the WACC and the areas of additional focus for future consideration"⁸. The CAA should provide detail on the group members and, in the interests of transparency, make available their advice so all parties are aware of the issues being considered.
31. CAA refer to HAL's view that it might be appropriate to spread additional "rewards" for capacity expansion over a period of at least 15-20 years. The CAA should share what exactly HAL is referring to in this context. As per IAG's position on financial incentives for HAL and their shareholders to pursue expansion, these are not required. The opportunity to expand the airport and the benefits this will secure through the regulatory system are the only incentive that HAL and its shareholders require. Additional rewards are not necessary.

Debt Indexation

32. During the Q6 review IAG (BA) provided the CAA with a paper from CEPA outlining a proposal on debt indexation⁹ which the CAA chose not to use this as part of the regulatory settlement. IAG supports the CAA re-visiting this issue as part of expansion regulation and the upcoming H7 review. We agree that there is a potential significant benefit in removing the CAA from needing to make a judgment where they may have previously exercised caution and over-allowed. A debt indexation mechanism would avoid this. IAG will work with the CAA on this issue to determine what potential there is for this to be applied to expansion and mitigate risk and reduce costs to consumers.
33. The CAA have outlined their thinking around applying debt indexation to both new and embedded debt¹⁰. IAG would challenge the CAA's position on not extending the possibility of applying debt indexation to embedded debt as well as new debt. Embedded debt will surely be re-structured and refinanced over the course of expansion and so consideration to the financing opportunities that the market offers for embedded debt should also be considered as in scope.

Financeability and Indexing for Inflation

34. As per IAG's position in the Q6 review the CAA should continue to assess financeability on the basis of a notionally financed company with an efficient balance between debt and equity finance. This benchmark remains the best approach to assess financeability and both the CAA's proposal to continue to use this approach and acknowledgment of the "clear benefit" this has for consumers¹¹ is supported by IAG.
35. The CAA propose to also assess an alternative notional financial structure closer to a more highly leveraged structure which will be more akin to the anticipated gearing levels the CAA expects HAL

⁸ Para 2.12

⁹ "Setting the Weighted Average Cost of Capital for Heathrow and Gatwick in Q6", CEPA, 15th February 2013. <http://webarchive.nationalarchives.gov.uk/20150601181840/http://www.caa.co.uk/default.aspx?catid=78&pageid=90&pageid=14279>

¹⁰ Para 2.30

¹¹ Para 3.14

to use to finance capacity expansion. IAG supports the CAA's position and approach if it leads to consumer benefits by assuming higher gearing levels.

36. At the present time HAL's actual gearing is higher than that of the notional financial structure the CAA used to inform the Q6 review. This will translate into higher costs for HAL in securing financing for expansion. The CAA must not make an accommodation to HAL for the higher cost of debt financing due to their current levels of gearing. As CAA note HAL's board is accountable for financing and gearing and if they have adopted a level of gearing that has benefited HAL in Q6 to date then they also need to absorb the risks that such an approach leads to in the context of expansion. Consumers and airlines should not pay more than they need to for HAL to transition to the gearing levels required for expansion.
37. IAG notes the CAA's position that in addition to the use of financial modelling of credit metrics applied to HAL it would also "expect to apply our judgment to assessing the overall results of analysis of credit metrics" and may "decide that it is appropriate to include headroom in the selection of benchmarks"¹². IAG would like to understand in more detail the CAA's view on the need to apply a qualitative judgment to the detailed quantitative analysis already outlined here.
38. The CAA recognises the need to transition from RPI to CPI for the purposes of inflation indexing. The CAA indicates they are minded to continue using RPI for the H7 review but do not offer any detailed view on the steps needed to conduct further analysis to inform a decision on this transition. The CAA should outline in more detail the steps needed to do this, identify a potential pathway to transition, and demonstrate why H7 should continue using RPI when it is no longer an official UK metric. How does the CAA position compare to other UK regulators?

Financial resilience and ring-fencing

39. In CAP 1610 CAA highlights that it will review ring-fencing arrangements and will consider further adjustments that may be required in light of expansion. IAG believes that any potential changes should be subject to a rigorous cost benefit analysis that shows the benefit of any changes to our passengers, along with the potential financial costs.

The regulatory treatment of early construction costs

40. The CAA put forward a proposal to allow HAL to incur early construction costs ahead of the DCO outcome and admit those to the airport RAB.
41. IAG believes that the scheme proposed is not strong enough and, if any such scheme were to be implemented, there is a strong case to apply special conditions to the treatment of early construction costs and assets for expansion in the RAB. These would include:
- There must be a formal "Go/No-Go" decision on Heathrow expansion once a final scheme and detailed costs are available before any early construction cost spend (unless entirely at HAL's risk) and before DCO submission. These costs must be independently verified by the IFS and the impact on charges assessed using the CAA charges model.

¹² Para 3.25

- Early construction costs should only be proposed by HAL following a “Go” decision at the designated “Go/No-Go” decision point following the successful designation of the Airports NPS in Parliament.
- Any proposal for early construction costs after this point must have a robust business case, cross checked by the IFS that can be fully vetted by airlines and must be approved through an enhanced version of the Q6 capital governance process.
- Final sign-off of any expenditure should only be done by a joint senior HAL and airline executives group – this will ensure the appropriate level of oversight for the size and complexity of the proposed early construction costs.
- HAL is not allowed to earn any return on such expenditure until after DCO is successful (at which point the return will be at the H7 WACC rather than the inflated Q6 WACC).
- In the event that HAL and airlines cannot agree on an early construction cost proposal:
 - The issue is referred to CAA for review
 - Independent third party evidence should be provided to the CAA on the issue from either the IFS (G+T) or Planning IFS (Arcadis) and be made available to all parties.
 - If the CAA decision is not accepted both HAL and airlines can have recourse to a CMA panel to provide a final decision.
- If HAL’s expansion DCO application fails then:
 - HAL should never earn a return on early construction costs and associated assets in the RAB
 - Airlines must have right of veto on subsequent early Category C asset retention or disposal decisions managed through the capital governance process
 - All early construction costs and asset disposals that return a profit must be subject to a HAL-airline profit share mechanism – this should comprise an incentive for HAL to dispose of assets where a profit can be achieved whilst returning the majority of funds realised to airlines, which they have been denied access to in the interim.

42. However, IAG remains of the view that the best solution for early construction costs that HAL wishes to incur in advance of a DCO decision on expansion is that these should be made solely at HAL’s risk. There may be a case for early construction costs to deliver expansion more quickly – the issue is who bears the risk? HAL clearly is not willing to entertain bearing that risk, despite being best-placed to understand and manage it, which in turn begs the question why then should consumers and airlines?

43. In addition to the above IAG would strongly encourage the CAA to consider a move from straight-line depreciation to unitised depreciation. The benefits of this approach would be to avoid a situation where current passengers pay more than future passengers. This could be applied to the pre-funding of early construction costs and to expansion as a whole. The Irish CAR has used this approach in regard to the expansion of Dublin airport T2 and has also been used to regulate Runway 5 development at Amsterdam Schiphol as well.

Waterside

44. IAG and HAL will both get independent valuations and then it will be a standard commercial negotiation. IAG does not have the power to compel other airlines in the Heathrow airline community to support our position on an early construction cost proposal for Waterside. As such the Q6 capital governance process should apply as for other early construction costs – with IAG

having observer status for this item and not having a direct input to the final decision-making from a HAL-airline community perspective.

Interim arrangements to extend the Q6 price control

45. It is not realistic to continue to try aligning the regulatory and planning timescales for expansion and so we do not support further extensions to Q6 beyond the proposed Q6+2. There is a danger that we just have a rolling extension of Q6 at a time when HAL are earning excess returns due to both passenger numbers being above forecasts and the WACC being based on out of date assumptions. Consequently IAG support H7 starting in 2021.

Q6+2 price paths

46. IAG rejects the CAA's proposal to switch up to a higher RPI +/-0% price path that increases airport charges beyond the level required to efficiently operate the airport today. Moving to RPI +/-0% would be a wholly arbitrary decision and is not supported by the evidence available to the CAA. A technical rationale beyond paying down the expansion bill early and returning any overpayment to consumers through depreciation over a long period is not sufficient and cannot be supported by IAG. Bearing in mind the price path for Q6 will have been determined around 6-7 years prior to Q6+2 starting any change to the price path would need to be fully evidence-based.

47. IAG would give full consideration to the options available to appeal an imposition of a RPI +/-0% decision from the CAA

48. Instead IAG believes there are three broad options for the Q6+2 price path:

- a. Roll forward the current price path with any HAL out-performance being used for expansion
- b. Re-do the whole regulatory settlement for Q6+2
- c. Re-base traffic volumes and other regulatory building blocks to generate a new Q6+2 price path

49. IAG does not believe a simple roll-forward of the RPI -1.5% price path is appropriate for Q6+2 and any potential further extension period. HAL was able to announce a dividend of £525m to its shareholders in February 2018 and would still be earning excess returns in this situation. A roll-forward of the RPI -1.5% price path could only be considered if HAL's excess earnings could be used to offset expansion costs rather than swelling the pockets of HAL's shareholders.

50. An alternative to a roll-over of RPI-1.5% with any HAL out-performance being put towards expansion would be to make a simple updated price determination for Q6+2 through a review of passenger forecasts and (if it can be done quickly) WACC. IAG believes that the CAA should do this.

51. CEPA's review of regulatory options for expansion, on behalf of the AOC, concluded that "the cost of capital for any rollover period should lead to a significant fall in charges" and "setting a cost of capital for the rollover period to reflect market conditions would be prudent and not resource intensive"¹³.

¹³ CEPA paper for Heathrow AOC/LACC CAP 1610 response

52. In light of the significant actual HAL out-performance of the Q6 regulatory settlement to date these measures are proportionate.

H7 airport charges

53. IAG believe that HAL should keep airport charges for expansion levels at or lower than the level assumed at the end of the Q6 period. This is what the CAA, HAL and airlines are already committed to under the CAA's Q6 regulatory settlement.

H7 regulatory period

54. CAA should look to start H7 in 2021 following Q6+2 rather than opt for a further Q6+n extension, even if expansion circumstances change.

55. We recognise that there will be a challenge in planning H7 if the outcome of the HAL expansion DCO application is not known at the start of H7 itself. IAG are advocating the development of a "2R lite programme" business plan until the DCO decision is made.

56. In this "2R lite programme" scenario:

- a. H7 would start only progressing projects that are common to both HAL's 2R masterplan and the expansion masterplan
- b. The H7 business plan itself would only be updated to incorporate expansion costs when DCO is achieved and the expansion programme is finalised

57. This approach would allow the H7 period to start without needing the expansion DCO to be in place – consumers and airlines will benefit from a full CAA regulatory review of HAL and any further delays to the airport expansion masterplan prior to DCO decision can be accommodated.

58. Further to this proposal the CAA should consider the regulatory model that the Irish regulator CAR, has adopted to manage airport expansion at Dublin. Their approach is based on identifying an "existing airport price settlement" which generates a base airport charge for the existing airport. Then, as set passenger growth volumes are met, this triggers investment in new components of expansion capacity, the costs of which are added to the airport charge as the assets come into use. This approach results in consumers and airlines only paying for expansion in component chunks once sustained passenger growth targets are met and so ensures that new capacity is only delivered when needed. The CAA must consider the merits of this model, both for managing the transition from Q6 into H7 and mitigating the timeline uncertainty of the expansion DCO process, with the proviso that charges must always be less than or equal to the charge at the end of the Q6 period.

59. More generally the H7 regulated settlement for expansion must help deliver an affordable solution through the following:

- Enables competition for the design, build and operation of airport services whilst still retaining a single charge across the airport (see points 6 -19)
- Ensures focus on capital efficiency and cost control throughout the lifetime of the expansion through measures such as

- all development capex is independently verified ahead of development beginning (Gateway 3)
- Only allowing Gateway 3 costs to enter the RAB – anything above G3 should be “at HAL’s risk” – they benefit if costs come in lower, they pay if costs come in higher
- Allows for airlines to develop commercial deals within the regulated settlement

Other issues

Regulatory out-performance

60. The CAA should review its policy on regulatory performance as part of the solution to expansion affordability. Whilst CAA propose to increase the level of airport charges ahead of expansion this is against the back-drop of a regulatory period where HAL has effectively made windfall gains as a result of the significant downturn in cost of capital, as evidenced in other regulated settlement assumptions and by PwC’s preliminary assessment, that see HAL enjoying a cost of capital in excess of what the market currently returns.

61. Other UK regulators make a distinction between:

- Outperformance due to regulated company actions; and
- Outperformance due to windfall gains

62. Bearing in mind HAL’s position operating the airport with the highest airport charges in the world, and the outperformance they have enjoyed throughout Q6 to date, it is unfair that consumers are being asked to pay even more for expansion when this could be funded in part by an element of that outperformance. The CAA must take HAL out-performance into consideration and IAG would support a hypothecation of HAL out-performance in the upcoming remainder of Q6 to meet the expansion affordability challenge. Such a mechanism could take effect following a successful Go/No-Go decision point after the NPS.

END