



Response to the CAA Consultation

Economic Regulation of New Runway Capacity – a Draft Policy

19 December 2014

1. Introduction

The Heathrow Airline Operators Committee (AOC) represents the airlines operating at Heathrow Airport. Therefore this response is a general overview rather than the specific view of any particular airline. Within this context we welcome this opportunity to respond to the Civil Aviation Authority's (CAA) consultation on the "Economic Regulation of New Runway Capacity – a Draft Policy".

We believe that the development of a third runway at Heathrow Airport provides the best opportunity for expansion of the nation's airport infrastructure and are very supportive of it. We also recognise that the delivery of such an investment will be a substantial undertaking requiring significant amounts of collaboration between all stakeholders in planning for, and the delivery of, the optimum runway along with supporting infrastructure.

In addition to this we would highlight the importance of the establishment of an equitable form of funding for this infrastructure. The AOC urges the CAA to ensure that all investments are delivered efficiently and that passengers bear only the portion of investment which can equitably be attributed to them.

Our response to this consultation is set out below. It follows the structure contained in the *Executive Summary* of the CAA's consultation.

2. CAA Duties

Interests of passengers

The AOC continues to welcome the CAA putting the interests of passengers at the heart of its policy making. This aligns with the position of the airlines for whom the interests of their passengers is of paramount concern. It is therefore welcomed that the CAA recognises that the interests of passengers and airlines often overlap. In our view the interests of the airlines do overlap with the interests of the passengers. Therefore, the interests of the airlines can be taken by the CAA as proxy for the interests of passengers.

This interest includes the need ensure that passengers pay for services as consumed by them. Whilst planning must include the consideration of the needs of future passengers this must not be at the expense of current passengers being asked to bear a price burden for services not consumed by them. We note the CAA comment that an example of the interests of airlines and passengers diverging could be exhibited with 'airlines focusing more than passengers on the present rather than the future'¹. In actual fact airlines, who have no guaranteed returns (in contrast to HAL), need to ensure business survival in current circumstances in order to serve the interests of future passengers. This includes the need for the business survival of a broad range of airlines in order to promote a competitive environment and the economic interests of future passengers.

Need for economic regulation

We note the interest of the CAA in commercial agreements between the airlines and the airport. This is discussed further below. However, at this point we note that the costs incurred and the operations of airlines at Heathrow are impacted by the fact that the supplier of airport services is a company with substantial market power (SMP) – Heathrow Airport Limited (HAL).

¹ Paragraph 2.13 of the CAA consultation paper

Therefore, whilst supporting the CAA position that competition is preferable to regulation, the AOC notes that the current situation at Heathrow requires robust economic regulation of HAL because it is not subject to competition. In the absence of competition passengers and airlines at Heathrow are reliant on the CAA to establish regulatory solution which:

- Protects and promotes the interests of passengers and airlines,
- Incentivises the efficient supply of airport services and infrastructure,
- Ensure the quality of services and facilities are provided to high standards, and
- Restricts the ability of the airport to leverage its substantial market power

Based on the substantial market power of HAL and the points above the AOC considers the CAA to be correct in noting that its ability to rely on commercial agreements is 'restricted as commercial agreements between airport operators and airlines may not be possible'.²

Proportionate intervention

The AOC agrees with the CAA that economic regulation should not be seen as a burden. In the experience of the airlines operating at Heathrow the SMP of HAL necessitates the application of economic regulation in order to achieve the benefits of the reduced prices, improved quality and innovation referred to by the CAA.

The interests of users

We welcome the indication by the CAA that it will consider the following factors in considering the interests of users:

a) Financeability

The AOC agrees that the airport operator should be able to raise funds. However, the AOC also welcomes the recognition by the CAA that any regulatory regime should not be tailored pre-dominantly to facilitate HAL being able to raise funds as other factors need to be equally balanced with this dimension of regulation.

b) Reasonable demands

The AOC welcomes the CAA highlighting the need for it to consider how best to promote the actual delivery of infrastructure to meet passenger needs once Government has decided on its airport expansion policy.

c) Economy and efficiency

The AOC welcomes the policy objective of the CAA to ensure that any costs associated with the delivery of additional runway capacity at Heathrow represents good value for money. The SMP of HAL and its desire for inflated returns on its asset base mean that ensuring economy and efficiency in the delivering of assets at Heathrow will be a critical activity for the CAA if a third runway at Heathrow receives policy and planning approval.

3. Principles

The AOC notes the preference, at this stage, of the CAA to set the broad principles which will inform its emerging regulatory policy on the treatment of Category 'C' costs rather than actually

² Paragraph 2.15 of the CAA consultation

set out its regulatory policy. This is welcomed and can be used to inform the development of the policy in a holistic context. The three broad principles established by the CAA and the views of the AOC on each of these is set out below.

1. Risk should be allocated to those parties who can best manage it.

The CAA is correct to highlight the range of risks associated with the development of new capacity. The AOC notes the CAA's position that 'risk should be allocated to those parties who can best manage it'.³ The CAA expects that such a position would result in:

- Final out-turn cost being minimised
- Perceived fairness being strongest
- Information about the price of risk being revealed

These expected benefits are considered further below:

Final out-turn cost being minimised

The CAA adopts this position on the basis that the party with the strongest incentive to reduce costs is also the one with the ability to do so. Whilst this position may hold true in competitive markets, it should not be assumed that it holds true for a regulated company with SMP. In the Heathrow context it is the airlines, operating in competitive environment, which have the strongest incentive to pursue lower costs – which are passed on to their passengers. The regulated company, HAL, has an incentive to reduce operating costs within a regulated period only but has limited incentive to reduce capital investment costs in a regulated period. With only tiny amounts (relative the capital budget at Heathrow) every being disallowed from the RAB the airport has limited incentive to reduce out-turn investment costs. Therefore, whilst the airport is the party best able to manage the costs of investment they are also the party with the least incentive do so. In addition to this the extent to which any inefficient investments are added to the RAB is decided only at the end of regulated period. This compounds the adverse impact on passengers and the beneficial impact for HAL shareholders of the airport not managing risks adequately. Therefore, the AOC notes that it is the airlines, along with their passengers, which actually carry the most risk.

The AOC notes the CAA position that 'making users carry risk without being paid for it is equivalent to taxing them or charging them more'. The CAA can ensure that airlines and passengers are compensated for carrying the risk of higher out-turn airport costs through paying lower airport charges to the airport in the first instance.

Perceived fairness being strongest

The CAA position on this is articulated in the text, 'The party that controls the risk can benefit or suffer from its own decisions, rather than those of others'.⁴ This again may hold true in a competitive market but not for HAL at Heathrow. At Heathrow the actions/decisions of HAL in managing projects, and its suppliers in those projects, have more of an impact on the airlines and passengers than on HAL itself. For example, delay to delivery impacts the operations and services received by passengers and airlines with minimal (if any) impact on HAL shareholders. In fact, HAL shareholders could stand to gain by the delay in spending. Also, HAL always seeks to add project overspends to its asset base. Sometimes both overspend and delay impact a project e.g. T3IB. This evidences that even though HAL controls the risk it does not suffer from that risk materialising – rather it stands to benefit from risk materialising. Therefore, in the pursuit of 'perceived fairness being strongest' the AOC urges the CAA to

³ Paragraph 3 of the CAA consultation

⁴ Paragraph 3.8 of the CAA consultation

ensure that the customers of the regulated monopoly do not suffer from the materialisation of risk in the monopoly supplier.

Information about the price of risk being revealed.

Asymmetry of information characterises the relationship between the airport and the airlines operating at Heathrow. Therefore, we would be cautious about the extent to which the price of risk actually becoming evident from the airport.

2. Commercial negotiations should be encouraged.

The CAA is correct in highlighting that because the airline sector is highly competitive the airlines will always seek to achieve optimal commercial arrangements with their suppliers. This has been achieved with most of their suppliers and passengers have benefitted from the commercial incentives faced by airlines and their suppliers. However, the one notable exception to this has been the supply of airport services from airports. Huge amounts of effort are continually expended by airlines in seeking to achieve optimal commercial arrangement with airports. However, this effort achieves limited value for airlines as the monopoly airports exert the bargaining power characteristic of their substantial market power.

The AOC understands the concern of the CAA regarding the risk of the extent of the regulators knowledge vis-à-vis what might be evident in commercial arrangements. However, the information available to the regulator is mostly greater than that available to the airlines, or it can use powers to obtain information that simply would not become evident to airlines in any negotiations with HAL.

The CAA indicates that HAL does not operate in a perfectly competitive market and that even in the presence of substantial market power there is scope for commercial arrangements. In response to this the AOC highlights that HAL rather than 'not operating in perfectly competitive market' actually holds a monopoly position and has exerted this in respect of commercial arrangements that the airlines have sought to establish with the airport.

We note that the CAA highlights the desire of HAL to enter into commercial arrangements with the airlines regarding capacity expansion at Heathrow. This is not surprising as the substantial market power of HAL would provide it with a bargaining leverage over the airlines.

Therefore, the AOC welcomes the indication by the CAA that whilst commercial arrangements are beneficial and, if parties have equal market power, likely to lead to an optimal solution, the SMP of the airport limits the prospect of such arrangements working in practice. In the view of the AOC it is therefore preferable for the CAA to establish a regulated solution.

3. Capacity can be paid for both before and after it opens.

The AOC notes that if capacity is paid for before it is in beneficial use it raises a risk of passengers being asked to pay for infrastructure which they may never use. The 'lumpy' nature of airport investments is further exacerbated by the impact of planning approvals, and the extent to which social and environmental considerations impact on the rate and nature of airport development (supply) in response to any emerging demand. Therefore the AOC considers that pre-funding should be avoided in considering how to finance runway expansion at Heathrow.

4. Price Control Structures

The AOC notes that a number of price control structural issues have been raised by the CAA in their consultation paper. We consider that these issues will need more detailed consideration once there is more clarity on what the recommendation is from the Airports Commission and any subsequent Government policy. In the meantime we would note:

- The AOC is of a view that there should not be a natural assumption that unanticipated, efficiently incurred capex should be added to the RAB. For any such investment to be added to the RAB it should be demonstrated by HAL that the need for the unanticipated investment has been thoroughly discussed with the airline community and that the airline community is in agreement with HAL regarding the need to incur the development costs. In addition to this HAL should be required to demonstrate that the investment has been incurred as efficiently as possible.
- The AOC recognises that a regulatory period of longer than 5 years could provide greater certainty to HAL and through this reduce the level of risk. Equally, a longer regulatory period could have the effect of baking in risks and disbenefits to passengers and airlines for an extended period and thus not be in the interests of passengers.

5. Scrutiny of Costs

The AOC welcomes the commitment of the CAA to undertaking a scrutiny of any development costs. It is particularly welcomed that the CAA has indicated it will do this on at least two occasions. Once being after the Government decision on where expansion can proceed but before any planning application is submitted to the Planning Inspectorate and the second time, if undertaken through regulation, in an ex-post form to determine the efficiency of the investment.

6. Recovery of Costs

The CAA has provided a useful categorisation of the costs incurred by an airport operator or infrastructure developer which aligns with the stages in which relevant costs are incurred. The comments of the AOC for each categorisation of costs are set out below.

Category 'A' costs - Costs incurred before a Government policy decision is made

The AOC welcomes the CAA policy with regard to category A costs. That is to say that all costs associated with submissions to and influencing of the Airport Commission should be borne by those who are making proposals to the Airport Commission. If a Heathrow based proposal is chosen as Government policy it will be important for the CAA to ensure that none of the Category A costs associated with the proposal are allowed to be part of any costs to be borne by users. Such cost may not be explicit but may be manifested in operators indicating that costs incurred by them in the Category A phase of development have left them short of funds for other projects previously agreed between HAL and the airlines.

Category 'B' costs – Costs associated with seeking planning permission

The AOC recognises that it is reasonable for airlines (and through airlines the passengers) to pay for some of the costs incurred in the development of capacity at Heathrow. However, in considering the category B costs the AOC does not think that simplicity of cost pass through should be an objective of the CAA in regard to the treatment of these costs.

In the event that a Heathrow based solution is chosen as Government policy the CAA should require the airport to engage constructively with the airlines in the development of a planning application. This would provide more transparency, and require the agreement of the airlines, of the costs incurred by the airport operator, the efficiency of these costs and what should or should not be passed on to users as part of the total final cost of the new infrastructure once it is in beneficial use.

It will also be important for the CAA to ensure there is a clear demarcation between the period in which category A costs are incurred and the period in which category B costs are applicable. In addition to this it will be important to ensure that there is clarity on the activities that have been (or will be) undertaken in these periods so that category A costs are not introduced into the period when category B specific activities are being undertaken.

Category 'C' costs – Costs associated with construction of new capacity

The AOC considers the CAA to be correct in its judgement that the publishing of a specific methodology for recovery of category C costs may result in the airport operator diverting attention to how best to profit from the regulatory framework established by the CAA. Therefore, the AOC welcomes the proposal from the CAA that it is minded to work to principles which can be used to inform future regulatory policy. The comments of the AOC on the current principles outlined by the CAA are set out above.

7. Market Power

Market power assessments are critical activities which inform the nature of any associated regulation. It will be important for the CAA and stakeholders to give careful consideration as to when the most appropriate time is to undertake a market power assessment.