YOUR LONDON AIRPORT
Gatwick

22 SEPTEMBER 2017

Stephen Gifford
Civil Aviation Authority
CAA House
45-59 Kingsway
London WC2B 6TE

Dear Stephen,

Re: CAP 1541 Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow

Gatwick Airport Limited (GAL) welcomes this opportunity to comment on core elements of the regulatory framework in design for the potential expansion of Heathrow. In our March "CAP1510 Economic Regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable" we raised four specific concerns:

1. The potential impact of Heathrow's charges on airport competition;
2. Ensuring that Heathrow delivers the NWR scheme that was selected;
3. Ensuring that Heathrow's charges are kept flat in real terms; and
4. Surface access and cost allocation.

Overall CAP 1541 outlines a fairly conventional form of regulation for Heathrow. We note that the technical price control elements outlined are mostly not developed with the circumstances at Gatwick in mind, and would thus not apply directly or automatically to Gatwick Airport. GAL will not therefore comment in detail on these aspects. We do however offer some observations, in the annex to this letter.

What is missing from the CAA's outlined approach, however, is a recognition that unlike most[1] of the other price regulated sectors in the UK, Heathrow is a dominant party in a market with direct horizontal competition. Therefore the traditional CAA concern with excessive airport charges and airport service quality should be complemented by a consideration for promoting competition in airport operation services. While we recognise that new capacity at Heathrow will not be available for some time, we would expect a greater overall emphasis in regulatory thinking on promoting

[1] In energy and water there are multiple distribution companies, however these are geographical monopolies. Telecoms is a notable exception, in which the regulator operates a comparable system of market power tests to that in the airports sector.

competition in airport operations services. We find this missing from the consultation - we do not consider that the CAA's comments in paragraph 1.6 CAP 1541 adequately addresses the airports competition issues.

Gatwick remains concerned in each of the other three areas we originally outlined in our March 2017 response. We provide further comments on these areas in this response.

Comments on the Heathrow NWR scheme definition

While little or no detail is available to other market participants regarding the evolution of scheme definition for the Heathrow NWR, Gatwick notes with concern the media reporting discussing the possibility of:

- Reduced terminal facilities
- A more easterly location for the runway
- Reduction in transfer facilities

While we understand why the airline community is stating these preferences, the CAA should bear in mind that Heathrow was recommended by the Airports Commission based on analysis of a detailed outline scheme. As we noted in our March 2017 response, Heathrow NWR was recommended to Government by the Airports Commission over Gatwick's second runway on the basis of a Heathrow scheme which would deliver long haul business connections which would be attracted by a premium facility with, for example, greater passenger facility areas than the Gatwick scheme. We would expect the CAA to challenge Heathrow to ensure that, in looking for economies on scheme costs, the scheme is still credibly able to deliver the expectations set by Government, and is consistent with the basis on which it was selected over Gatwick.

Comments on ensuring that Heathrow's charges are kept flat in real terms

It is clear that the selection of Heathrow's proposal was based on the requirement from Government and the CAA that charges be kept flat in real terms while delivering the chosen scheme.

It is however important that this is not achieved by giving Heathrow an overly generous risk/reward balance whereby costs are kept low by risks being transferred to users, or by other forms of support such as undue amounts of Government funding for surface access costs.

Comments on principles for the recovery of surface access costs

We believe that the CAA's overarching principles for the recovery of surface access costs remain broadly appropriate. However, the CAA should have regard to some factors which are different from the situation in 2005, as well as some of the particulars of the Heathrow surface access schemes which affect the extent to which their costs should be reflected in user charges.

In our view, the following factors should be taken into account in determining the principles for the recovery of surface access costs:

- Following the introduction of the Civil Aviation Act 2012 the CAA now has a general duty to promote competition in airport operation services which it did not have in 2005;

- In 2014 the European Commission published state aid guidelines for aviation, placing clear limitations on what state funding (if any) can be provided for aviation infrastructure;
- In the process of being selected as a preferred scheme, Heathrow made significant environmental and surface access promises without which the scheme would not have been plausible;
- The very substantial scale of the costs involved in the Heathrow surface access schemes, the significant uncertainties still attached to these schemes, and the wide range of views as to how their costs should be allocated.

Promoting competition in airport services
The Civil Aviation Act 2012 places a duty on the CAA to further the interest of users, where appropriate by promoting competition in airport operations services. In addition to this, the European Commission's new state aid guidelines for airports place very severe restrictions on public funding in support of large airports and makes it clear that they expect large airports to cover their own capital and operating costs without state assistance.

Stemming from the breakup of BAA, and against the background of the new runway debate and political process, significant investment in capacity expansion has been taking place in the London system. These investments include, but are not limited to:

- **Gatwick**: GAL is continuing to invest over £200m per year in its facilities. Over the past 7 years this ongoing investment programme has refreshed and expanded both terminals, installed a new baggage facility and pier in South Terminal, new security areas in both terminals, undertaken substantial investments in the operational resilience of the airport and facilitated the increase in passenger numbers to over 45m in 2017.
- **Stansted**: is planning an increase of its capacity from 35 million to 44 milllion passengers. This is planned to be enabled by investment of £130m in a new arrivals building, as well as a further £50m on checkin capacity, seating and aircraft stands.
- **Luton**: is currently undertaking an ambitious expansion plan which includes an expansion of terminal capacity, an extended parallel taxiway (to enable more aircraft movements) and a £200m light rail system linking the airport to the mainline train station. It is expected that when this expansion is completed, the airport will be able to serve more than 18 million passengers (up from around 10 million before).
- **London City**: is investing £370m to grow to accommodate 6 million passengers by 2021. These works include an extended terminal, a parallel taxiway and additional stands.
- **Southend**: completed its first expansion to a capacity of 2 million passengers in April 2014.

Further afield, Manchester is undertaking a £1 billion transformation programme to optimise its terminals and enable it to make better use of its two runways.

These airport investments have been (or are being) financed by private investors within the competitive market framework established by the BAA break-up and in the expectation, supported by the Airports Commission, that airport expansion can and should be privately financed without recourse to public funding. Such private finance is dependent on investors perceiving a level playing field, something that is clearly also essential for fair and effective competition.

Against this background of airport competition, the allocation of an undue amount of Government funding towards surface access schemes which are oriented to Heathrow could have a substantial effect on the competitive dynamic. Any perception in the investment market that the cost allocation between Government and Heathrow Airport were beneficial to the latter could have two negative effects on airport competition: first, providing a direct cost subsidy to one airport over others in the same market; and second, distorting the market for private finance for airports, by creating the perception of bias and thus raising the capital costs for other London airports. This in turn could crowd out other investments as a result.

While the allocation of surface access costs between an airport and Government is unavoidably complex, the CAA's competition duty means that it should seek to ensure that, in delivering a regulatory framework for Heathrow, it does not in its treatment of surface access funding distort the airport market, or crowd out other needed investment. In principle, the criteria established by the CAA, in particular criterion (d), should help to achieve this. However, the duty towards competition suggests that the criteria should be amended to embody the need to safeguard competition, and this should be given substance by transparent demonstration that any cost allocation does not effectively cross subsidise HAL.

Recovering the cost of promises made by Heathrow
The Heathrow scheme faces significant environmental and noise challenges. In promoting its bid, Heathrow was in competition with the Gatwick scheme, but also with new entrant bids such as the Heathrow Hub and Thames Estuary airport scheme. In order to influence the Airports Commission's assessment, the promoter of Heathrow NWR made significant promises about air quality, mode share and rail accessibility, above and beyond existing and planned schemes such as Crossrail.

These include:

- Meeting legal air quality limits;
- Ensuring no increase in airport related road traffic;
- Securing an increased public transport, cycling and walking mode share of at least 50% by 2030 and 55% by 2040 for passengers; and
- Reducing staff car trips by 25% by 2030 (relative to 2017 levels), with a further reduction to 50% by 2040.

Meeting these obligations will require substantial investments in the surface access infrastructure serving Heathrow beyond what is currently committed. For example, there may well be schemes or investments necessary to enable the Heathrow scheme to be built and legally operated which are above and beyond any measures outlined in the UK Air Quality Plan (July 2017)[2].

---

[2] In the draft UK Air Quality Plan (July 2017) no account is taken of the adverse effects of LHR-NWR, despite the Airports Commission's and Government's NPS studies showing its operation would cause increases in concentrations on local road links local and in central London.

These investments will be needed at this time only to facilitate the expansion of Heathrow. They are therefore likely to have very limited wider economic benefit or direct passenger benefits in their own right. In allocating the recovery of these costs, the CAA should recognise that:

- Heathrow expansion is the main driver for most of these schemes being brought forward now;
- Whilst there may be some collateral benefits to users from these investments, consideration must be given to whether these collateral benefits could have been delivered at less cost than through schemes devised to enable Heathrow compliance; and
- The benefits to Heathrow are clearly much greater than the direct benefits to airport users.

In addition, the Airport Commission process demonstrated that there existed an alternative airport expansion option with near identical net benefits but without needing surface access investments to be viable whereas Heathrow could be legally expanded only with these schemes. The starting point should be that these surface access costs should therefore be recovered principally by Heathrow either through aeronautical charges, or charges directly on surface access users, rather than funded by the Department for Transport or Transport for London.

Process of allocating costs between HAL, other transport users and taxpayer
As noted earlier, the process of allocating surface transport costs between different categories of users is unavoidably a complex and contentious one. In principle, it is debatable whether the question the policy is trying to answer should be *"how much HAL should contribute to surface access infrastructure necessary to expand the airport?"* - rather than *"How much should society contribute to the surface access costs of Heathrow?"* When the issue is looked at in this light, we believe it should be considered whether it is appropriate for this major exercise to be left entirely to the CAA. This is because in allocating costs (ultimately between airport users, other transport users, and taxpayers), the CAA has a principal general duty towards the interests of airport users, and not towards the other two affected groups.

We do not doubt the CAA's professionalism or integrity, but we recommend that the CAA should consider formal involvement of relevant Government departments (DfT/HMT) and other transport bodies (notably Transport for London, Network Rail, Highways England), to assist in both developing its regulatory policy approach to surface access costs and in reaching judgements on specific scheme cost allocations. A cross-regulatory and funding body group along these lines could also be advised by a panel of independent economists. Such mechanisms of formal stakeholder involvement should help the CAA to develop and implement a robust surface access costs policy, which stands the test of time. It would also ensure that any contribution by other parties towards Heathrow's surface access costs are proportionate and deliver value for money, as well as enabling clear demonstration that HAL is not effectively being cross-subsidised.

It is important that the CAA surface access policy takes full account of these factors to avoid distorting competition in airport operations (and by extension in the airline market), and thereby

YOUR LONDON AIRPORT
Gatwick

compromising the incentives on private parties to undertake investment in the London airport market.

Yours Sincerely

Mattias Bjornfors
Economic Regulation Manager

YOUR LONDON AIRPORT
Gatwick

Annex: Comments on elements of the Proposed Regulatory framework for Heathrow

Gatwick has previously set out our approach to regulation of capacity of in our responses to CAP1195, CAP1221 and CAP1510. This annex builds on these views and provides some additional commentary on key issues in the CAA's proposals for Heathrow.

Profiling regulatory depreciation and the single till

We note the proposal to use a Regulatory Asset Base -based regime and potentially using alternative profiling of depreciation to "balance affordability and financeability". We acknowledge that this is one particular way to devise a regulatory construct to address a particular challenge. The regulatory till is another such regulatory construct.

In principle, the outcome would be exactly the same in a single and dual till world if the rents for use of the terminal space were allocated correctly between the two tills. The single till does however raise both opportunities and challenges in a capacity constrained world as rather than allowing prices to rise as a price signal for investment in capacity (as happens in for example the energy industry or manufacturing), it has the opposite effect of reducing prices, therefore creating a conflict between current and future users[3].

An alternative way of balancing affordability and financeability in the presence of capacity constraints, would be to allow some of the commercial revenue to be used to invest in capacity. Once the capacity constraint eases, it would in the airport's best interest to maximise its use, by moderating airport charges in order to maximise traffic.

Such a regulatory approach would substantially achieve the same effect as the CAA manipulating the depreciation profile of the RAB[4], but through a market-driven, incentivising approach.

Duration

As we have outlined before[5], we believe longer control periods can have significant benefits through a reduction in regulatory risk. Regular regulatory decisions grow the opportunity for changes in regulatory policy, thereby raising regulatory risk. For example our R2 Commitments proposals featured a longer period from the opening of capacity, to account for the recovery of project costs, in which regulatory risk can be avoided. This would have benefited passengers through a lower overall project risk and thereby a reduced cost.

---

[3] It is important to note in this context that supressing the airport charges of current users to cost in a capacity constrained scenario does not actually result in any net user benefit as the price paid is dictated by the air fare. In this situation the overall cost to users increases as future users pay more (while current users still pay a scarcity premium)

[4] We do however note that unlike utilities where demand risk is not a significant problem, the recovery of capital investment through the RAB is not guaranteed – particularly in a non-capacity constrained world. Gatwick has under-recovered against the RAB return projection in the last 2 regulatory periods. This means that the existence of the RAB does not provide a guarantee of returns for investors and is therefore nugatory.

[5] See GAL's responses to CAP1221 and CAP1195

Affordability
Affordability has been a prolific topic across the regulatory sectors, particularly in the water, gas and electricity sectors where increases in bills attract significant attention, not least because they are to a significant extent non-discretionary and clearly fall on individual consumers. In the airport sector, however, there is a less direct relationship between airport charges and passengers, not least (as the Airport Commission demonstrated) where there are significant scarcity rents (evidenced by slots trading at up to $70m at Heathrow[6]). CAA analysis of affordability issues in the airport sector should take account of differences between the airport and other regulated sectors. Any reduction in airport charges at a capacity-constrained airport will therefore only have a dampened effect on affordability for passengers and cargo owners.

Alternative delivery mechanisms
We welcome the recognition that alternative delivery mechanisms, such as Gatwick's commitments, could have a role to play in capacity expansion.

Incentive mechanism
We note the proposal to introduce a licence condition requiring HAL to operate, maintain and develop Heathrow in an economical and efficient and timely manner so as to satisfy the reasonable requirements of users regarding the quality and capacity of the airport.

Such licence conditions are common in regulatory sectors where the regulated company is in sole control of delivering the monopoly service (such as transmission networks). While they could have a role to play in an airport environment, we note that it could be problematic as proposed capacity expansions are more prone to political delay, and under certain circumstances airlines may have an incentive and ability to delay delivery through the planning and regulatory processes.

[6] With the value of a slot being the discounted future value of the congestion rents an airline can earn using that slot. In the absence of capacity constraints a slot has no value.