

ECONOMIC REGULATION AT HEATHROW AIRPORT FROM 2020: PROPOSALS FOR INTERIM
ARRANGEMENTS
CAA CAP 1769 CONSULTATION

Richmond Heathrow Campaign Response - 23 April 2019

INTRODUCTION

1. This document is the response of the Richmond Heathrow Campaign (RHC) to the CAA Consultation on Economic Regulation of Heathrow Expansion as contained in the document: *Economic Regulation At Heathrow Airport From 2020: Proposals for Interim Arrangements - February 2019 CAP 1769*.
2. The Richmond Heathrow Campaign (RHC) represents three amenity groups in the London Borough of Richmond upon Thames: The Richmond Society, The Friends of Richmond Green, and the Kew Society, which together have over 2000 members. The members of our amenity groups are adversely affected by noise from Heathrow Airport's flight paths, poor air quality and road and rail congestion in west London. We acknowledge Heathrow's contribution to the UK economy and seek constructive engagement in pursuit of a better Heathrow. Economic regulation is an important part of this. We are an active participant in the Heathrow Community Noise Forum.
3. Our premise is that it would be preferable to aim for a better Heathrow rather than bigger Heathrow and to capitalise on the world beating advantage of London's five airports, in particular by improving surface accessibility to all five airports, which would be a major benefit to users.
4. Our approach is to continue supporting the case for no new runways in the UK. We believe the evidence produced by the Airports Commission's Final Report 2015 and by the government in the Airports National Policy Statement June 2019 (ANPS) supports this position, even though Heathrow's Northwest runway (NWR) expansion option was recommended in both cases. Our reasoning is set out in our responses to the DfT on the RHC website at www.richmondheathrowcampaign.org.
5. RHC has responded to five CAA consultations on economic regulation- CAPs 1510, 1541 in 2017, CAPs 1610 and 1658 in 2018 and CAP 1722 in 2019. The responses and other material are on the RHC website.

RHC RESPONSE

6. Heathrow has the highest aero charges of any major airport in the world and by a substantial margin. We have argued in the past that this is partly due to Heathrow's excess profits and high cost structure.
7. Heathrow's Excess Profits should be eliminated in iH7. In our response to CAP 1541 in 2017 we estimated, using PWC figures for the Airports Commission, that Heathrow was

benefiting from excess profits of around £300 million in 2016 and that the RAB regulation was not preventing these profits but actually supporting them. In part, these excess profits were due to Heathrow not paying adequately for the environmental costs. Heathrow was also benefiting financially from relatively high gearing with debt and tax relief on interest on that debt which was leading to an unacceptably high equity rate of return. The PwC report - *Estimating the Cost of Capital for H7 November 2017* accompanying CAP 1610, shows that profits regularly exceed the regulatory profit and return on capital by £100 million or more per annum. We believe some airlines concur. We have not updated our estimates but remain concerned that subsequent (e.g. iH7 and H7) price reviews should recognise this anomaly and that they should seek to reduce the excess profits and unacceptably high rate of return on equity.

8. Heathrow's High Cost Structure should be reduced in iH7. We have seen the debate in previous CAA consultations concerning airline excess profits, which the CAA claims the airlines are making on account of the lack of capacity and resultant scarcity rent. Estimates of ticket prices, exceeding 20% of those at other airports on a like for like route basis, have been made by the CAA in previous consultations. But IAG and other airlines claim they are not making excess profits at Heathrow, which is a position we endorse, given the cyclical nature of the airline business over the longer-term. We believe high consumer prices, to the extent they exist compared to competitive airports, are due to Heathrow's high cost structure rather than scarcity rents or demand.
9. The CAA is statutory charged with ensuring the consumers (passengers and freight users) do not overpay and that they receive a quality service. It is not clear why the CAA would accept commercial arrangements between the airlines and Heathrow (as provisionally supported by the consultation) that perpetuate the excess consumer prices that the CAA believes exist. Normally, the CAA cannot influence airline ticket or freight prices but the agreements between the airlines and Heathrow for iH7 introduce a link between consumer prices and Heathrow's aero charges, which arguably provides the CAA with lawful means, using Heathrow's regulatory licence, to influence consumer prices. Otherwise, the proposals for iH7 merely perpetuate the existing consumer prices that the CAA says are high due to lack of capacity and excess airline profits but in our view are high because of a high cost structure. It is not in the interests of the airlines or Heathrow to reduce the prices charged to consumers. We question whether the agreements between Heathrow and the airlines do bare down on Heathrow's costs but instead provide a cloak of commerciality that does not exist.
10. Clearly, the CAA and government see the addition of capacity is the way to reduce the congestion charge said to be included in the consumer prices. In our view, this approach fails to address the more fundamental issue of Heathrow high cost structure. We suggest the opportunity is missed in iH7 to reduce Heathrow's high costs being fed through to consumer prices.
11. The Regulatory model should cease supporting international-to-international (I-I) transfer passengers in iH7. We have made the case in RHC's responses to previous CAA consultations that I-I transfers do not provide economic benefit to the UK and that their

contribution to supporting unviable routes is a myth. This is based on detailed analysis RHC has undertaken using CAA statistics. We repeat that in our view the regulatory model is supporting financially a segment of Heathrow's consumers that is not warranted. Heathrow allocate the aero charge to different segments of the market - one of which is I-I transfers. We believe the total aero-charge should be re-balanced between market segments in iH7 so as to reduce the charges made to terminating passengers and freight users.

12. We note from the consultation that the in principle the CAA sees the iH7 as a two year extension to current Q6 pricing ending in December 2019 (already extended by one year) but with some flexibility to deal with results deviating from the estimated RAB building blocks. We have provided three reasons above why RHC believes iH7 should be more radical in reducing charges - Heathrow's excess profits, high cost structure and inappropriate support of I-I transfers. As we say earlier, part of the excess profits are due to a failure of Heathrow to mitigate the environmental costs to local communities.
13. RAB pathway versus agreements between airlines and Heathrow. We support in principle more direct competition and the idea of agreements between the airlines and Heathrow, if these agreements were to achieve the more radical approach we recommend. We note that the consultation is about comparing the RAB and agreement approaches. Also, we note that the latter would result in early rebates to the airlines, although seemingly the RAB approach might produce a similar result but over a longer period. However, neither approach seems to bare down on the aero charge as much as we would suggest is necessary to neutralise Heathrow's monopoly position. Ticket prices will be little changed, other things being equal.
14. Risks. Ticket prices are vulnerable to the unchartered risks ahead, partly on account of Brexit but also Heathrow's major expansion with a 3rd runway. We believe Heathrow and its shareholders should be responsible for the risks of delay and project complexity, and that the associated costs should not be a burden on the airlines and in turn on the consumer as category B and C costs. While the subject of risk is dealt with in the consultation, we think it needs to be developed further.
15. Heathrow Expansion. While H7 is intended to deal with Heathrow expansion there are interfaces between the current Q6 regime, iH7 and H7. The points we make above about iH7 should be taken forward into H7 as well. To the extent consideration of excess profits, high costs and imbalance in allocation of aero charges is deferred, the more the problems are embedded. The NPS says the charges with 3R should not increase in real terms. We have argued previously and continue to argue that they should decrease. In theory, we suggest the economic regulation should ensure this happens and then it is up to HAL to achieve a lower targeted aero charge and a challenging target should drive out inefficiencies.
16. According to the Airports Commission, Heathrow's aeronautical charges could rise from £22.53 per passenger in 2014 to an estimated £31.20 with expansion (£ real 2014). This compares with around £9 at Gatwick, £12 at Schipol, £8 at Dublin and Manchester and

£11 at New York JFK, for example. We argue, given our comments above, that £22.53 is far too high as a base. We note the 'Required Aero Yield' in Table 1.1 of the consultation is £22.29 and £21.97 in 2020 and 2021, respectively using the RAB model's RPI-1.5%, £19.94 and £20.49 using CAP 1658 (Heathrow's estimates) and £17.46 and £16.94 using CEPA's estimates. It is not clear from the consultation which, if any of these, might be the base for the aero charge going forward with 3R expansion. There is the question as to how reliable are iH7's aero charges as a guide or base for subsequent aero charges with expansion. We believe the iH7 charges are too high and will provide a platform for high 3R aero charges in the future. Moreover, in the absence of airline scarcity rents the airlines will not be able to offset the high aero charges but instead will have to pass them through to the consumer.

17. We know that the airlines are against pre-loading the aero charge before first flight from the 3R. The issues we have raised here about Heathrow's current high charges arguably in effect could amount to Heathrow pre-loading the charges. iH7 pricing as proposed, apart from resulting in overcharges to consumers in 2020 and 2021, could continue the inbuilt excesses in the longer term.
18. We agree that there are advantages of an iH7 "lite" as outlined in the consultation but there are disadvantages we have highlighted here. We respectfully suggest the CAA should better recognise and respond to these deficiencies in iH7.

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