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18th August 2020

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

Dear Rob,

Re: Response to Economic Regulation of Heathrow – CAP 1940

Thank you for the opportunity to respond to the CAA's consultation, updating on the latest developments at Heathrow. This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community").

This submission sets out agreed principles and outcomes that we believe the CAA's policy should aim to address. Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

<u>The H7 Programme</u>

As set out in the Airline Community's response to the CAA's CAP1914 we continue to:

i. support developing the H7 price control for a two-runway airport and on the basis of a five-year period. We would be open for the length to vary but only where: (i) there is a clear case and benefit for doing so; and (ii) a suitable framework is in place;

ii. remain of the view that any re-start of Heathrow expansion is highly unlikely to be feasible in the H7 period. The CAA states within CAP1940 that "*we intend to retain the option of dealing with Expansion by adjusting or resetting HAL's price control*"[1]. If and when an Airport National Policy Statement ("ANPS") is in place we suggest this should be dealt with separately at the time, and possibly remain outside of the existing Heathrow RAB at HAL's risk;

[1] CAP1940 para 1.14

iii. be strongly of the view that, in response to HAL's suggestion of a *'commercial deal'*, the underlying price control needs to be set in a robust manner to ensure that Heathrow, as an airport with substantial market power, remains regulated in a manner appropriate to protect users and consumers of its services;

iv. note that in finding the right balance of addressing risk and reward within the regulatory framework such consideration must be based on a true 'risk sharing' proposition and cannot seek to de-risk HAL completely nor be considered solely in isolation of other aspects of the overall framework and building blocks.

A key assessment and determinant in our view of these uncertainty mechanisms will be (1) the extent to which it provides certainty and control; (2) ensures HAL remain accountable; (3) are based on validated plans; and (4) the impact on the amount of risk assumed to sit within the cost of capital and on the level of airport charges.

We would add that we do not recognise HAL's assertion set out within CAP1940 that the current regulatory arrangements do not address risk and reward appropriately. We note that HAL have benefited throughout Q6 from such arrangements, including the over-achievement of the regulatory WACC by £844m despite a continued fall in the cost of debt throughout the period and award of over £3.5bn in dividends – not including the £100m paid out in April of this year. It is clear that HAL has been compensated and rewarded for the risk it has taken;

v. see the value in using 'scenarios', both in the development of a meaningful Business Plan(s) as well as a possible mechanism for dealing with uncertainty within H7. We therefore support the CAA's position with CAP1940 that *"the development of meaningful scenarios as a fundamental starting point for the development of 'joined up' outcomes in respect of capex, opex and commercial revenues in the RBP"*[2] is necessary – this is covered further under 'Developing HAL's Revised Business Plan; and

vi. support the CAA's intention of having greater involvement within Constructive Engagement.

The Airline Community note that re-building passenger volumes and restoring consumer confidence will be critical during this H7 period. As the impacts of the Covid-19 pandemic on Heathrow, aviation and the wider economy become more apparent, we expect an even greater focus by consumers on price, service and value-for-money. We welcome therefore the CAA support within CAP1940 that affordable airport charges will be key to supporting recovery. We also strongly believe HAL must be specifically tasked in addressing this, particularly given current charges are amongst the highest in the world, through ensuring opportunities for efficiencies are targeted and realised and capital expenditure is kept to an appropriate and required level.

With regards to managing airport charges, we do not in general support the use of the RAB as a mechanism to defer increased charges over the long-term[3]. Any specific proposals will need to clearly demonstrate real consumer benefits and any such 'regulatory mechanisms' should only be considered once HAL has demonstrated it has exhausted all opportunities within its own control.

[2] CAP1940 para 1.26
[3] CAP1940 para 1.33

We note the CAA's comments within CAP1940 with regards to the importance that HAL can be 'efficiently financed'. The assessment of this can only be assessed on core, regulated operations based upon the notional debt to equity structure set in the regulatory settlement. HAL's financing strategy appears to rely on an ever-expanding Regulated Asset Base ("RAB") and raising debt at levels far above notional company as set out in the license, the risks of which must be borne by HAL. These effects are distinct from the question of "financeability" of the regulated business, and we believe debt levels should ideally be more prudent, as was envisaged in the regulatory settlement.

Finally, we would note our support for the CAA's focus on ensuring the interests of consumers are at the heart of the regulatory process. To that end we would suggest explicitly referencing within the overall objective for H7 that supports recovery, as set out in para 1.41, the importance for affordable charges for *"consumers"* as well as airlines. This is an area we continue to evidence through Constructive Engagement and to that end attach our presentation as of 20th August as Annex A in support.

Developing HAL's Revised Business Plan

The Airline Community believe that the CAA should ensure that HAL's costs and revenues are reviewed on a detailed bottom-up basis to best inform the price control decision. The CAA state that "*we expect that Opex forecasts for H7 should be capable of reflecting significant changes in the levels of staff between terminals and activities" and "we expect the RBP…to contain opex estimates for each planning scenario at a level of detail that facilitates understanding of changes in relevant activities*"[4]. We expect HAL to comply with the CAA's requirements in the development of scenarios during Constructive Engagement on this basis and that they are then included in the RBP and any subsequent iterations thereafter.

With regards to scenarios, as set out under "The H7 Programme" above, the Airline Community are supportive of the CAA's approach and the requirements on HAL to develop such, as set out in CAP1940.

We do not however believe HAL's 'bookend approach' adequately addresses the scenario concept envisaged and therefore we strongly encourage the CAA to seek to address this, particularly given the limitation of time within Constructive Engagement. It is important that the scenarios should cater to a range of outcomes and should not be limited to simply producing "book-ends" with a prejudiced assumption on the opening RAB position built into the figures.

In order to support the meaningful development of scenarios, the Airline Community presented our latest thinking at the Regulatory Framework Constructive Engagement session on 13th August 2020 at which the CAA were in attendance. We believe this approach goes towards addressing the questions and outcomes the CAA are looking for.

The development of these scenarios should also help inform the required fuller debate of uncertainty mechanisms within H7 being considered, for example the extent to which offsetting the capital plan or traffic risk-sharing negates the need for re-openers.

[4] CAP1940 para 2.19

We are also supportive of the CAA's positions for enhanced business case analysis and understanding operational resilience both of which will be important aspects in developing a Revised Business Plan ("RBP") given their importance to airlines and consumers. HAL's 'top down' 'bookend' review must not be allowed to be a barrier to meaningful engagement on these, and other, topics.

With regards to Outcome-Based Regulation ("OBR") we agree with the CAA's position that HAL should "*as a minimum…focus on delivering consumers' and airlines' core needs and priorities*" within the RBP and that future scenarios should outline the levels of service quality that consumers and airlines could expect[5].

The Airline Community remain committed and see a demonstrable high value in the existing components of the Service Quality Rebate Bonus Scheme ("SQRB"). Not only has it played a key role in significantly improving and maintaining good levels of service from HAL within the Q6 period but it has help ensure HAL remain accountable and focused on ensuring core operational elements delivered by airlines and required to meet consumer expectations also continue to be delivered. We believe this must remain a key part of any OBR measures, targets and incentives within H7.

With regards to 'continuous improvement approach' referenced in CAP1940 we believe this requires much further development. There is already the mechanism for allowing such changes within the existing framework however the incentive for HAL to do so is not there. To that end we would highlight our experience to date with HAL in their response to the short-term changes in updating the SQRB scheme which shows an attitude that seeks to unreasonably remove any risk and therefore accountability on targeting itself to deliver the appropriate outcomes for consumers.

Finally, we note that the CAA has produced updated guidance in CAP1940 regarding the requirements for a high-quality RBP and we are fully supportive of this as a goal. We are concerned however whether: (i) HAL will ultimately fulfil this, particularly given the limited detail provided so far; and (ii) will do so in a timely manner to enable effective airline scrutiny and engagement in developing the RBP. We would urge the CAA to ensure HAL are addressing these concerns as HAL develop their RBP and not wait for the RBP itself to make that assessment.

Efficiency Incentives: Capital Expenditure

The Airline Community welcomes the CAA's review of capital efficiency incentives for HAL, noting that this is an area of development. We see that the CAA's Working Paper (CAP1951) and ongoing engagement throughout Constructive Engagement will allow for greater understanding, discussion and development which we look forward to engaging with you on. The outcome of the CAA's Q6 Capital Efficiency review will also further shape the Airline Community's views on this topic. Notwithstanding this we would note the following:

The Airline Community are supportive:

i. of the evolution of the Q6 Development & Core process, including the use of meaningful Gateways; the requirement of right-sized airline governance and in particular the requirement for airline 'approval'; and the role of the IFS. We would not wish to see a rolling back on any of these aspects;

[5] CAP1940 para 2.36

ii. of HAL being accountable to delivering 'benefits' as opposed to merely the capital elements of programmes. We note the CAA's concept of 'delivery obligations', the principle of which we are supportive of although believe this is an area that requires further understanding and development as to how these might work in practice including the different cost categories;

iii. reconciling incentives during the H7 period so as to avoid the difficulties of reviewing projects at the end of the period when a considerable length of time may have passed by then; and

iv. setting a cost baseline and developing a framework that then allows for a flexible approach, taking into account other changes, either in relation to cost reviews or total capital expenditure for example

We do however also have concerns on some aspects of the proposals within CAP1940 in that:

i. the size and shape of the H7 capital plan will be very different from that envisaged within the Initial Business Plan where largescale capital projects related to expansion were to be undertaken. Indeed, given the impact of COVID-19 a 'low case scenario' in particular will likely see minimal capital expenditure with a focus on sweating existing assets and seeking to drive costs down. As such, whilst supportive of the intentions, we question the extent to which ex-ante is necessarily appropriate, particularly without understanding the potential complexities and costs in administrating versus the gains it may bring;

ii. similarly with point (i) above, the treatment and incentivisation of different cost categories needs to carefully balance its effectiveness with an ability to appropriately administer. With regards to the incentive rates themselves, we are particularly concerned that the CAA refer to an ex-ante rate of 13% in Q6 that needs to be higher in H7. Cost categories must be transparent, promote efficiency, and not be treated as a simple overlay onto projects that already have a 15% rate in for 'leadership and logistics; and

iii. we are not supportive of making triggers "symmetrical". HAL should be seeking to deliver projects in a most timely manner in order to deliver benefits to an agreed balance of cost and timeliness. These dates are ultimately determined by HAL who hold the monopoly on information. Without full disclosure of information or an 'Airline Community appointed IFS' (as opposed to 'jointly') – and even then there would be further hurdles to overcome – rewarding early delivery runs the real risk of HAL being able to 'game'.

With regards to triggers we would add here that we would also refute the statement in the CAA's CAP1940 webinar that *"trigger payments penalise HAL for late delivery of projects"* and would counter that triggers are there to compensate consumers and airlines with a rebate for not receiving a benefit or service beyond the period of time proposed and agreed to by HAL when they would otherwise be making a return; and

<u>Financeability and the Cost of Capital</u>

The issues and questions raised by the CAA in CAP1940 on this matter have been addressed by CEPA in consultation with the Airline Community in the report attached Annex B.

Regulatory Treatment of Early Expansion Costs

The Airline Community does not support the CAA's proposed approach on early expansion costs.

Firstly, this approach fails to recognise the significant differences between Category B and the early Category C costs. The Airline Community were explicit throughout its engagement on expansion that expenditure on early Cat C costs was at HAL's risk, which subsequently manifested. Other than in the case of some exceptional circumstances, the Airline Community never approved any such costs. This position was not least informed due to HAL's failure to provide a credible, risk assured end to end schedule, as required by the Airline Community. The Airline Community were consistent in its challenge on HAL working to an unrealistic 2026 date, and the subsequent works by the CAA and IFS supported such, yet HAL continued to incur such costs supporting this timetable and without agreement. The CAA must recognise the different situation between Category B and early Category C and should conclude that early Category C cost should not be admitted onto the RAB.

We note that the DCO has not been successful and whilst HAL would in any other environment be liable for the entirety of such costs, HAL should as such only be able to recover 85% of efficiently incurred spend related to Cat B and that furthermore any expansion costs added to the RAB only done so at the cost of debt.

The Airline Community are also concerned that the £500m is still to be finalised and subject to upward pressure with no clear incentive, nor governance on HAL to mitigate this based on the proposals within. For clarity we are assuming that the figure assessed includes the monies already paid through aeronautical charges and is not solely the amount the CAA expect to allow onto the RAB.

With regards to future costs associated with expansion and its appeal, following the quashing of the Airport's National Policy Statement (ANPS) it is HAL's right to appeal the judgement. However, given the lack of Government support and therefore clear policy, it is clear that any future costs HAL incur would now fall under the definition of 'Category A expenditure', as defined in CAP1469, and therefore must be at HAL's own expense.

Finally, the Airline Community would highlight that over £1bn has been added to the RAB for such expansion schemes for which neither airlines nor consumers have received any benefit to date, whereas HAL will continue to be financially rewarded via a return being earnt. The CAA cannot allow this to continue and must look at finding a more balanced approach to risk and cost between HAL and consumers.

We look forward to discussing and developing further with yourselves the points set out within this response. In the meantime, if you have any questions on this airline community response please do not hesitate to contact us.

Yours sincerely,

Simon Laver
London (Heathrow) Airline Consultative Committee

Nigel Wicking
Chief Executive
Heathrow AOC Limited

Annexes

(Documents provided via email)

Annex A – IATA Assessment on Near Term Yields and Air Fare Trends, as presented during Constructive Engagement in response to the Importance of Affordability for Consumers

2020.08.18 - Airline
Community Response

Annex B – CEPA Report on Financeability and Cost of Capital

2020.08.18 - Airline
Community Response