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**Response to the CAA's Consultation on the
Economic Regulation of Capacity Expansion at Heathrow:
Policy Update and Consultation**

CAA CAP 1722

11th January 2019

Introduction

The Airline Operator's Committee (AOC) and the London Airlines' Consultative Committee (LACC) welcome this opportunity to respond jointly to the CAA's consultation on the economic regulation of capacity expansion at Heathrow Airport (CAP 1722). In this response we also include our response to the work commissioned by the CAA from FTI Consulting on scarcity rents at Heathrow Airport (LHR).

Where possible, our response follows the structure of the CAA's consultation documents. The airline community at LHR also makes the following general comment:

The airline community at LHR supports the principles of Better Regulation. However, we are becoming increasingly concerned that in its efforts to minimise regulatory burden, the CAA may have lost some focus on its primary duty to *'further the interests of users of air transport services'*¹. For example, the CAA's indecision on the length of the Q6 / iH7 price control, and the lack of clarity around how it will compensate our passengers for the extension of an increasingly loose price control has forced the airlines to attempt to negotiate a commercial deal with HAL.

It is a very basic tenet of economics that a negotiation with a party that holds SMP is very unlikely to lead to the efficient and fair outcomes that come from competitive markets. Indeed it is the very *raison d'être* for economic regulation. We are surprised therefore that the CAA sees real merit in such an approach.

If and when the third runway programme at LHR is completed HAL will be a very significant regulated business. We believe it will be the second largest regulated business in the UK by RAB value. In such circumstances, our passengers will deserve a strong economic regulator that is proactive in protecting their interests. It is important that the airline community at Heathrow, and our passengers have a regulator that inspires confidence, and that we believe has the capability and the will to impose strong regulatory outcomes on the licence holder at LHR. We would urge the CAA to consider how best it can build the confidence in its capability and will to do so.

¹ Civil Aviation Act (2012)

CAP 1722

Chapter 1 – Overall timetable and interim price control

The airline community has significant concerns with respect to the CAA's proposals in this Chapter. We are particularly concerned with the CAA's proposals that commercial bi-lateral deals could take the place of an interim price control. This seems to us, however well intentioned, to be inconsistent with the CAA's duties, potentially harmful to the consumer interest and to be based on a misunderstanding of the reason for the ex-ante price control of HAL.

We are clear that any deal should be seen in context, and for what it is – a rational response to the situation that the airlines and their passengers have been put in by the CAA. It is clear from the CAA's own analysis that HAL has significantly outperformed the Q6 control. Furthermore, this outperformance was not unforeseen. HAL's performance in terms of say passenger numbers is much closer to the airline community forecast for the Q6 period, and the airline community had warned the CAA that its opex settlement was too high. In short, it is arguable that the Q6 control was both generous to HAL and foreseeably so.

It is also clear that it is expeditious to allow a limited extension of the Q6 control, and that the timetable is fluid, giving rise to a real risk that future extensions may be required. The CAA's current policy is to roll the Q6 control on, and for some kind of truing up mechanism to be imposed (although how remains unclear) at some point when the H7 control would begin.

Airlines at LHR find themselves operating from what is by the CAA's own admission an airport where charges are high, within the context of a generous price control with an uncertain end, and an uncertain mechanism for truing up a part of the overpayment in a small number years. Airlines also operate in a fiercely competitive environment. Consequently, it is not surprising in this context that airlines may attempt to do a 'deal' with the monopolist who holds SMP over them, so that they can claim back at least a portion of the over-payment, and therefore re-invest in their product and continue to compete with airlines, including those operating elsewhere for passengers. This does not mean that the negotiations are preferable, or optimal, but that they are simply a rational response to the uncertainty of the expansion and regulatory timetable, the CAA's indecision, and the continuation of a price control that over-rewards HAL.

Within the context of airlines being ‘forced’ to negotiate with HAL by a failure of CAA policy and regulation, we have a number of concerns. For markets to work well, one of the conditions is, broadly, that there are a large number of buyers and sellers. Each is able to contract with the other. The competitive interaction between the buyers and sellers, each having the option to walk away and find a better deal, is what leads to a competitive outcome. This is not the case at LHR. HAL is a monopoly supplier to the airlines at LHR, and by the CAA’s own findings it has Substantial Market Power (SMP).

An SMP finding means not just that HAL has a monopoly position, but that it has the ability to exploit that position to the detriment of consumers. In such circumstances regulators deploy ex ante controls eg price capping, precisely because the risk of abuse is so great that reliance on normal competition law as a remedy is insufficient.

Given HAL’s SMP over the airlines at LHR, any commercial deal cannot be as optimal for consumers as a robust and properly applied price control. For the CAA to argue that such deals would start to ‘*move the relationships between the airport and the airlines to a proper commercial footing*’², given the continued existence of HAL’s SMP is both concerning and fails to recognise both the nature of the market and the purpose of economic regulation. The protection of the consumer interest from abuse that stems from HAL’s SMP is the very essence of the CAA’s *raison d’être*.

The CAA has already stated that it would need to assure itself that any commercial deal was in the passengers’ interests. The airline community fully supports this position, and would encourage the CAA to ensure that it applies its appraisal rigorously. As such, the CAA must state what its process will be; what the timelines are; what the objective tests are; the evidence it will consider; and the burden of proof required. For the avoidance doubt we expect the CAA’s assessment to be rigorous and the burden of proof associated with it to be objective, robust and consistent with a rigorous and defensible decision.

We are also concerned about the ability to enforce the regulatory settlement and any commercial deal. Different terms applied across the airport would make enforcement both complex and more difficult. In addition, a ‘commercial deal’ would, most likely be enforceable through the Courts, and not through the CAA’s enforcement procedures. This could impose costly burdens on the airlines, and remove those areas in the negotiated contract from the licence breach and enforcement tools at the CAA’s disposal. Consequently, the airline community requests that if any deals are agreed, that they become part of HAL’s licence, and

² CAA, CAP 1722, para 16

can be enforced by the CAA through the licence. We understand that the commercial detail of any deal would need to be held privately and confidentially and would not be subject to public scrutiny.

We are also concerned with the interplay between any commercial deal and the regulatory settlement. Most commercial deals between airlines and airports in a competitive market typically take the form of discounts for volume or incentives to grow. Assuming that is the case at LHR, then presumably HAL will face lower demand risk as it is incentivising the airlines to grow volume or at least not reduce them. If this is the case, then HAL's demand risk would have reduced. The CAA will need to take account of the impact of this on HAL's WACC as part of its assessment.

Finally, we are concerned that any 'commercial deal' may be seen to be a precedent for the reduced economic regulation of HAL, and a move to a 'Gatwick style' of regulation at LHR. We believe that a 'Gatwick style' approach would be wholly inappropriate for the regulation of HAL, and that any 'commercial deal' should set no precedent for either a move to such an approach or a lightening of the economic regulation of HAL.

In terms of the overall timetable for the next control period and the ending of the extension to the Q6 control, the airline community notes that HAL still have to show conclusively that their new proposed timetable is robust to slippage.

Given the need for an extension to the Q6 control to what in total would be 3 years, and the likelihood of further extensions, the airline community believes that the CAA must explore other approaches. We renew our objection to the CAA policy of maintaining RPI-1.5 for each roll over year, and then somehow truing up through regulatory depreciation. We note that this is not a full 'truing-up' as the CAA will not re-open all building blocks, and those that are re-opened will not apply to all years. Consequently, the CAA is simply allowing excessive returns to be accrued by HAL, which must be to the detriment of passengers. We also note that the CAA has been unclear as to how they will 'true up' – we have been told that an adjustment will be made to regulatory depreciation. But on what basis, using what discount rate, and over what time period?

We also note that the CAA have been unable thus far to explain why their proposed policy to allow HAL's shareholders to experience excess returns and then claw part of them back in the future is preferable to just setting the right control, reducing prices and allowing the airlines to

invest for their passengers. Given that the CAA's primary duty is to the passenger rather than HAL's shareholders this strikes us as curious.

We argue that the continued uncertainty around the expansion timetable and the CAA's approach to extending the Q6 control is not in the passenger interest. The CAA must examine all approaches to protecting the passengers' interest. In this context we urge the CAA to give very serious consideration to the contingent approach adopted by the Commission for Aviation Regulation (CAR) for Dublin airport.

It seems to us that the CAA could set two price paths – one for business as usual at LHR, and another that would kick in at say the granting of a DCO. This would give all parties certainty and allow the setting of a price control that would be more in line with furthering the interests of passengers.

Our final comment on this Chapter revolves around the proposed regulatory timeline and the requirement for HAL to issue Business Plan. We firmly believe that it is preferable for the CAA to return to the structure of the earlier proposed timelines where HAL would be asked to produce two Business Plans. This is because given the expansion timeline, the amount of capex at risk is likely to be more significant than in previous plans, there is a significant risk of change, and it would provide a better level of transparency and audit for what are decisions of great importance. In addition, a second 'final' Business Plan would have the benefit of pulling together all the proposed updates and new data highlighted by the CAA, into one document, allowing a proper holistic consideration by all parties.

Chapter 2 – Promoting economy and efficiency

The airline community supports any drive within the CAA to make HAL more efficient, and in principle we do not object to the CAA imposing a licence condition on HAL to make it behave in an efficient way.

However, we do have a number of observations and concerns about the wording, focus and scope of the proposed licence condition, how it will work in practice, and how it will interact with the way in which the CAA discharges its other duties and powers.

We agree with the CAA that any condition should further consumers interests by not exposing them to inefficient costs. However, we are not convinced that the condition should be focused solely on how HAL runs its business rather than what it produces. We note this also seems to

run counter to the CAA's pre-occupation with outcomes rather than inputs in terms of service quality.

The CAA state that they '*recognise HAL's view that the commercial pressure that the airlines apply to HAL to be efficient does have an impact*³. While we are delighted that our role in helping HAL be more efficient has been recognised, we would counsel the CAA that:

- i. we are not satisfied that HAL is an efficient operator, and believe that further efficiencies can be made;
- ii. the airlines 'pressure' on HAL to become more efficient is limited by lack of airline resource, information asymmetry and HAL's SMP; and that
- iii. engagement with the airlines is not a sufficient condition for an efficient HAL, or a substitute for strong intervention from the CAA.

We also caution the CAA that a new licence condition should be seen as something that is in addition to their existing powers, rather than instead of. In other words, the adoption of the proposed licence condition should increase the pressure on HAL to be made more efficient. The airline community has always maintained that the Q6 control settlement was generous to HAL, and we believe that had the CAA set more challenging targets for opex, and was more rigorous in its application of the efficiency test for allowing capex into the RAB, that HAL would already be more efficient than it is today. We would not wish to see an efficiency licence condition become part of a rationale for future loose price controls. Rather it should signal a tougher CAA that is better equipped and more determined to further the interests of passengers by creating an efficient licence holder at LHR.

In short a licence condition will not make HAL efficient. The CAA must enforce it rigorously. As part of that the CAA must be clear by what it means by key terms such as 'efficient', what its objective tests will be and that it will not suffer from information asymmetry when applying the tests. Furthermore, in order for the condition to be effective, the CAA's desire to enforce the condition must be seen as serious and credible by HAL.

In terms of the proposed licence condition itself we have a number of concerns and comments:

- i. In its current form the condition is too broad. HAL is asked to '*secure the of Heathrow Airport*⁴' (our emphasis). This could be interpreted as requiring HAL to ensure the economical and efficient operation of all businesses at LHR (eg airlines, UK Border Force, Groundhandlers etc). This of course is beyond

³ CAA, CAP 1722 para 2.11

⁴ CAA, CAP 1722 para 2.16

HAL's control, and it seems unfair to ask HAL's management to act in this way. It could also be seen as the unintended interference in the running of competitive business by the CAA, and contrary to Better Regulation Principles;

- ii. it is unclear what the terms 'economical' and 'efficient' mean and how the CAA will test HAL spend and activity against the terms;
- iii. similarly what does 'timely' mean?;
- iv. there is potential a conflict between condition (a) which appears to be about the day to day operation of the airfield, and (b) which seems to be about development. How will the CAA resolve issues around for example running the airfield as is, at a lower cost and growing the airfield? How will it deal with conflicts between spending large sums to grow quickly, against smaller sums and growing more slowly?;
- v. in terms of capex versus opex how would the CAA resolve issues between say spending on new capacity and the ongoing costs for operating the new capacity?;
- vi. any condition should also give the airlines the assurance that it will be without degradation of service (to take an extreme example HAL could become more efficient by closing all but 1 control post, but that would have significant adverse effects on service standards, the operation and resilience of the airport, and airlines ability to deliver the services our passengers have paid for);
- vii. we note that there is nothing in the condition about effective spend. We would urge the CAA to add this to ensure that HAL activity is not only efficient but delivers what its customers want and need.

For the avoidance of doubt the airline community, whilst fully supportive of the CAA looking to improve its capability to regulate HAL in a stronger way, strongly objects to, and will not support, any proposal that has the consequence of extending economic regulation and/or HAL oversight and control into our businesses. We would urge the CAA to redraft its licence proposals so that it is clear that the licence conditions apply solely to HAL and the goods and services that HAL provides within the context of economic regulation.

In addition to these concerns, to the extent that HAL is not already operating efficiently, and to the extent that investors could reasonably expect any such licence condition to bite, in theory at least, HAL's risk profile could change. We wonder whether the CAA has conducted any cost-benefit analysis of the likely improvements in efficiency that could be made (over and

above the CAA setting tougher price controls) with the increased risk (and therefore potentially a higher WACC) for HAL.

In summary, the airline community is supportive of seeing a more efficient HAL, and for the CAA to have the tools to make that happen. And thus, in principle, we are supportive of the CAA's proposals. However, in practice an economic and efficient licence condition cannot be instead of setting tight price controls, and we have concerns that the current drafting has the effect of extending economic regulation into airline operations – and we cannot support that. We urge the CAA to redraft its proposals and think carefully about how it will give real effect to the condition by defining the terms closely, laying out the objective tests it will use and imposing the data requirements on HAL so that it properly test HAL's levels of efficiency and economy.

Chapter 3 – Alternative delivery arrangements

The airline community supports the CAA's intent in asking HAL to explore alternative commercial and delivery arrangements. We agree that the focus (within the context of affordability) should be on the efficient and cost effective delivery of capacity, and that exploiting greater competition could be an effective way of securing the interests of our passengers are protected.

The airline community at LHR is keen to explore ways to bring greater competition and improved governance to bear, to deliver a more efficient and cost efficient Heathrow Airport for our passengers. It is an accepted tenet of economic theory that competition drives efficiency, and that fierce competition amongst airlines is what drives us to deliver for our passengers. It is logical therefore that we should explore the extent to which the benefits of greater competition can be brought to bear in the expansion of Heathrow Airport.

It is in this context that the airline community proposed a Buildco type approach, as we believe that such an approach could yield benefits. In our initial discussions with HAL, they have been open to exploring the idea further. Recognising the CAA's position that at the current time it will focus on progressing the Arora Group scheme the Airline Community believes that the BuildCo concept can best add value drawing on the competitive dynamic between HAL and the Arora Group. We will work to further develop this concept and understand how it can be applied to the HAL and other schemes.

In particular we see real benefits in a focus on capital efficiency and challenging the willingness of scheme promoters/builders to take a lower WACC and deliver Expansion for the most

efficient cost to the consumer. This better aligns the allocation of risk to the scheme promoter/builder who has the greatest degree of control over these costs and is therefore best placed to take those risks. The airline community therefore invites the CAA to discuss the BuildCo idea with us, and to work with us to develop the idea and explore its merits.

With respect to HAL's Innovation Partners scheme, we do not understand the CAA's position. Like the CAA, we do see some merits in the scheme. However, we also have some concerns. Like the CAA we are clear that the Innovation Partners Scheme does not meet the criteria laid down by the CAA's April 2018 consultation. For example, for any proposal to come through HAL's scheme, it must meet HAL's strategic objectives. To the extent that HAL's shareholders' interests may not align with the interests of consumers, this seems to us to introduce a potentially significant and negative externality into the process.

It is clear that the CAA does not believe that HAL's Innovation Partners Scheme does not meet all the criteria that the CAA set down. We are puzzled therefore that the CAA's response to this is that *'HAL should properly justify its approach to these matters'*⁵. Given that the CAA has been aware of the way that the Scheme was set up we are surprised that it has waited until now to comment, and that it has not taken a stronger approach. This to us, could be seen as being symptomatic of the relatively reactive/laissez faire way in which the CAA has chosen to discharge its duties.

Chapter 4 – Surface access

The airline community strongly supports the CAA's view that it should adopt a user pays principle. This seems to us, to be the most effective way of ensuring that passengers pay for (assuming that the surface access capacity is delivered and designed efficiently and economically) only what they use.

We strongly disagree with any weakening in the application or interpretation of this principle. For example we strongly disagree with the comments from TfL, who argue for a wider interpretation of this principle and the CAA's primary duty. We would remind the CAA that in the context of expansion it is an economic regulator not an environmental one. Its role is to protect consumers from the abuse that stems from HAL's SMP. It is not to help TfL or the Highways Agency further the execution of their environmental duties or to bankroll those Agencies.

⁵ CAA, CAP 1722, para 3.18

We would also remind the CAA that it has previously confirmed in response to previous consultations that the passenger would not act as the ‘lender of last resort’, and we would urge the CAA to remain true to this commitment. Part of this commitment means that rather than funding the residual, the CAA must assure itself of a positive case for expenditure. As part of that, it is the CAA that will determine how strictly the user pays principle is applied and what the final bill is. It is not for HAL or TfL to ‘demonstrate’ as the CAA states, but rather for the CAA to positively assure itself that any spend is consistent with the user pays principle.

CAP 1722b – ‘A Critique of Published Reports Regarding Scarcity Rents at Heathrow Airport’ FTI Consulting

The airline community at Heathrow Airport maintains its position and strongly contests any suggestion that it earns scarcity rents at Heathrow Airport. Furthermore we maintain that there is no objective evidence to the contrary, and that the studies which attempt to show scarcity rents are methodologically flawed, and often contain other errors of analysis.

In terms of the FTI critique of the Frontier study, the airline community supports the following points drawn from the FTI study:

- the finding that *‘Frontier’s econometric analysis of the ‘congestion premium at Heathrow Airport is not sufficiently robust’*
- rather than modelling scarcity rents themselves, the Frontier analysis adopts a residual approach, which is likely to overstate any scarcity rent, by confusing residual errors with scarcity;
- the distinction between seats and capacity (we will return to this below);
- the use of aggregate data – we have commented on this in the past – especially the risk of aggregation errors (Simpson’s Paradox), and the issues of data quality and availability;
- a lack of diagnostic data to demonstrate that the modelling is robust to modelling issues and that the results are reliable;

However, we also find that there are further errors in both the FTI and Frontier work.

Error 1: the allocation of scarcity rent

The common narrative in the studies that purport to show that airlines at Heathrow earn scarcity rents is:

- i. LHR is full therefore scarcity rents must be being earned by someone;
- ii. HAL are price controlled so it can’t be by them;

- iii. therefore airlines must be earning the rent.

In the context of this particular discussion it is point ii of the narrative that is our focus. The argument made is that because the CAA caps HAL's charges with a price control that HAL cannot capture any scarcity rent that might exist. This is simply not logically correct.

For the avoidance of doubt, whilst in the following discussion, we assume scarcity rents at LHR, this is solely for purposes of highlighting a conceptual error in the Frontier and FTI work. We continue to reject any suggestion that we earn scarcity rents at Heathrow.

The price of a flight to a passenger is set by fierce competition between airlines in the market. If HAL were not price regulated by the CAA it would be free to decide on its own pricing, and indeed raise prices and capture any rent if it chose to do so. Similarly, when it sets a price control the CAA is effectively deciding on the distribution of any scarcity rent between HAL and the airlines.

In this context, the airline community makes the following observations taken from the CAA's own analysis:

- i. LHR's prices are considerably higher now than they were even a decade ago;
- ii. LHR is the most expensive airport of its type in the world; and
- iii. HAL have consistently and significantly outperformed the Q6 settlement.

This would seem to us to be sufficient *prima facie* evidence to warrant further consideration on whether HAL is earning scarcity rent. And indeed, if that were the case then if there were scarcity rents at LHR then they are being captured by HAL and not the airline community.

We do not comment on the IAG analysis of the Frontier report, and recognise that there are many reasons why a company's shares may trade at a premium. However, IAG's observation of a premium in relevant shares, taken with a proper analysis of returns to equity relative to a relevant benchmark (say the FTSE for example and/or other comparator airports) might also lend additional weight to the notion that HAL is capturing any scarcity rent. We would urge the CAA to undertake such an analysis.

We also posit that the airlines and HAL are not the only stakeholders where any potential rent could accrue. Rent could be captured by HM Government through, for example, APD, or by countless other stakeholders such as ground handlers, and other service providers. We also

note that all of these actors are also, in theory at least, able to raise their prices in response to perceived levels of demand.

In short, it is not axiomatic that if there were scarcity rents to be captured at LHR that they would be captured by the airline community. There are plenty of other actors that are capable of capturing the rent (including HAL and HM Government), and to be robust, any analysis must properly consider the impact of these actors on the potential existence of rent and where and by whom it is accrued.

Error 2: is LHR full?

There is also the question of whether in a narrow sense, LHR is actually full. FTI point out, quite rightly, in their analysis, that it is important to draw a distinction between runway capacity and seats. In this context the following comments from HAL are instructive:

'There remain 21.6 million empty seats flying through Heathrow in the year to June 2018.

In order to support airline partners to help fill these 21.6million empty seats, Heathrow proposes to introduce a passenger growth incentive scheme....⁶

It is hard to reconcile any argument for the existence of scarcity rents at LHR with the existence of significant excess capacity in the form of 21.6 million empty seats. Even HAL recognise that the excess capacity is significant, and indeed consider it significant enough to warrant introducing a passenger growth incentive scheme by which they intend to reduce it.

Summary

In short, the airline community agrees with some of the findings by FTI on the shortcomings of the Frontier analysis. However, there are errors in the FTI report and indeed in the Frontier study, which have not been addressed, and we make the following high level points:

- i. for scarcity rents to exist there must be an excess of demand over supply. The existence of 21.6m empty seats per annum at LHR makes it difficult to suggest that scarcity rents exist; and
- ii. accepting i, even if scarcity rents did exist, it is not axiomatic that they would accrue to airlines. LHR is an exceptionally expensive airport to operate from (even by the CAA's analysis), and its outperformance of its price controls,

⁶ *Heathrow Airport, Airport Charges for 2019: Consultation Document* (HAL, August 2018)

suggest that if any scarcity rent did exist at LHR that it is accruing to HAL, or perhaps to other actors, and not the airlines.

Yours sincerely

A handwritten signature in black ink, appearing to read "Mark Gardiner".

Mark Gardiner
Chairman LACC

A handwritten signature in black ink, appearing to read "Simon Arthur".

Simon Arthur
Managing Director
Heathrow AOC Limited