



London (Heathrow) Airline Consultative Committee

Consumer and Markets Group
Civil Aviation Authority
11 Westferry Circus
London
E14 4HD

13 August 2019

**Economic Regulation of Heathrow Airport Limited from January 2020:
Notice of Proposed Licence Modifications. CAA CAP 1825**

Dear Sir/Madam

The Airline Operators' Committee (AOC) and the London Airline Consultative Committee (LACC) welcome this opportunity to respond to the CAA's notice of licence modifications (CAP 1825). Our response is structured to mirror the structure of the CAA's document.

Interim Price Control Arrangements for 2020 and 2021

Before making our comments on the CAA's proposals to give effect to the 'commercial deal' through a licence modification, we remind the CAA that the AOC and LACC do not have the option of accepting or rejecting the 'commercial deal'. That is rightly only offered to our airline members. Consequently, we make no comment on the 'commercial deal' itself, and comment solely upon the CAA's regulatory treatment as it affects our members and their passengers.

The CAA correctly notes that the airline community does not regard the 'commercial deal' as a true commercial deal for a number of reasons, including that HAL holds SMP over the airlines. Consequently, we do not regard the 'deal' as either optimal, or as a precedent for future arrangements¹. We note that the CAA has not included our comments that airlines feel forced into this sub-optimal position because of the inability of the CAA to provide a regulatory outcome that returned HAL's excessive outperformance to our passengers in a timely and certain way. An effective economic regulator protecting the interests of our passengers at Heathrow Airport is preferable to a 'commercial deal' with a monopolist that holds SMP over us. In short, the very existence

¹ For more detail please refer to our responses to CAA CAPs 1722 and 1769.

of the 'commercial deal' is not a mark of the CAA pursuing its duties effectively, but rather indicates that the CAA's proposals for the iH7 period had significant shortcomings.

We note that the CAA believes that the 'commercial deal' will *'enable(s) us to have a greater focus on the important matters related to capacity expansion and the H7 price control review'* (CAP 1825 para 1.23). That being the case, the airline community expects (and would welcome) a product of the proposed licence modification to be:

- improved attendance and active participation by the CAA at key expansion and price control meetings;
- greater pace in the development of key variables for expansion (e.g. WACC and regulatory structure);
- More effective policing of whether HAL's spend is efficient.

The airline community would welcome these outcomes and are keen to support the CAA in delivering them.

Price control arrangements beyond 2021

The airline community supports the CAA's view that 2021 should be the target for finalising the H7 control which should take effect in 2022. For the avoidance of doubt, we do not at this stage see merit in another extension of the Q6 control, or indeed to a further 'commercial deal' or 'Gatwick style' arrangements at Heathrow.

Cat B in 2020 and 2021

We note that in Appendix E, para C1.12, that the CAA is proposing to amend the licence to continue the payment of £10mpa of cost pass through Cat B spend in 2020 and 2021.

The airline community is concerned to see this proposal. The CAA is currently consulting on its policy for the recovery of Cat B costs above £265m. Indeed, the CAA is consulting on 'enhanced incentives' because *'there is only limited evidence on the efficiency of HAL's Category B costs, and we have observed the near doubling of HAL's estimates of these costs. These factors strongly suggest that it is appropriate for us to carry out a review of our existing policy in respect [of] Category B costs.'* (CAA CAP 1819, page 20, para 1.17).

We strongly agree with the CAA's concerns that policy needs to be reviewed and incentives significantly strengthened to address HAL's lack of efficiency and escalating Cat B costs. Consequently, we are somewhat concerned to see this proposal. It seems to us that it is effectively 'out of process' as it pre-empts the outcome of its consultation in CAP 1819.

This decision also seems to us to run counter to the CAA's policy aims for Cat B above £265m. For the avoidance of doubt, the airline community strongly supports the removal of the automatic granting of £10mpa for Cat B spend above £265m.

The airline community therefore recommends that the CAA do not proceed with this specific licence text modification for Category B costs. Instead they should give proper consideration to the responses to CAP 1819, and only when they have done so, propose any licence modification that are required.

Treatment of non-signatory airlines to the Commercial Deal

The CAA argue that normal commercial deals are enforced through the Courts and therefore that the 'commercial deal' between HAL and the airlines should also be. We are disappointed that the CAA has failed to recognise that the 'commercial deal' is not a normal commercial deal but a one off and temporary regulatory accommodation between the airlines and the monopolist that holds SMP over them.

We note that the CAA has accepted that all airlines at Heathrow, whether they sign up to the 'commercial deal' or not will be placed on it. It seems odd to us that airlines who choose not to sign the deal would not be subject to a regulatory backstop with the full protections that the CAA would offer via regulation. We proposed in our response to CAP 1769 that airlines who did not sign up to the deal would receive the CAA default position via economic regulation, but that the sum would be paid back faster than the CAA proposed. It is disappointing that the CAA has not given due consideration to our proposal.

Promoting Economy and Efficiency

The airline community has never objected to an efficiency condition being imposed on HAL via the licence. However, we have been keen to ensure that the CAA saw such a condition as a tool it would use to enhance its enforcement capabilities rather than something that would allow it to stand further back and rely even more on the airlines to police HAL's efficiency. The CAA state that *'an efficiency condition would complement, rather than replace, HAL's price control arrangements...'* (Para 2.3, CAP 1825). It therefore seems that the CAA see it as an additional regulatory tool rather than a replacement. However, we are uncomfortable with the CAA's statement that *'...the CAA will only commence an investigation in the light of credible evidence that we receive.'* (Para 2.40). This suggests to us, that far from using the tool as part of an active policy to ensure an efficient HAL, the CAA appear to be planning to use the condition in a reactive way, and may even conclude that the absence of a complaint under the licence condition implies that the spend is somehow efficient.

We remain sceptical about the use of such a condition, and believe that much of the value of such a condition could be achieved by the CAA setting tight rather than loose price controls and by enforcing its own policy of only allowing efficient spend into the RAB.

In order for this licence condition to be credible, it requires two things:

- i. there must be a clear and agreed understanding of what constitutes efficiency; and
- ii. there must be the credible threat that the CAA would actually enforce the licence condition by recognising inefficient spend when it is evidenced and then by disallowing it.

Arguably, at the moment, neither condition is met. As is evidenced by the CAA's decision to allow £80m of Cat B spend, the glaring weakness of the CAA's efficiency policy is that it has no objective definition and measure of efficiency. Furthermore, in the case of the Cat B spend, the CAA have recognised that HAL's efficiency is low. Independent evidence concurs and shows that the weak tests for efficiency are failed. In these circumstances, when the CAA take no action, it calls into question the credibility of the CAA to enforce any efficiency licence condition.

Consequently, if the CAA are to proceed with an efficiency licence condition, the airline community urges it to:

- i. urgently develop and agree a definition of efficiency and a set of objective tests for efficiency to be measured against; and
- ii. restore confidence in the CAA's ability to ensure that HAL is only rewarded for efficient spend by rigorously enforcing their own policy.

In terms of the drafting of the proposed condition, the airline community is concerned that the CAA is giving undue weight to HAL's financeability. Financeability is but one of the CAA's secondary duties, and all should be given equal weight.

Whilst the airline community does not object in principle to the proposed licence modifications, we are conscious that the CAA has much work to do to ensure that its policies are credible and meet the objective of delivering an efficient HAL.

Service quality regulation in iH7

We note that the CAA has stated it is important for HAL to demonstrate that it continues to deliver service quality in the interests of passengers and, indeed, that one of the benefits from the commercial arrangement is for improved service quality. In considering the arrangement for the iH7 period the airlines indicated to the CAA that HAL was now regularly exceeding a number of passenger facing dimensions of service quality in the SQRB scheme. Since this was the case, the airlines tried to make the case that the CAA should increase the required service quality performance standards for HAL in these areas. Increasing these performance standards would have been specifically in the interests of passengers. Therefore, we are disappointed that the CAA has chosen not to take the opportunity of continuing to incentivise further HAL to deliver further improvements in service quality for these two years.

In addition to this the airlines did not support the CAA's proposal that aspects of a potential future Outcome Based Regulation framework for service quality be shadow tracked by HAL in iH7. If the output of this tracking is going to be used by the CAA to determine the H7 standards of quality it will set for HAL then HAL has the incentive to underperform in these areas to make the case that future levels of quality expectation should be limited. Therefore, when the H7 levels of quality are established by the CAA for HAL it will be important for the performance standards to be set at levels which are agreed to be in the interests of passengers and airlines rather than a reflection of the what HAL has been able to achieve up to that point.

Regulatory timetable

Our comments on the regulatory timetable have already been sent to the CAA. In summary, we consider that the CAA should ensure that the usual six month period post HAL publishing its IBP be allowed for Constructive Engagement (CE). The CE period provides airlines (and indeed other stakeholders) with a formal opportunity to scrutinise and respond to HAL's IBP within a framework of formalised structural engagement with HAL. The CAA also benefits from receiving the well-considered views of the airlines on HAL's IBP at the end of CE. Therefore, it is important for all stakeholders that the full six month period is allowed for CE.

We recognise that this is likely to require the CAA to be committed to ensuring its overall H7 review timetable is adhered to by all stakeholders. The airlines are committed to

working productively with all stakeholders within the usual regulatory review timescales. In doing so we would note that it will be important for the CAA to ensure that HAL respects the time table set out by the CAA. This is particularly the case regarding the CAA's expectations of the submissions from HAL being for an IBP and FBP. And with any further submissions from HAL only being accepted if there is a common agreement amongst stakeholders for the additional input. The airlines are keen to avoid a repetition of the approach taken by HAL in the Q6 review. This being that HAL submitted additional versions to the CAA of its FBP – often with little indication to the airlines that it was doing this. In fact, at one point HAL produced a version of its FBP in which it had unilaterally struck out significant amounts of capital expenditure in a form of ultimatum to stakeholders about the level of the price cap. This placed significant pressure on the Q6 timetable. This pressure can be avoided in the H7 review if the CAA sets out its expectations to all stakeholders at the outset and then enforces these requirements.

We hope that you find these comments useful, and would welcome the opportunity to discuss them with the CAA.

Yours faithfully,

Signed:



Ian Howick
Chair Heathrow AOC LTD



Simon Laver
Secretariat LACC