

Economic regulation of Heathrow Airport Limited from January 2020: notice of proposed licence modifications CAP1825

Heathrow's response

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1. Executive summary

1. The iH7 commercial deal between Heathrow and the airline community is a significant milestone for Heathrow. The deal is in the best interest of consumers. It demonstrates that Heathrow is committed to working commercially with the airline community to find innovative ways alongside Heathrow's current and future regulatory arrangements. Heathrow will continue to work with the airline community and the CAA to find the best possible regulatory and/or commercial solution to deliver a Heathrow operation and expansion that is both financeable and affordable, in the interest of consumers.
2. Heathrow agrees with the CAA's conclusion that the iH7 deal is in the best interest of consumers. We therefore support the CAA bringing forward a licence modification to give effect to the commercial deal through Heathrow's licence. Heathrow is supportive of the licence proposed by the CAA for iH7. In addition, we recognise and value the openness exhibited by the CAA in drafting and consulting on this licence condition.
3. Heathrow maintains its view that an economy and efficiency licence condition is neither necessary nor appropriate. The CAA continues to fail to substantiate the need for this condition or provide an assessment of why a licence condition is the most effective and appropriate intervention. It has not performed any quantitative impact analysis of the costs and benefits of introducing this new licence condition.
4. Going forward we would expect that the CAA provides detailed justification and quantitative analysis on how licence conditions are necessary to achieve the desired objective and are ultimately in the best interest of consumers, before introducing any potential new licence modification. This would be particularly relevant in the context of the CAA's recent consultation on financial resilience matters.

2. Interim price control arrangements for Heathrow

5. Heathrow agrees with the CAA's decision that the iH7 commercial deal is in the best interest of consumers for the reasons stated by the CAA. More than 90% of Heathrow's passengers in 2020 and 2021 will be covered by a commercial agreement signed between the airport and airlines. While there are challenges for both parties in terms of process, risks and uncertainty, overall this is positive news for Heathrow and the airline community. The agreement aligns Heathrow's and airline incentives to make best possible use of the capacity available and it provides the framework for fostering commercially driven engagement for the benefit of consumers. The agreement, as discussed by the CAA, will support the delivery of an affordable Heathrow expansion and H7 settlement by providing further commercial incentives to airlines to fill empty seats.
6. The iH7 deal gives us hope that future deals may be possible. Heathrow will continue to assume that the base case remains a regulatory settlement. But we will continue to look to engage the airline community, including potential new entrants, around what a future deal could involve. Irrespective of whether a commercial deal in future years is feasible, there are important lessons that the CAA, the airline community and Heathrow can learn from the iH7 commercial deal:
 - a. Heathrow and the airline community provide an integrated product for consumers. Working together in good faith to find a suitable agreement for all parties can result in outcomes that are in the best interest of consumers, and superior than "old school" prescriptive regulatory decisions. Having said that, Heathrow considers that the CAA's

role in iH7 and beyond is instrumental. For example, it is clear that the iH7 agreement does not replace regulation but rather builds on it.

- b. The CAA's role in supporting and guiding Heathrow and the airline community to jointly find commercial outcomes is also very important. The CAA has provided guidance and the right space for commercial outcomes to emerge. Going forward Heathrow considers that the CAA should continue to encourage commercial agreements.
 - c. The iH7 commercial deal provides incentives for airlines and Heathrow to jointly benefit from passenger growth. This in effect repositions discussions regarding passenger growth, from confrontational ones about value allocation to how best to together support growth. Incentives for passenger growth, i.e. passenger risk sharing principles, should be investigated and potentially introduced as part of any H7 regulatory decision.
7. Heathrow is supportive of the licence modifications proposed by the CAA to reflect the commercial agreement and to extend the existing Q6 conditions into 2020 and 2021. The modifications seek a fine balance between minimising change to Heathrow's licence while accurately reflecting the commercial deal in the licence. We note the collaborative approach taken by the CAA in this area.
 8. We nevertheless remain concerned with the CAA's rationale expressed in Appendix C, where it discusses the need for the licence condition to protect airlines rather than consumers. As per previous responses, we encourage the CAA, in line with its primary duty, to focus on making regulatory decisions and licence changes that further the interest of consumers rather than protect the commercial interest of the airlines operating at Heathrow.
 9. Heathrow will respect the terms and conditions of the iH7 commercial agreement and the regulatory conditions as codified by the proposed extended licence. We will continue to report, engage and consult with stakeholders as we have done in Q6. In the near future, we aim to agree a capital investment envelope for iH7 as we did for Q6+1, so that in we can formally communicate that investment envelope for 2020 and 2021 to the CAA. Relatedly, Heathrow notes and welcomes the CAA's confirmation of the regulatory depreciation figures associated with 2020 and 2021. These numbers will be reflected in future Regulatory Accounts.
 10. Regarding price control arrangements beyond 2021, as we have discussed in previous responses to the CAA, there will never be perfect alignment between the regulatory process and the statutory planning consent process. Heathrow believes that it is in the best interest of consumers that H7 begins in 2022. Heathrow thus agrees with the CAA that targeting an H7 start in 2022 while maintaining flexibility within the H7 regulatory framework is the best option to deal with potential uncertainty. It will enable the delivery of an Outcome Based Regulatory regime that targets the end to end passenger journey. It will also provide the opportunity to reassess a number of the important underlying building blocks of Heathrow's price cap.
 11. Heathrow considers that an important feature of defining a regulatory framework is that it is able to deal with the potential misalignment between the regulatory process and the statutory process. The CAA should develop a clear procedure that permits for regulatory changes or triggers once Heathrow formally notifies the CAA that it will proceed with Expansion. This would follow from DCO being granted and Expansion regulatory conditions being defined. In effect, once an objectively defined trigger is met, the CAA would adjust a number of parameters of the regulatory framework including the WACC and underlying passenger

volume assumptions (i.e. 25,000 additional ATMs). Heathrow considers that this in the best interest for consumers as:

- a. It ensures that the H7 period is not further delayed, avoiding a delay to the delivery of Heathrow expansion and the risk that the Q6/ iH7 airport charge further deviates from underlying economic reality.
- b. It ensures that airport charges payable accurately reflect Heathrow's (expansion) investment.
- c. It enables Heathrow to make an informed decision regarding an expansion process that is financeable and therefore deliverable.
- d. It is consistent with regulatory best practice. In effect, it is incentive-based regulation in its purest sense.

3. Promoting economy and efficiency

12. Heathrow's position on the proposal to introduce a new condition to promote economy and efficiency remains unchanged by the CAA's arguments. Heathrow does not believe that an economy and efficiency licence condition is either necessary or required, as per our previous representations to the CAA. The CAA has continued to fail to set out why it considers a licence condition is necessary to achieve its objective of ensuring that Heathrow behaves in an economical and efficient manner.
13. We do not believe that the regulatory tools already available to the CAA are insufficient or that their strength reduces towards the end of any given price control. In actual fact, the CAA imposes regulatory incentives on Heathrow capturing every aspect of the services provided by Heathrow and the cost of providing them. The CAA has also demonstrably introduced new incentives and targeted policies to impose new regulatory incentives on Heathrow as new or novel situations have arisen through the regulatory period. By virtue of meeting the regulatory conditions set by the CAA, Heathrow is already incentivised to behave in an economic and efficient manner.
14. We remain disappointed that the CAA has not done a quantitative impact analysis of the cost and benefits of introducing this new licence condition, and do not accept that this analysis should not be undertaken simply because the benefits may be "*difficult reasonably to quantify*" (paragraph 2.27) This is inconsistent with the CAA's duties and the need to follow Better Regulation principles, nor is it consistent with regulatory precedent. Performing this type of analysis is going to be of particular importance in the CAA's future decision making, especially regarding pre-DCO Category C costs policy and potential licence modifications, financial resilience conditions and any other decision associated with the H7 regulatory process. The CAA's failure to comply with its duties in this regard is therefore concerning to Heathrow, given we are still at the start of the decision-making process for the next regulatory period.
15. The current drafting of the licence condition appears to be focused on how Heathrow should conduct its business rather than the specific outcomes that Heathrow has to deliver. To that end the CAA has not included particular areas of focus that the condition should target and explicitly outlined that the condition would not enable the CAA to mandate specific investments like capacity expansion. Given that the licence condition would not enable the

CAA to mandate specific investment¹, we remain significantly concerned that the current draft maintains the word “development” without definition. This is misleading and leaves the licence condition subject to judgement to the detriment of all stakeholders involved and exposes Heathrow to open-ended interpretations. This is poor regulatory practice and a great concern to Heathrow. We would review our options going forward should the CAA not provide clarity on this particular area.

16. Heathrow acknowledges the changes made to the version of the proposed licence condition presented in the CAA’s March 2019 consultation paper in light of certain concerns raised in Heathrow’s response. In particular, Heathrow notes that the CAA accepts Heathrow’s request to highlight the importance of taking into account the need for Heathrow to finance its activities when complying with the condition. Heathrow remains concerned about the uncertainty and potential unintended consequences that CAA’s proposed wording creates and, attached at Appendix 1, we set out additional representations and a mark-up of the proposed condition to exemplify the issues.
17. Regarding how this licence condition could be used in the future by the CAA, Heathrow agrees with the CAA that a sensible starting point to assess whether any action under an efficiency condition is required should be informed by the CAA’s duties and its prioritisation principles and enforcement policy. Heathrow agrees with the CAA’s discussion that the CAA’s focus in considering taking any steps in relation to the efficiency condition will be concentrated on matters that seem likely to have a material adverse impact on users.
18. It is important that this condition does not become a “catch-all” mechanism under which every action taken by Heathrow is scrutinised by means of a licence investigation or a provision relied on simply when the CAA cannot substantiate grounds to investigate pursuant to more relevant and more targeted condition. This increased regulatory burden would unlikely serve to further the interests of users nor protect them from potential detriment but would instead introduce delays to the provision of services for users and create an environment of regulatory instability that would prevent the efficient and economical delivery mandated by the condition.
19. In the foreword to the CAA’s enforcement policy, the CAA acknowledges its responsibility to be clear about when, why and how it will take action. Heathrow requests that the CAA takes appropriate measures to give certainty and make it sufficiently clear to all stakeholders involved, and also to the CAA’s successors, the circumstances in which, or the thresholds that must be exceeded before, an investigation under this licence condition would be triggered. It should also outline the criteria for or how the CAA plans to assess any request made by stakeholders in advance of commencing an investigation. For example, would the CAA require documentary evidence supporting a claim of a serious breach or evidence of significant harm to users or evidence of a material adverse impact as a prerequisite to opening an investigation? What data will the CAA rely on in evaluating whether or not to investigate? We consider that this clarity could be given through the provision of a statement of policy, published on the entry into force of the licence condition, clarifying the intention of the condition and the circumstances in which the CAA would see the condition being triggered.
20. This would be in the best interest of consumers, since the licence condition would be used effectively and efficiently as per its original intent. This would help prevent it becoming a vehicle under which the CAA may investigate any minor or trivial matter, creating disruption to all parties and regulatory uncertainty for Heathrow. Building on the CAA’s consultation, Heathrow proposes the following set of events in which the condition would not be triggered:

¹ CAP1819, page 34, paragraph 2.31

- a. Trivial and/or insignificant matters or commercial disputes between Heathrow and the airlines, for example of lack of agreement on an investment decision for a given project at Gateway 3, or any disputes arising from the iH7 commercial deal
- b. Areas where Heathrow is subject to specific regulatory incentives, for example a rebate payment under the SQRB scheme.
- c. The CAA would not investigate complaints that have not been highlighted through governance and/or engagement first, providing the opportunity for Heathrow and the stakeholder who raised the complaint to solve the problem in good faith and in line with established principles and processes.

4. Appendix – Mark-up of CAA’s proposed licence condition

	Rationale for change
<p><i>B3.1 The Licensee shall conduct its business and its activities that relate to the provision of airport operation services at the Airport so as to secure the economical and efficient:</i> <i>(a) operation and maintenance; and</i> <i>(b) timely and appropriate enhancement and development of the Airport.</i></p>	<p>Development is not defined, nor easily definable, leaving Heathrow open to risk in the application of the condition.</p> <p>We also consider that the inclusion of development is not relevant in Heathrow’s case. While the concept of development is included in licence conditions present in other sectors, it does not mean that such an inclusion is relevant in a licence condition for Heathrow. As set out in our response to CAP 1722, the needs and issues of one sector cannot be transplanted into another. This is particularly relevant when thinking about the challenges faced in energy and water networks as essential services to ensure that they remain up to date and fit for purpose in the long-term interests of users. This is not the case for Heathrow, which does not provide an essential service. It is therefore the concept of securing enhancement in the services provided that would be more relevant to ensure benefits for users and meet their reasonable demands.</p>
<p><i>B3.2 In complying with Condition B3.1, the Licensee shall seek to identify and take account of the reasonable demands of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services provided by the Licensee at the Airport are met. In so doing, the Licensee shall carry out appropriate consultation with users, airlines and other relevant stakeholders, including providing timely and accurate information to them, so that they can assist the Licensee to identify reasonable demands for airport operation services.</i></p>	<p>While we acknowledge the CAA’s intention to reflect the language of its duties under the Civil Aviation Act 2012, we remain concerned that the obligation set out in proposed B3.2 could lead to actions that are uneconomical and inefficient, taken in order to “<i>secure the reasonable demands of users</i>”.</p> <p>We note and agree with the CAA’s statement in paragraph 2.37 that “<i>what constitutes economy and efficiency in any particular case involving airport operation services will depend on the circumstances at hand</i>”, however, given the language proposed in B3.2, there seems to be an inconsistency and it remains unclear whether the CAA intends that a consequence of its language in the proposed B3.2 should be that HAL, irrespective of other circumstances, would be non-compliant with the condition B3.1 if it does not “<i>secure the reasonable demands of users</i>”. To provide clarity and certainty, a condition which requires Heathrow to identify</p>

	<p>and take account of the reasonable demands of users would better allow Heathrow to take economical and efficient decisions.</p>
<p><i>B.3.3 In complying with its obligations under this condition, the Licensee shall take into account all relevant circumstances, including the need for it to avoid any action or omission that might reasonably be expected to adversely affect its ability to finance its provision of airport operation services at the Airport.</i></p>	<p>We maintain our response to the CAA’s previous consultation on this topic regarding the need to secure that Heathrow is able to finance its licensed activities and we urge the CAA to ensure that Heathrow is not required to take actions which might reasonably be expected to adversely affect its ability to finance its activities under the licence.</p> <p>We acknowledge the change proposed by the CAA to clarify that Heathrow is <i>required</i> to take account matters relating to its ability to finance its activities in complying with the condition, however suggest that further specification is required in B3.3 to avoid uncertainty about the scope of this obligation.</p>