

Notice of proposed modification to Heathrow Airport Limited's economic licence to extend the current price control by one year

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Chapter 1

Introduction

Purpose of this document

- 1.1 This document is a formal notice under section 22(2) of the Civil Aviation Act 2012 (the Act) to modify the licence issued to Heathrow Airport Limited (HAL) on 1 April 2014. The proposed modifications are to extend the current price control on HAL, that currently runs from 1 April 2014 to 31 December 2018 (known as Q6), by one year so that it will end on 31 December 2019. The proposal is to roll over the existing control in the last year of Q6 on the same terms, i.e. a price path of the Retail Price Index (RPI) -1.5%.

Background

- 1.2 In March 2016, we launched a review (known as the H7 review) of the price control and associated arrangements that would apply when the current cap expires at the end of 2018. We published a discussion document and undertook a series of industry workshops and seminars at which we sought views of interested parties on the process, strategic themes and relevant issues for the H7 review.
- 1.3 In written responses to the document and subsequent discussions, industry stakeholders suggested that we should consider extending the current price control by at least one year.
- 1.4 Stakeholders thought that the level of uncertainty over the Government response to the work of the Airports Commission on new runway capacity in the South East of England, would affect the quality of the work on the H7 review they could undertake. In particular, HAL thought that the additional time created by an extension, would enable it to enhance the quality and consumer focus of the H7 business plan. Airlines noted the

significant staff resource required to engage in expansion plans across the industry and thought that better alignment between H7 and new capacity would reduce the risk of nugatory work and the complexity of H7.

1.5 In light of these views we consulted in July 2016 on whether we should:

- extend Q6 by one year;
- extend Q6 by two years; or
- not extend the price control.

Our preference was to extend Q6 by one year with the current RPI-1.5% price control rolled over for the additional year.

1.6 We received five written responses to our consultation: from HAL, a joint response from the Heathrow Airline Operators Committee (AOC) and the London Airport Consultative Committee (LACC), IAG/British Airways, the Lufthansa Group¹ and Virgin Atlantic Airways. All respondents agreed with our preferred option of extending Q6 by one year. IAG/British Airways, the Lufthansa Group, HAL and AOC/LACC agreed with a roll over of the current price control. Virgin favoured a price control in the additional year that would take account of revised traffic forecasts to account for HAL outperforming the Q6 forecasts. The responses are available on our website and are discussed in further detail in Chapter 2.

1.7 We held a workshop in August 2016 attended by HAL, the AOC, LACC and a number of airlines (including British Airways and Lufthansa). All present supported extending the price control by one additional year and rolling over the current price control into the additional year.

Statutory requirements

1.8 Under sections 22(2) to (4) of the Act before we can modify a licence condition we have to publish a notice that:

- states that we propose to modify the licence;

¹ The Lufthansa Group (on behalf of Lufthansa, Swiss International Air Lines and Austrian Airlines) expressed their support for the AOC/LACC response.

- specifies the proposed modification;
- gives our reasons for the proposed modification;
- states the effect of the proposed modification; and
- specifies a reasonable period for making representations.

This document is such a notice.

- 1.9 Section 1 of the Act gives us a single primary duty to further the interests of users of air transport services in respect of our economic regulation functions. Users are defined in the Act as present and future passengers and those with a right in property carried by the service, i.e. cargo owners.
- 1.10 The scope of our primary duty concerns the range, availability, continuity, cost and quality of airport operation services. We must carry out our functions, where appropriate, in a manner that will promote competition in the provision of airport operation services.
- 1.11 In discharging our primary duty, we must have regard to a range of other matters under the Act. These include:
- the need to secure that HAL is able to finance its licensed activities;
 - the need to ensure that all reasonable demands are met;
 - the need to promote economy and efficiency;
 - the need to secure that HAL is able to take measures to reduce, control and mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - better regulation principles.

Chapter 2

Our reasons for and the effects of the proposed modification

- 2.1 We propose to modify Condition C1 of HAL's licence to extend the current price control by one year so that it ends at 31 December 2019. The changes to Condition C1 and associated changes to other licence conditions are in Appendix A.

Our reasons for the proposal

- 2.2 In this section, we set out our reasons for our proposed modification. These are largely unaltered since our July consultation. Most respondents agreed with most of our reasoning in the July consultation. Where respondents disagreed, we comment on whether their views have caused us to change our reasoning.

Extending the price control

- 2.3 We consider that extending Q6 by one year would be in the interest of users as it would reduce the risk that the H7 process is sub-optimal due to runway uncertainty and lower levels of industry engagement.
- 2.4 An extension is likely to improve engagement as it would allow stakeholders to plan their engagement on H7 with more certainty and allow resources to be prioritised towards new runway capacity should a Government decision be made. We consider that new runway capacity is likely to deliver considerable consumer benefits, including more choice, lower air fares and higher service quality.
- 2.5 We recognise that extending Q6 will not eliminate uncertainty around capacity expansion which is likely to persist well into the planning stage of the process. However, without an extension, it will be difficult for stakeholders to focus on a business plan while there is significant

uncertainty over whether the airport will operate with 2 or 3 runways in the future.

Rolling over the current price control

- 2.6 In previous price control extensions the legislation at the time, the Airports Act 1986, only allowed us to maintain the current price control in the additional year (unless the airport consented otherwise). Under the Act we can change the price control in an additional year, but consider that we should maintain the current price control in the additional year.
- 2.7 In our view the Q6 price control furthers the interests of consumers by reducing airport charges in real terms, by rolling over the price control for an additional year we will maintain this benefit for an additional year. In its response HAL disagreed that falling prices were by definition in consumers' interest. It considered that consumers' interests were best served through appropriate levels of spend to achieve the outcomes that consumers value. We consider that the price control should balance price and quality, ideally offering customers a choice of different price/quality combinations to suit their requirements. Some consumers may prefer higher prices for a higher quality or more resilient service, however, we consider it self-evident that, everything else being equal, consumers prefer lower charges.
- 2.8 If we were to re-open the price control, we consider that the benefit of the additional time would be negated if it was spent in reassessing the building blocks for the additional year. As mentioned above, HAL, the AOC/LACC, IAG/British Airways and the Lufthansa Group favoured rolling over the price control with no re-opening of any of the building blocks in their written responses.
- 2.9 However, we acknowledge that there are drawbacks with a simple roll over of the price control based upon assumptions determined in 2014. The risk of actual performance becoming out-of-line from that assumed when the price control was set is higher with the price control rolled over than if we re-opened the price control. HAL's regulatory accounts show

that in the first two reporting periods of Q6 (April 2014 to December 2015) its regulatory operating profit of £1.6 billion was 17% higher than the level assumed in the Q6 determination. In their responses to the July 2016 consultation the AOC/LACC, IAG/British Airways and Virgin mentioned this.

- 2.10 In our July 2016 consultation, we noted that HAL's outperformance against the Q6 determination was driven principally by higher than assumed passenger numbers. In its response Virgin said the price control for the additional year should be based on revised traffic forecasts. Virgin understood that a partial re-opening of the building blocks to set a new price control for the additional year would involve some degree of simplification, but considered that this would be warranted as it would further the interests of users and ensure that HAL's returns are in line with those anticipated in the Q6 determination. If the traffic forecasts were not revised, Virgin thought the difference in outperformance should be considered during the H7 process.
- 2.11 Re-opening any of the building blocks would use up some of the time freed up to consider regulatory issues around expansion. Re-opening the traffic forecasts would require new forecasts for the additional year and there may be knock-on implications for other building blocks including the capital plan, operating costs and commercial revenues. It seems unlikely that these would be automatically accepted by all stakeholders, and there is no guarantee that they will be accurate. Given this, we continue to believe that we should continue the current price control into the additional year, without revisiting the traffic forecasts or any other of the building blocks.
- 2.12 HAL said that, consistent with the extension of the Q5 price control, all other variables should be extended from 2018 to 2019. Thus, assumed depreciation should be the same in the additional year as in 2018, and service quality standards should be maintained at the 2018 level.
- 2.13 On service quality standards we agree with HAL. With respect to depreciation, we will expect HAL to consider this issue further with airlines

as part of the discussion around treatment of capital expenditure in the additional year (see para 2.22 below). The AOC and LACC noted that the Q6 settlement contained a smoothing element in the revenue yield per passenger across the years of Q6. It thought it important that any ongoing impact of this provision should be jointly discussed and any resultant action agreed among all stakeholders.

- 2.14 We have considered whether the value of X, at 1.5% for the additional year of Q6, should be adjusted to account for any smoothing that was assumed at the Q6 determination. We have concluded that the same logic applies to this issue as it does for traffic forecasting and so no adjustments should be made for this reason.

Extending Q6 by two years

- 2.15 We consulted on the option of extending Q6 by two years. However, this was not our preferred approach as the variance between the Q6 building block forecasts and outturn performance at the end of the extension could be significantly greater than the difference with a one year extension. We did not consider this to be in the interests of consumers as charges could be significantly higher (or lower) than they would otherwise be if a new price control had been set.
- 2.16 Moreover we considered the likelihood of all stakeholders accepting a two year rollover of the price control as markedly lower. There is no precedent for a two year extension. We also thought that with a two year extension the momentum in the industry following our H7 strategic themes document could be reduced as stakeholders disengaged to work on other priorities.
- 2.17 No respondent favoured a two year extension, but they all wanted us to leave open the opportunity for a further extension for a second year if circumstances at the time warranted it. They thought there should be a cut-off date by which we would decide whether there would be an additional one year extension. At the industry workshop stakeholders suggested we should make a decision by 30 June 2017. We agree that