

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

CAP 1825



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About this document

This document gives formal notice under section 22(2) of the Civil Aviation Act 2012 (“CAA12”) of our proposal to modify Heathrow Airport Limited’s (“HAL”) economic licence to:

- extend the current price control by a two year interim period, up to 31 December 2021, taking account of the commercial arrangements between HAL and certain airlines for this period;
- include a new licence condition to promote economy and efficiency by HAL in the operation, maintenance and development of Heathrow airport; and
- make minor changes to update the price control arrangements, remove obsolete terms and make a change to HAL’s regulatory audit requirements to reflect current auditing guidelines.

This statutory consultation follows on from our consultation on interim price control arrangements in February 2019¹ and our consultation on the regulatory framework to support capacity expansion at Heathrow in March 2019.²

Stakeholder views invited

We welcome views on all the issues raised in this document. Please e-mail responses to economicregulation@caa.co.uk by no later than 13 September 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information disclosure under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

¹ Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements
www.caa.co.uk/CAP1769 (“the February 2019 Consultation”)

² Economic regulation of capacity expansion at Heathrow: policy update and consultation
www.caa.co.uk/CAP1782 (“the March 2019 Consultation”)

If you would like to discuss any aspect of this document, please contact Elly Shafran (elly.shafran@caa.co.uk).

Executive summary

Purpose of this document

1. This document is a formal notice under section 22(2) of the Civil Aviation Act 2012 (“CAA12”) to modify the licence of HAL on 1 January 2020.
2. The proposed modifications reflect our intentions to:
 - further extend the current price control (the “Q6” price control) by two years, and to accept the commercial arrangements agreed with HAL and certain airlines at Heathrow for 2020 and 2021 as the basis for the interim price control, ahead of the next main price control for HAL (which is due to be implemented from the start of 2022);
 - introduce a new licence condition to promote economy and efficiency in the operation, maintenance and development of Heathrow by HAL. This licence modification would remain in place beyond the interim price control period noted above; and
 - make further minor changes to update the price control arrangements, remove obsolete terms and make a change to HAL’s regulatory audit requirements to reflect current auditing guidelines.

Main issues raised in this consultation

Interim price control arrangements for 2020 and 2021

3. The Q6 price control on HAL's charges to airlines is due to expire on 31 December 2019. We consulted in April 2018³ on a possible approach to extending the Q6 price control to 31 December 2021. We explained the advantages of this interim price control (“iH7”) include aligning the next main

³ Economic regulation of capacity expansion at Heathrow: policy update and consultation
www.caa.co.uk/CAP1782 (“the April 2019 Consultation”)

price control period ("H7") with the wider capacity expansion programme at Heathrow airport.

4. We suggested that the existing path for HAL's prices would continue at RPI-1.5% but that we would also reset some of the building block assumptions (passenger forecasts, costs and certain elements of the cost of capital) to take account of HAL's expected performance in 2020 and 2021. We said that the benefits of any expected outperformance would be shared with airlines and consumers in the longer term by making an adjustment to HAL's regulatory asset base (RAB).
5. There were then negotiations between HAL and certain airlines operating at Heathrow on commercial arrangements to cover 2020 and 2021 as a substitute for the interim price control arrangements described above. The commercial arrangements agreed between HAL and certain airlines are referred to in this consultation as the "commercial deal" or the "commercial arrangement" and provide for:
 - a 'fixed rebate' to all airlines currently operating from Heathrow totalling £260 million, split into two equal payments of £130 million to cover 2020 and 2021;⁴
 - a further volume rebate if the number of passengers rises above certain thresholds in 2020 and 2021;⁵
 - if passenger numbers were to turn out significantly lower than expected, the commercial arrangement also provides some downside protection for HAL (in these circumstances the fixed rebate to airlines would be reduced); and
 - default arrangements for any airlines that did not sign the commercial deal, so that those non-signatory airlines would receive an appropriate share of the fixed rebate but would not benefit from the volume rebate.
6. The commercial arrangement is conditional on the CAA setting an RPI-1.5% price path and retaining some existing price adjustment mechanisms including

⁴ Payment of the fixed rebate would be spread over a four year period, commencing after the rebate was accrued.

⁵ The volume rebate would be paid in full the year after it is accrued.

those for the Service Quality Rebates and Bonus (SQRB) scheme and security expenditure. Any capital expenditure adjustments and regulatory depreciation would be based on the baseline capital expenditure assumptions as set out in the April 2018 Consultation.⁶

7. The February 2019 Consultation said that the CAA initially considered that an interim price control based on the commercial deal could have wider strategic benefits in terms of encouraging a more commercial relationship between HAL and airlines in the future, would allow stakeholders to focus on the important issues associated with capacity expansion, and would better align the next main price control with the timetable for the wider capacity expansion programme. We also noted that these advantages could outweigh any possible difficulties associated with concerns about the stringency of the proposed arrangements.
8. We received seven responses to our consultation which are available on our website.⁷ HAL and airlines preferred the commercial deal to a price control with a RAB adjustment, but airlines, and groups representing airlines, raised a number of concerns around the process for establishing the commercial deal, whether there will be longer term benefits from the commercial arrangement and how the commercial deal should be reflected in HAL's licence. These matters are discussed further in chapter 1.
9. We understand from HAL that the commercial deal has now been agreed and signed by 46 airlines operating at Heathrow airport, whose operations cover around 89 per cent of the passengers using Heathrow.
10. On balance, stakeholders have not raised concerns that would cause us to change our position, which remains that an interim price control based on the commercial deal negotiated by HAL with airlines for 2020 and 2021 is in the interest of consumers. As a result, we propose to extend the existing Q6 price control to the end of 2021 on the basis of the commercial deal. A draft licence modification that reflects this proposal is set out in Appendix E.

⁶ CAP 1658. Appendix D Table D.4 www.caa.co.uk/CAP1658 (also set out in Appendix B of this document).

⁷ Heathrow Price control review H7, [Consultations and policy documents, CAP 1769](#)

Promoting economy and efficiency

11. In March 2019, we consulted on whether a new condition in HAL's licence to promote economy and efficiency in the operation, maintenance and development by HAL of Heathrow airport would further the interests of consumers. We restated the position that we had explained in earlier consultations that HAL's licence does not currently drive efficiency across all its activities or provide an obligation against which the CAA can investigate inefficiency. In these circumstances, the new licence condition would be helpful in creating a rounded and proportionate set of regulatory obligations.
12. HAL and airlines' views varied on this issue. HAL opposed our proposal to introduce the new licence condition, largely on the basis of arguments that the introduction of such a condition was not necessary and had not been properly justified, but it also made suggestions on the drafting of the condition. Airlines and other stakeholders broadly supported such a condition alongside making suggestions on the drafting of the condition.
13. Stakeholders agreed that, if we were to introduce a new condition to promote economy and efficiency, it should cover only the activities of HAL at Heathrow, rather than having wider application to airlines or third parties such as Border Force.
14. Following a review of stakeholder responses, we intend to modify HAL's licence to include a condition to promote economy and efficiency from 1 January 2020 onwards. We consider that the new condition will be an important part of the overall regulatory framework, providing a further safeguard for consumers' interests, particularly if serious or systemic issues were to arise. A draft licence condition is set out in Appendix E.

Our duties

15. In developing this consultation, we have had full regard to our statutory duties under the CAA12, which are set out more fully in Appendix A.

Structure of this document

16. The structure of this consultation document is as follows:
- chapter 1 outlines our reasons for and the effects of the proposed modification to put in place interim price control arrangements for 2020 and 2021;
 - chapter 2 outlines our reasons for and the effects of the proposed modification to put in place an obligation on HAL to promote economy and efficiency from 2020;
 - Appendix A summarises our statutory duties;
 - Appendix B addresses the main points respondents made on how best to reflect the terms of the commercial deal in HAL's price control licence conditions, and sets out our preferred approach to these matters;
 - Appendix C explains the more general licence updates to reflect the extension of the price control and deals with respondents' views on these matters. It also explains the minor changes to update the price control arrangements, remove obsolete terms, and explains a change to HAL's regulatory audit requirements to reflect current auditing guidelines.
 - Appendix D addresses the main drafting comments respondents made on our March 2019 draft of the economy and efficiency condition; and
 - Appendix E sets out the proposed licence modifications for statutory consultation.

Next steps

- 3.1 We invite comments from stakeholders on the issues raised in this consultation document by 13 September 2019. We cannot commit to taking account of representations made after this date.
- 3.2 Having considered stakeholder views, we will decide what modifications, if any, to make to HAL's licence. If we decide to modify HAL's licence, we shall publish a notice of the modification in accordance with section 22(6) CAA12. If we decide

not to modify the licence we will publish a notice giving our reasons for not doing so in accordance with section 22(5) CAA12.

Chapter 1

Interim price control arrangements for HAL

Introduction

- 1.1 We propose to modify HAL's licence to extend the current price control by two years, based on the commercial arrangements negotiated between HAL and airlines for 2020 and 2021. Our proposal is consistent with the approach set out in the February 2019 Consultation, which explained the advantages of a transitional arrangement to broadly align the next main price control with HAL's capacity expansion programme and proposed that the commercial deal negotiated between HAL and airlines should be the basis of the iH7 price control.
- 1.2 This chapter:
- provides a brief summary of what we said in the February 2019 Consultation;
 - sets out the main points raised by respondents to the February 2019 Consultation; and
 - addresses the points raised by respondents and it sets out and explains our broad approach to the interim price control arrangements.
- 1.3 Our approach to implementing these arrangements by modifications to HAL's licence is dealt with in Appendix B, with the licence drafting that forms the basis for the statutory consultation under CAA12 set out in Appendix E.

The February 2019 Consultation

Our proposal to further extend the existing price control

- 1.4 We consulted in April 2018 and February 2019 on a proposal to extend the Q6 price control for two years until 31 December 2021.^{8,9} We said that purpose of the iH7 price control would be to protect the interests of consumers by aligning the next main price control period with the wider capacity expansion programme at Heathrow airport. We said that this approach would give HAL more time to produce a high quality interim business plan, so that more robust information on the costs of capacity expansion can be considered during the next main price control review.

Our proposal to accept the commercial deal for iH7

- 1.5 In February 2019, we consulted on a proposal that the two year commercial deal negotiated by HAL and airlines should be accepted by the CAA as the basis for the price control arrangements for 2020 and 2021. We said that the commercial deal reflected the potential wider strategic benefits for consumers, including:
- stakeholders will be able to focus on the challenges of capacity expansion, rather than on short term issues for establishing a detailed interim price control for 2020 and 2021;
 - facilitating airport and airlines to work together ahead of the next main H7 price control to deliver better outcomes for passengers, for example, reduced prices, improved service quality and the development of new services;
 - the potential for future commercial arrangements relating to capacity expansion to support traffic growth and the overall affordability and financeability of the capacity development at Heathrow; and
 - better arrangements for managing passenger traffic risks during 2020 and 2021.

⁸ See “the April 2018 Consultation” at www.caa.co.uk/CAP1658

⁹ See “the February 2019 Consultation” at www.caa.co.uk/CAP1769

- 1.6 We also presented our assessment of the revenue that HAL is likely to generate from the commercial deal. Our analysis suggested that HAL would receive a lower revenue allowance under the commercial deal compared to a “headline” RPI-1.5% price path. It also indicated that the assumptions underlying the commercial deal were less stringent than the estimates of the underlying cost drivers for 2020 and 2021 which had been developed by CEPA as part of our early work on an interim price control.¹⁰ However, we said that we expected that this difference would come down had we continued with our assessment of HAL’s cost drivers as part of the iH7 regulatory review process.
- 1.7 We acknowledged that the commercial deal means that airlines are likely to gain in the short term (the rebates paid by HAL during 2021 to 2025 has the effect that airlines will effectively pay a lower price than the “headline” RPI-1.5% price path), but that charges to airlines may be higher than they would otherwise have been in the longer term.
- 1.8 Overall, we considered that the wider strategic benefits outweighed the concerns around the form of the commercial deal (rebates being paid during 2021 to 2025, rather than a RAB adjustment over a longer period) and about the stringency for HAL of the targets included in the commercial deal.
- 1.9 We said that we would modify HAL's licence to ensure that the commercial deal integrates properly with existing regulatory arrangements at Heathrow. We invited early views on this in the February 2019 Consultation, but we said that we would engage on the specific licence modifications later in the year.
- 1.10 We also said that it is important for HAL to demonstrate that it continues to deliver service quality in the interests of passengers during 2020 and 2021, particularly given that the commercial deal incentivises passenger growth. A further extension of the Q6 price control for the period to 31 December 2021 delays the introduction of the outcome based regulation (OBR) framework, so we suggested that the interim price control period could offer the opportunity for HAL to begin to “shadow track” key parts of the future (OBR) framework that it is

¹⁰ See preliminary CEPA review of Heathrow Airport Limited's (HAL's) initial business plan submission for the Heathrow interim H7 price control (iH7) at www.caa.co.uk/CAP1769A

currently developing for its H7 business plan. We said that tracking key indicators during 2020 and 2021 would not only have the benefit of piloting their suitability but could also provide evidence to help set incentive thresholds, bonus and penalty rates which would help improve the final OBR framework for the H7 price control.

Stakeholder views

- 1.11 HAL and the airlines that responded to the February 2019 Consultation preferred the commercial deal as the basis for the iH7 interim price control, compared to our earlier proposal for an interim price control with an adjustment to HAL's RAB to take account of the expected value of certain efficiency gains.
- 1.12 HAL said that it is a proportionate and targeted regulatory decision for the interim period which will allow stakeholders (HAL, airlines and the CAA) to focus on the capacity expansion programme and the next main H7 price control review. It also suggested that the commercial deal should incentivise airlines to increase passenger volumes for example, by optimising aircraft utilisation, which has the potential to unlock terminal capacity in the near term, ahead of the wider expansion programme. HAL said that the commercial deal is a step towards achieving future commercial arrangements and was in line with its ambition of working towards better commercial relationships with airlines.
- 1.13 Airlines said that they support the payment of rebates in the short term, rather than a RAB reduction in the longer term, saying that it would provide certainty to airlines and allow for the timely return to consumers of the benefit from outperformance by HAL. Airlines also broadly supported the arrangements for volume rebates¹¹ and agreed with HAL that this mechanism is likely to incentivise passenger growth.
- 1.14 Three airlines¹² expressed reservations around some of the assumptions supporting the commercial arrangement, including the lack of stretch in HAL's

¹¹ The volume rebates are available to airlines that have signed the deal if the number of airlines passengers rise above certain thresholds in 2020 and 2021.

¹² This was a confidential joint response from three airlines.

- assumptions on passenger numbers. They also raised an issue around how the overall airport rebates and targets included in the deal are allocated to individual airlines operating at Heathrow, suggesting that certain long-haul carriers may be disadvantaged.
- 1.15 The Airlines Operators' Committee (AOC) and the London Airlines' Consultative Committee (LACC) raised concerns over our assessment of the commercial deal and said that limited evidence exists that the commercial deal would deliver longer term benefits to consumers. Concerns were also raised about our assessment of the revenue that HAL was likely to receive under the commercial deal, when compared to CEPA's preliminary estimates of HAL's underlying costs for 2020 and 2021. The AOC and LACC noted that commercial negotiations with companies that hold substantial monopoly power will not lead to genuinely competitive outcomes.
- 1.16 Airlines raised concerns over the process by which the commercial deal was negotiated, saying that HAL did not give them enough time properly to assess the baseline assumptions (including the forecasts of passenger numbers) that support the commercial arrangement. Airlines also said that most carriers had limited success in negotiating significant changes to the commercial terms that were initially proposed by HAL.
- 1.17 They also raised concerns that the CAA's April 2018 initial proposal for the interim price control was 'very weak', especially as a one year extension to the Q6 price control had already been implemented. They said that they were left with no alternative but to discuss and agree the commercial deal offered by HAL. Airlines said that they did not support future commercial arrangements at Heathrow airport because of concerns about HAL's market power and the lack of airline bargaining power (particularly for airlines with smaller scale operations at Heathrow airport). They noted that the commercial deal reflected a specific set of circumstances for 2020 and 2021 and the CAA's proposals to share efficiency saving through reductions in the RAB rather than rebates.
- 1.18 Airlines agreed that the SQRB mechanism should be retained for 2020 and 2021 but said that there are some areas of the scheme that should be reviewed to take account of the opportunities available to HAL to deliver higher levels of

service quality (including in relation to the Quality of Service Monitor and security queues). IAG also suggested that the CAA should complete a service quality audit to ensure that the SQRB scheme continues to be administered correctly ahead of the H7 price control.

- 1.19 Airlines did not support our proposal to shadow track key parts of the OBR framework during 2020 and 2021. They were concerned that this could lead to perverse incentives for HAL to underperform during the interim price control period if future targets are based on performance during 2020 and 2021. HAL agreed in principle that the interim price control period presented a good opportunity for shadow tracking but raised concerns that this could undermine work that they have started in this area.
- 1.20 HAL supported our proposal to introduce a new licence condition for the interim price control period to reflect the commercial deal and welcomed further engagement with stakeholders on this issue. Airlines argued for a "belt and braces" approach to enforcement to ensure that the rebates under the commercial deal are paid and suggested that the contractual rights offered under the commercial deal should be replicated in full in an obligation in HAL's licence. Further detail of stakeholder feedback on this issue is set out in Appendix B.

Way forward

Commercial arrangements between HAL and airlines for 2020 and 2021

- 1.21 Having considered stakeholders' responses, we remain of the view that basing the interim price control on the commercial deal negotiated by HAL and airlines at Heathrow for 2020 and 2021 is in the interests of consumers. This is the first time that commercial arrangements have been negotiated to cover operations at Heathrow, so evidence of the wider benefits of such arrangements is limited at this stage. There remain advantages in encouraging HAL to adopt a more commercial relationship with airlines and accepting the commercial deal as the basis for the interim period will allow stakeholders to focus on dealing with the important issues around capacity expansion. Nonetheless, it is also clear that HAL has a significant amount of work to do if it is going to be able to build on the

- commercial deal and develop a more commercial relationship with airlines in the future.
- 1.22 Despite the reservations that they have expressed, airlines have indicated a strong preference for the commercial deal that they have negotiated with HAL for 2020 and 2021, compared to the price control that we would have otherwise set (with an adjustment to HAL's RAB rather than rebates). Airlines whose operations cover around 89 per cent of passengers at Heathrow have signed the commercial deal.
- 1.23 Accepting the commercial deal as the basis of the interim price control facilitates regulation being focused on areas where it is most needed, which is consistent with the principles of better regulation. It also enables us to have a greater focus on the important matters related to capacity expansion and the H7 price control review, which should allow us to better protect consumers in the medium and longer-term.
- 1.24 The volume rebate mechanism included in the commercial deal provides some additional benefits from passenger growth to those airlines that have signed it, while giving some protection to HAL if passenger volumes decrease in 2020 and/or 2021. In the longer term, consumers should benefit if HAL achieves greater efficiency savings than those underlying the commercial deal, as these can be shared with consumers at the next main price control review.
- 1.25 We acknowledge that some airlines have raised concerns about their relative treatment compared to other airlines under the commercial deal. We note that the price control framework for the economic regulation of HAL airport does not determine the treatment of individual airlines as it focuses on the average level of airport charges per passenger, rather than determining individual elements of HAL's charging arrangements. HAL will still be required to consider airport charges in accordance with the broader requirements of the price control, the Airport Charges Regulations 2011 and competition law.
- 1.26 We note that airlines that have not signed the commercial arrangement will benefit from the overall RPI-1.5% path of charges and the fixed rebates that HAL has offered to all airlines operating at Heathrow (regardless of whether they

have signed the commercial deal). We also note that much of the existing regulatory framework, for example around capital expenditure governance, HAL's RAB and the work to support capacity expansion, continues in place and should help protect the interests of consumers and airlines in the medium and longer term.

- 1.27 As noted above, airlines have raised concerns around HAL's approach to negotiating the commercial arrangement. We also recognise that future commercial arrangements at Heathrow have received limited support from airlines. HAL will need to consider carefully how to address these concerns if it is to build on the commercial arrangements in the future.

Reflecting the commercial deal in HAL's licence

- 1.28 It will be important to adopt a proportionate approach to introducing the interim price control, with HAL's licence capturing those high-level features of the commercial deal (including the fixed rebates) that are available to all airlines operating at Heathrow. The proposed licence modification, and our reasons for and the effects of this proposal, are set out in Appendix B where we also assess the key issues raised by stakeholders on reflecting the commercial deal in HAL's licence and our views on these issues.

Delivering service quality during 2020 and 2021

- 1.29 At this stage it would not be proportionate for us to review the existing SQRB targets, or to carry out a detailed audit of these arrangements, given the advantages of building on the successes of the SQRB and moving towards an approach to outcome-based regulation (OBR) for the H7 price control.
- 1.30 We remain of the view that HAL should continue to develop an evidence base during 2020 and 2021 to support its H7 proposals and that the period to 31 December 2021 presents a good opportunity for HAL to test aspects of the OBR framework, including shadow tracking to the extent that this is appropriate. Testing potential aspects of a new framework can give greater confidence about their introduction in H7. We will continue to engage with HAL on its development of OBR, including how it can test the framework before the H7 price control period.

- 1.31 Bearing the above in mind the existing SQRB mechanism will be retained for the period to 31 December 2021 which will incentivise HAL to continue to deliver quality services during 2020 and 2021.

Relationship between commercial deal and HAL's H7 price control

- 1.32 The commercial deal provides rebates to airlines to be accrued during 2020 and 2021, but not actually paid in full to airlines until subsequent years in the H7 price control period.
- 1.33 Respondents agreed that the rebates payable in respect of the period to 31 December 2021 should not be treated as reductions in HAL's revenues, and so should not affect the setting of the H7 price control. We support this approach and do not intend to make any extra allowances when we set the price control for the H7 period because of these rebates. It would not be in the interest of consumers for the regulatory regime to allow HAL to recover revenues more than once in relation to services it provides. Nonetheless, in setting HAL's next main price control, we will consider both affordability and financeability and cannot rule out making adjustments to our projections of HAL's price control revenues to take account of financeability of the capacity expansion programme.

Price control arrangements beyond 2021

- 1.34 We remain of the view that our regulatory framework should be broadly aligned with the wider capacity expansion programme. The February 2019 Consultation said that we intend to retain the option of putting in place further interim arrangements to cover 2022 if the capacity expansion programme is significantly delayed. We noted that these arrangements would involve resetting more of the key drivers of the price control revenue, including the reassessment of the cost of capital.
- 1.35 In July 2019 we issued a consultation on early costs that HAL expects to incur to support capacity expansion, and the timetable for developing the regulatory framework for HAL.¹³ We highlighted that the wider timetable for capacity expansion is under a degree of pressure (which is not, in itself, surprising given

¹³ See the "July 2019 Consultation" at: www.caa.co.uk/CAP1819

the scale and complexity of the programme) and we are consulting on whether the regulatory timetable remains appropriate. Our current view is that there would be a number of advantages to retaining a target of 2021 for the main H7 price control proposals rather than delaying the regulatory timetable or introducing a further transitional period. This approach could involve the greater use of uncertainty mechanisms to deal with those elements of the programme which will be less certain.

- 1.36 Stakeholders with comments on these matters should respond to the July 2019 Consultation on early costs and the regulatory timetable by 22 August 2019.

Views invited

- 1.37 Views are invited from stakeholders on any of the issues raised in this chapter.

Chapter 2

Promoting economy and efficiency

Introduction

- 2.1 The March 2019 Consultation¹⁴ built on previous consultations since 2014 in considering whether a new condition in HAL's licence to promote economy and efficiency by HAL (an "efficiency condition") would further the interests of consumers. We stressed the importance of such a condition in filling a gap in the regulatory framework for HAL, in that it is not practicable or desirable to try and develop incentive arrangements to cover all aspects of its conduct.
- 2.2 This chapter:
- provides a brief summary of what we said in the March 2019 Consultation;
 - sets out the main points raised by respondents to the March 2019 Consultation on these matters; and
 - explains our decision to move forward with our proposals for an efficiency licence condition, with Appendix E setting out the licence drafting for statutory consultation.

The March 2019 Consultation

- 2.3 The March 2019 Consultation reiterated our position that HAL's licence does not explicitly drive efficiency across all its activities or provide a general obligation against which the CAA can investigate questions of inefficiency. It went on to make clear that we consider that neither other elements of the regulatory regime, nor pressure from airlines adequately compensate for this, and that *ex post* application of competition law does not sufficiently protect the interests of consumers.

¹⁴ See Economic regulation of capacity expansion at Heathrow: policy update and consultation www.caa.co.uk/CAP1782 ("the March 2019 Consultation")

- 2.4 In this light, we refined our approach to an efficiency condition to focus more clearly on how HAL conducts its business rather than precisely what it delivers. Consistent with our approach of not mandating either capacity expansion (which should be funded and incentivised through HAL's next main price control), or other particular investments (which should be decisions for HAL's management using established governance mechanisms), we said that an efficiency condition would complement, rather than replace, HAL's price control arrangements and facilitate oversight of the way that HAL runs its business generally to avoid regulatory "gaps".
- 2.5 While not being suitable for determining (or intended to cover) either:
- commercial disputes between HAL and the airlines it serves; or
 - insignificant matters,
- such a condition would give stakeholders (particularly airlines) the ability to raise concerns in "real time" rather than through slower issue-specific regulatory developments or having to wait until the conclusion of the next price control review.
- 2.6 Overall, we were minded to continue to develop an efficiency condition with a view to implementing a condition at the start of the 2020 and the interim price control period (which will run for two years before HAL's next main price control). We said that such a condition has the potential to be an important part of the overall regulatory framework, ensuring efficiency and economy in the provision of airport operation services ("AOS") and providing a further safeguard for users' interests, particularly if serious or systemic failings in HAL's conduct were to arise.

Stakeholder views

- 2.7 The stakeholders whose responses addressed the introduction of an efficiency condition broadly followed the approach that they had taken in response to previous consultations:
- HAL opposed its introduction, but nonetheless suggested specific drafting changes; and

- airlines, their representatives, and other stakeholders broadly supported an efficiency condition targeted at how, rather than what HAL delivers.
- 2.8 Stakeholders agreed that any such a condition, if introduced, should be clear in covering only the activities of HAL at Heathrow airport, rather than having wider application to airlines or third parties such as Border Force.
- 2.9 In opposing an efficiency condition, HAL continued to say that the CAA had failed to justify the introduction of an efficiency condition in line with its statutory duties. It suggested that the CAA had failed to demonstrate the weaknesses in its existing power with respect to ensuring economic and efficient delivery by HAL. It cited the CAA's "Section 16" reports as evidence that the CAA has been able to influence effective engagement and said that section 50 CAA12 provides the CAA with adequate tools to gather information. It also said that the CAA should carry out a full quantified impact assessment or cost benefit analysis before introducing any such condition.
- 2.10 Without prejudice to these comments, HAL expressed the view that the drafting of any condition should be clear and properly reflect the CAA's duties. In so doing, it agreed with the CAA's approach that the condition should focus on behaviour, not outputs and not mandate expansion or specify "areas of focus". It also took the view that the drafting of the condition should track more closely the wording of CAA12, and that certain terms used in the draft condition should either be defined or expanded on in order to clarify the condition. HAL made drafting comments on the condition in the March 2019 Consultation which are summarised and addressed in Appendix D.
- 2.11 HAL also took the view that it is not appropriate to include an efficiency condition in its licence at this stage, considering its implementation rushed, and seeing its entry into commercial agreements with airlines for the interim price control period as a change of circumstances which signals a more commercial relationship between HAL and airlines. In any event, the CAA should provide further assurances that its enforcement guidelines and prioritisation criteria that will apply to any enforcement action to make clear that the condition is not aimed at resolving commercial disputes or trivial matters.

2.12 Individual airlines commented that:

- HAL's market power makes it incumbent on HAL to demonstrate efficiency in all aspects of its business and in how it responds to its customers;
- airlines do not bring commercial pressure to bear on HAL as the capacity constraints at Heathrow means they have no countervailing buyer power;
- HAL's opposition to a condition, along with its lack of responsiveness to airlines, helped to show why an efficiency condition is needed;
- while HAL may not reasonably be expected to deliver all the desired outputs all the time, it should deliver all the desired outputs and outcomes most of the time and customers should not be expected to pay for undesired outputs or outcomes;
- "economy and efficiency" do not need to be defined in the condition as they are well understood;
- references to the requirements of present and future users and the need for HAL to be able to finance its activities should not lead to an increase in HAL's rate of return;
- any additional "perceived" risk for HAL would not necessarily be reflected in HAL's actual financing costs and an efficiency condition should increase investors' confidence that they will receive a fair return; and
- the CAA must be seen to act on the licence condition to ensure that HAL acts efficiently and in the interests of consumers.

2.13 Airline representatives remained more cautious, considering that a new condition should not replace effective and rigorous regulation that should focus on appropriate outcomes. They also considered that more stringent price control arrangements might help address some of the issues associated with the current regulatory framework.

2.14 The Arora Group ("Arora") supported the new condition but were disappointed that failure to engage with a competitor by HAL would not prima facie "engage" the condition, believing this will undermine the CAA's policy on alternative delivery arrangements. Arora also said that the CAA has an important role to

play in creating a level playing field. It took the view that increases in HAL's Category B and C costs is evidence of requirement for condition and that any competitor is at a disadvantage due to:

- the wealth of data and information from operating Heathrow that HAL holds; and
- HAL's costs are directly recoverable from airlines.

2.15 Arora welcomed the CAA's approach of referring to elements of its own duties in the condition as an aid to interpretation, but considered that the CAA should assess compliance in accordance with all its duties. It urged the CAA not to let the timetable for introducing the condition slip beyond the end of 2019.

2.16 Another respondent was generally supportive and thought that the obligations should be drafted clearly to hold HAL to account. This respondent was also concerned that the use of RAB based regulation may not provide sufficient incentive for HAL to develop cost effective expansion proposals. It cited HAL's costs for providing car parking as evidence that HAL may not be cost efficient. It also suggested that the condition should be drafted to require HAL to have full regard to the Airports' National Policy Statement ("NPS").

2.17 HAL, airlines and their representatives also requested that the CAA clarify how the condition will operate, including information gathering and resourcing of investigations. They also made comments on the drafting of the condition which are addressed in Appendix D.

Way forward

The reasons for and effect of the proposed modification

2.18 We have set out in a series of consultations why we consider that modifying HAL's licence to include a new efficiency condition is justified. The reasons for the proposed condition and the effects of it have been set out in those previous consultations and are summarised below:

- An efficiency condition should address the fact that it is not practicable for price control incentives fully to capture all aspects of HAL's behaviour.

We consider that is the case because:

- we cannot be certain that incentives can be designed in such a way that they could be relied on, by themselves and without more, to drive economy, efficiency and timeliness in all aspects of HAL's existing business and in developing new capacity (especially given both the requirements for detailed information and foresight that the design of such incentives would require in the circumstances of a programme as complex and difficult as capacity expansion, and given the size and complexity of HAL's business);
- there is the risk that incentives may be gamed or may have unforeseen consequences; and
- we cannot be certain that *ex post* reviews (a form of incentive) would be fully effective in protecting consumers from the costs of inefficiency, not least because they are more suited to the disallowance of inefficient expenditure rather than dealing with other inefficiencies.

In addition, for the period of the interim price control at least, the incentive arrangements applicable to HAL are likely to be less effective, not least because of the time elapsed since the last full price control was set (the Q6 price control period commenced in 2014).

- The regulatory regime applicable to HAL does not contain a general obligation to promote economy and efficiency across the full range of HAL's activities.

Although HAL's licence does contain tightly focussed obligations on efficiency, in relation to the promotion of capital projects (Condition C3) and operational resilience (D2), neither CAA12 nor HAL's licence contains a general obligation to promote economy and efficiency across the full range of HAL's activities.

Furthermore, the use of competition law is not well suited to addressing efficiency issues (see further below).

- An efficiency condition should be included in HAL's licence to be part of a suite of regulatory tools that, taken together, should promote and incentivise efficient behaviour by HAL in the interests of consumers.

Given:

- that the CAA must have regard to promoting economy and efficiency on the part of each holder of a licence;
- the absence of general obligations on HAL to operate efficiently; and
- the limitations of incentives set out above,

an efficiency condition should sit alongside incentives to prove a tool that would facilitate the CAA in having regard to the need to promote economy and efficiency on the part of HAL and satisfy its obligation to do so under CAA12.¹⁵

- An efficiency condition should provide clear expectations for the way HAL conducts its business, working alongside the price control, not in place of it.

As noted in above, the efficiency condition should complement, not replace the price control.

To provide clear expectations for HAL, the efficiency condition should also make appropriate reference to the reasonable demands for airport AOS and requiring HAL to consult appropriately to determine what these are in order to help it frame its conduct, as well as further tracking the requirements of section 1 CAA12.

- An efficiency condition should provide the CAA with the ability to address issues arising from HAL's behaviour generally and in "real time", without the need either to wait for the outcome of the next price control or the development of issue-specific licensing rules, to address particular and/ or unforeseen circumstances that may have arisen and are causing detriment to consumers.

¹⁵ As such, an efficiency condition should track the CAA's duties in CAA12 as far as reasonably practicable so that the CAA has the tools to satisfy its duties.