

Economic regulation of Heathrow: programme update

CAP 1914



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About this document

This document provides an update on our programme for the development of the economic regulation of Heathrow Airport Limited (“HAL”) in the light of the very significant changes and uncertainties brought about by:

- the severe impact of the Covid-19 pandemic on the aviation sector as a whole and passenger numbers at Heathrow airport;
- the Court of Appeal’s decision setting aside the Airports National Policy Statement; and
- HAL’s subsequent decision to pause its programme for expanding Heathrow airport in the light of these developments (although it is appealing against the Court of Appeal’s decision).

It outlines our proposals for changing our overall approach to developing the regulatory regime for HAL in the light of these developments.

Views invited

We welcome views on all the issues raised in this document, especially on the issues set out in the executive summary and dealt with in chapters 1 and 2. Please e-mail responses to economicregulation@caa.co.uk by no later than 22nd May 2020. 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 under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

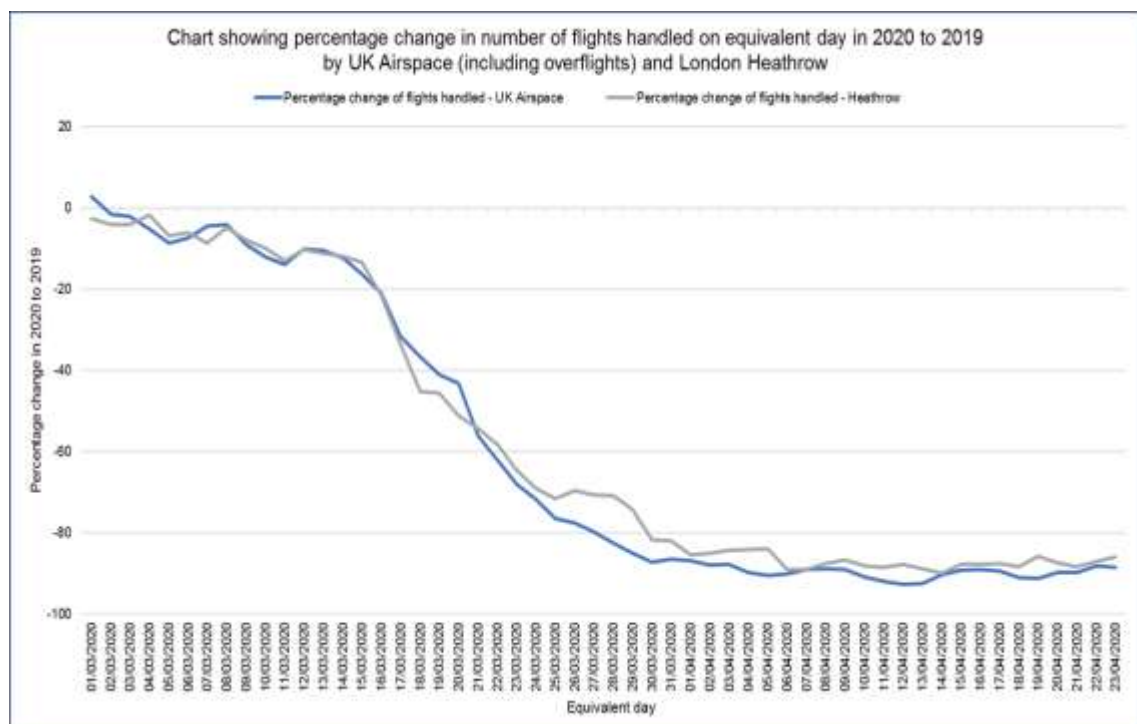
If you would like to discuss any aspect of this document, please contact Rob Toal (Robert.Toal@caa.co.uk).

Executive summary

Introduction

1. Recent developments have had a fundamental impact on the global economy as a whole and especially on the aviation sector. The impact of the Covid-19 pandemic through international restrictions on travel and national rules discouraging all but essential journeys has had a dramatic impact on the level of air traffic. As indicated by Figure 1, initial data analysed by the CAA suggests that, as at 23rd April 2020, air traffic in UK airspace has reduced by over 85% from the equivalent period in 2019, with flights from Heathrow airport also reducing by a similar percentage.

Figure 1: Reduction in UK airspace (including overflights) and Heathrow traffic 2019-2020 as at 23rd April 2020



Source: CAA Analysis of EUROCONTROL data

2. Prior to the full impact of Covid-19 being felt, the Court of Appeal delivered its judgment that the Airports National Policy Statement ("NPS") had not been

lawfully produced.¹ This judgment removes the underpinning under the Planning Act 2008 which HAL was using to support an application for consent to expand Heathrow airport. This judgment is subject to the outcome of the appeal being sought by HAL in the Supreme Court and any review of the policy set out in the NPS carried out by the Government.

3. In response to these developments, HAL decided to pause its expansion programme in March 2020, stopping nearly all work and spending on preparing its application for planning consent and early construction activities.
4. The impact of Covid-19 has brought about very considerable uncertainty to the aviation sector as a whole and, in particular, the regulation of HAL. This uncertainty has many aspects, including:
 - for how long the current very low levels of traffic will last;
 - the timing and speed of subsequent recovery;
 - the future mix of passengers, airlines and aircraft type that might use Heathrow airport;
 - the impact of these factors on HAL's revenues from airlines and other commercial sources; and
 - the impact on financial markets and the consequences of all these matters for the financial viability of companies operating in the aviation sector.
5. In the light of this uncertainty and the Court of Appeal's decision on the NPS, it is unclear whether capacity expansion will proceed and at the very least there will be significant implications for the timeline of the capacity expansion programme. Nonetheless, HAL and airline stakeholders have told us that they want us to continue work on HAL's next price control, but with a focus on the "two runway" airport, with the intention of having a new price control in place from 1 January 2022. This is also necessary as the current price control for HAL expires on 31 December 2021. To reconfigure our work programmes so that we can work

¹ See: *R (Friends of the Earth) v Secretary of State for Transport and Others* [2020] EWCA Civ 214

towards putting these new price control arrangements in place, we will need to find ways of dealing with:

- the issues created by very low levels of air traffic; and
- the uncertainty about the timing and shape of the recovery in air traffic in the future and the impacts this is likely to have on HAL's revenues.

6. The paper outlines how we are seeking to respond to these challenges, including through changes to the regulatory programme and timetable.

Main issues raised in this consultation

7. The nature and extent of the uncertainties caused by the current circumstances mean that the range of plausible outcomes for the development of HAL's revenues over the course of the coming years is significantly wider and more difficult to predict than usual. These uncertainties also mean that the factual background against which the CAA will be taking its decisions will be dynamic and difficult to predict.
8. Of the issues outlined above, it appears that the impact of the Court of Appeal's decision and HAL's response in pausing its programme for the expansion of Heathrow airport is the more straightforward for us to address. We will refocus our work over the coming months to develop a price control that is suitable for a two runway airport. This price control will not need to address the complications brought by the very large capital expenditure associated with capacity expansion.
9. The challenges created by Covid-19 will present much greater difficulty and it would not be realistic to think of the work we should do to set new regulatory arrangements as a "business as usual" process. This is particularly the case because it is too early to know what the impacts of Covid-19 will be over the next few years. These impacts will also be affected by decisions that are made by the UK Government (including in relation to economy-wide and sector support packages) and decisions made by Governments around the world, especially in relation to "lockdowns" and travel restrictions, which will have an impact on the timing and shape of the recovery in traffic levels.

10. These impacts may create fundamental issues with little or no regulatory or commercial precedent to guide how they should be resolved. Therefore, our policy and approach will need to be sufficiently flexible to deal with new evidence and circumstances as they emerge.
11. In the longer term, we expect traffic levels to recover. In these circumstances, we would expect that the market positions of regulated airports may return to “pre-crisis” levels, although we recognise that it is simply too early to form a definite judgment on this.²
12. As for the expansion of Heathrow airport, the Government may choose to review the NPS with a view to dealing with the issues covered by the Court of Appeal’s judgment. Alternatively, that judgment could be successfully challenged at the Supreme Court. In these circumstances, we must retain the option of dealing with any proposals by HAL to reinstate the capacity expansion programme. Given the developments associated with Covid-19, it seems unlikely that we will see such proposals in the short term, but we retain the option of dealing with these matters in the future by adjusting or resetting HAL’s price control.
13. Therefore, we consider that it is appropriate for us to focus on a two runway price control and this paper sets out our high level views on:
 - the new strategic context, including the use of scenarios to help explore how the present uncertainty might start to crystallise in the likely future path of air traffic volumes, and airport costs and revenues. These should allow us to assess the best approach for setting HAL’s next price control. In particular, we will consider a range of options for the form and duration of the price control; and
 - the importance of a more flexible process and timetable, but with a continuing emphasis on the importance of constructive engagement.

² Irrespective of any short term practical difficulties that the current uncertainties might bring for the conduct of a market power determination, given the length of time that such a review would inevitably take, it would not be possible for the CAA undertake a market power determination in respect of Heathrow airport prior to setting the next price control for HAL. As such, the position remains that Heathrow airport has substantial market power for the purposes of CAA12.