Beth Corbould
Consumer & Markets Group
Civil Aviation Authority
CAA House, 45-59 Kingsway
London WC2B 6TE

Sent by email to: economicregulation@caa.co.uk

2nd June 2017

Dear Beth,

Re. Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control (CAP 1540)

International Airlines Group (IAG) welcomes the opportunity to respond to the CAA's document detailing guidance for Heathrow Airport Limited (HAL) in preparing its business plans for the H7 price control. This letter specifically covers the two specific issues on which the CAA is consulting stakeholders: should CAA provide a financial incentive on HAL to develop a high quality business plan; and how can CAA best align the regulatory and business planning timetables, in light of developments in the wider process for new runway capacity?

In summary we do not believe that HAL either requires or should be provided a financial incentive to develop a business plan.

As far as the regulatory and business planning timetables are concerned we are supportive of extending Q6 further (Q6+2) but only if the passenger forecast is rebaselined – our logic being as follows:

- Normally we would look to reopen the WACC – however that would involve increased complexity and is not in line with the concept of a simple extension. Therefore we want to find a simple mechanism that addresses risk.
- We can only accept current WACC if risks remain as they were when it was originally set;
- The key risk to the HAL business is volume risk;
- This has demonstrably not materialised, as traffic is well ahead of forecast;
- So for the WACC to be 'fair', traffic volumes have to be re-based.

We also believe that the CAA should think about this for Q6+1 as well as for subsequent years as the arguments are equally valid.

On outcome-based regulation and consumer engagement IAG supports the response made by the AOC. We may look to submit further comments on these issues if required.

Our detailed feedback is as follows:

Quality of business plan incentives

1. We do not believe that HAL either requires or should be provided a financial incentive to develop a business plan. Development of a business plan that is focused on the needs of consumers, whether passengers, cargo-owners or airlines, is HAL's job. They should not

require an incentive to do so. If they fail to do so then we would expect the CAA to take remedial action to ensure the airport business plan does meet the expectation of consumers and airlines.

2. In our view it would be wholly inappropriate for HAL to receive an additional payment or more generous allowance on a regulatory input in return for development of the H7 business plan. Heathrow is already the most expensive airport in the world and, at a time when it is pursuing expansion which will increase charges further, to allow it to financially benefit from developing a business plan is neither reasonable, nor in the interests of passengers.

3. If the CAA were to insist on introducing a financial incentive then it should be subtractive (not additive). In case HAL fails to develop a business plan that is consumer-focused or ambitious, then a less generous settlement should be put in place versus what the CAA would otherwise do or a set financial penalty should be levied as part of the reconciliation at the end of Q6.

4. The CAA would be acting against the best interests of consumers by effectively increasing the charges those consumers pay to HAL for the airport services it provides to them and airlines.

Aligning regulatory and business planning timetables

5. We agree with the CAA that consideration should be given to how best align the regulatory and business planning timetables in light of expansion. Ensuring that the H7 business plan is developed with the best available understanding of HAL’s expansion plans should be a key objective. It is clear that more time is therefore needed to allow more detail of HAL's expansion plans and timetable to be known. For this reason we would discount both the *"condense"* and *"combine and stretch"* options that would retain a 2020 start date, i.e. following Q6+1 in 2019.

6. The *"realign by 12 months"* option, effectively allowing a second extension year (Q6+2), not only allows more time for HAL's expansion plans to be developed and taken account of by the H7 business plan, but also allows airline, CAA and HAL resources to focus more fully on expansion in the additional 12 months created through 2018.

7. Therefore we support the option of realigning the regulatory and business planning timetables by 12 months with H7 starting in 2021.

8. We would support a more detailed review of the HAL regulatory settlement as a result of a proposal to have a Q6+2 and do not believe a simple rollover is appropriate and this is informed by a number of factors.

9. Reviewing the 2016 regulated accounts shows that HAL is over-achieving passenger forecasts by 3m per annum, which is equates to revenues of around £70m. Commercial revenue benefits (due to increased passenger numbers and investment in commercial revenue schemes) outstrip variable operational costs giving HAL a further £8m per annum benefit. By the end of Q6 this figure could be around £100m per annum, driven by increased passenger numbers. Whilst we accept this is a benefit to HAL within the review period, we cannot accept that a £200m benefit in the two rollover years are deserved and so we would expect to see traffic forecasts rebased.

10. The operational cost price path set by the CAA for Q6, is to reduce annually by introducing efficiencies throughout the HAL business. We accept that this is built into the current settlement of RPI-1.5%, and if rolled over a reducing operating cost price path would continue; however, we maintain that only a third of efficiencies highlighted by the airlines were included in the original settlement and by rolling over for two years would give HAL the opportunity to further capitalise on airline efficiencies.

11. RPI-1.5% does not represent a fair rollover settlement for either Q6+1 or Q6+2, is costing airlines around £200m on passenger numbers alone (and probably more if a more aggressive operating cost reduction is adopted and the WACC revised to reflect the reality of how HAL's business has become an even safer investment through Q6). We therefore believe the CAA needs to find an equitable formula for distributing the £200m over achievement HAL will make in the rollover years.

12. We also aware however that we do not want to trigger a smaller but full price control process. This would be onerous and time-consuming and destroy the time benefit and opportunity created by a Q6+2 extension.

13. We believe the most appropriate way forward would be to re-base passenger forecasts for both Q6+1 and Q6+2. The passenger forecasts for Heathrow in Q6 have significantly underestimated actual passenger levels. By re-basing passenger forecasts for both extension years, HAL's revenue requirement for the additional period is recovered against the actual passenger base, thus reducing the per passenger charge payable and preventing airlines paying the set airport charge for passenger volumes over and above the forecast levels, with HAL unable to bank additional revenue.

14. The benefits of such an approach are that:
    - it addresses clearest area of HAL outperformance in Q6 period;
    - it restores the balance of the CAA's original risk judgment on the WACC at the outset of Q6 versus the passenger forecast risk; and
    - the per passenger charge cost to airlines and consumers is reduced at the outset of the extension years rather than waiting for a subsequent rebate/'true up';

15. We recognise that a method would need to be agreed to develop new forecasts, but note that this does not have to be done now. Also one of the advantages of this process is that a judgment could be taken much closer to the start if the extension years based on actual passenger numbers and allow more robust forecasts to be determined.

16. We will engage with the CAA to develop proposals for how best to take development of a Q6+2 option forward if that is chosen as the most appropriate way forward.

If you have any queries on this response please contact David.Milford@BA.com

Yours sincerely,

Neil Cottrell

Pp: Ian Clayton