Consumer and Markets Group

John Trippier,

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Dear John,

ORR consultation on the charging framework for the Heathrow Spur

We welcome this opportunity to respond to your consultation on the charging framework for the Heathrow Spur. We hope you find the following comments helpful. I can confirm that we have no objections to you publishing this letter.

The role of the CAA and our interest in your proposals

The CAA regulates Heathrow Airport Limited (HAL) for economic purposes under the Civil Aviation Act 2012 (CAA12). In doing this, we are under a general duty to carry out our functions in a manner that we consider will further the interests of users of air transport services (i.e. passengers and cargo owners) regarding the range, availability, continuity, cost and quality of airport operation services. Prior to the enactment of the CAA12 we regulated HAL (previously part of BAA plc) under the Airports Act 1986 (AA86), where users (hereafter referred to as airport users) were more widely defined to include people using specified services or facilities at the airport.

We fully recognise that the charging framework for the Heathrow Spur is a decision for ORR under the Access and Management Regulations 2005. We have an interest in your proposals as far as our current duties are concerned because a decision not to include any historic long-term costs in rail charges would effectively mean that the entirety of these costs would have to be met by airport users. This could mean a material increase to airport charges especially given the context that only a small proportion of airport users are beneficiaries of the Heathrow Spur and not all the users of the Heathrow Spur are airport users. We also have an interest in your proposals if they could pose any unintended consequences for our ability to incentivise airport operators to privately finance the building of rail access projects that benefit airport users.

Evidence that existed before the Heathrow Spur was built

We appreciate that this may have been a challenging issue to assess given the lack of evidence available from the time the Heathrow spur was commissioned and built, some 25 years ago. We support your approach of considering all the evidence in the round and to consider what inferences should be drawn from the available evidence.

We have searched both our own archives and the National Archives, but are unable to add much evidence to what you have already considered. As we noted in our 2005 consultation on surface access that you referenced in your proposals, the Heathrow Spur was added to the HAL Regulatory Asset Base (RAB) in 1991 by the then Monopolies and Mergers Commission "with very little regulatory debate".[1] In terms of what BAA plc took into account in making its commercial decision to build the Heathrow Spur, clearly that is a matter for HAL to advise you on and provide any supporting evidence it has to support its view.

Relevant CAA policy on surface access

We note from your proposals that you reviewed a number of CAA documents relating to our price control reviews for the periods 2003 – 2008 (Q4) and 2008-2013 (Q5) with regards to our treatment of surface access costs in those reviews. As you have drawn a number of inferences from those documents we think you might find it helpful if we clarified some of the context to those documents.

In summary, although there was not much regulatory debate in 1991 around the inclusion of the historical long-term costs into the HAL RAB, the CAA did develop and document a policy on surface access from 2001 onwards in line with our duties under the AA86. This policy was that airport users should not be expected to subsidise the costs of surface access infrastructure except where it was required as a condition of planning consent for airport expansion. Our policy was that direct users (e.g. rail users) should be required to pay for their full contribution. This policy reflected the government's 'user pays' principle, as outlined in Annex D of our 2005 consultation on surface access costs.[2] Although we cannot source a public statement of policy on surface access that predates 2001, we have no reason to doubt that a similar 'user pays' type approach would have been taken into account during earlier price control reviews, especially given we would have been operating under the same legislation that focused on the interests of airport users.

During Q4 the CAA explicitly considered that the costs of surface access schemes should, wherever possible, not be met by airport users. The CAA wanted to move from a single till approach to a 'dual till'[3] approach by splitting out all the non-aeronautical charges from the aeronautical charges. The main driver for this was to ensure that regulated airport charges only covered those services and facilities where BAA had a monopoly. With regards to surface access in this debate,[4] we considered that service access was not a core airport monopoly service or facility

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[1] See Annex D, paragraph D.6 of *'Airports review - policy issues: consultation paper'* CAA Dec 2005 which can be found at http://webarchive.nationalarchives.gov.uk/20140713054907/http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportsreview_dec05.pdf.

[2] See Annex D of the 2005 consultation (a link can be found in footnote 1).

[3] HAL has historically been regulated under a single till arrangement whereby the CAA takes into account all costs and revenues from both aeronautical and non-aeronautical services and facilities. Non-aeronautical services and facilities include car parks, retail facilities and other commercial services and facilities. The Heathrow Spur has been included in HAL's RAB since 1991under this single till arrangement.

[4] See documentation on Q4 at http://webarchive.nationalarchives.gov.uk/20140713054907/http://www.caa.co.uk/default.aspx?catid=78&pageid=11827.

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and that it was capable of generating its own revenue streams. Furthermore, we were concerned that any subsidisation of surface access through airport charges would dampen incentives for more efficient pricing of surface access, and more generally could introduce regulatory distortions into the development of surface access. We did accept that where new surface access infrastructure was required as a condition of planning consent for airport expansion (such as the Terminal 5 extension), this could be included in the aeronautical RAB as part of the overall expansion infrastructure.

The Competition Commission (CC) eventually rejected the CAA's overall preference to move to a dual till because, in summary, it concluded that it was not sensible to split the two sides of the business as the aeronautical and commercial activities in fact represented one business and that aeronautical facilities could generate both aeronautical and commercial revenues.[5] The CC considered that it was sensible to include surface access costs and income in the single till along with other commercial activities but it did not address the issue of sharing the recovery of surface access costs between the different users, as the focus of the debate was on the much wider dual till/single till issue.

Our approach was further elaborated during the Q5 review. We issued a clear statement of our surface access policy in December 2005, which we confirmed and adopted in our final decision for Q5 in 2008.[6] The foundation of this policy is that costs should be recovered from those using the surface access infrastructure to the maximum extent practicable. Airport charges, calculated in a single till basis, would only make up a shortfall (residual) for the costs that are not otherwise recovered by charging users of the surface access infrastructure. In particular, we said that:

(1) "the airport operator should take reasonable steps to ensure that the direct users of surface access facilities defray the costs to be recovered through airport charges to the maximum extent practicable through the application of direct charges for the use of such surface access".[7]

(2) "the proportion of net surface access costs borne by the airport operator (after direct users have contributed through direct road or rail charges) should be based on the relative benefits derived by airport users versus non-airport users of the surface access projects required to support airport expansion".[8]

(3) "direct users' cost attribution: the CAA would expect airport operators to demonstrate that they had assessed a full range of technically feasible options for placing as much of the surface access costs as possible on the direct users of these transport facilities".[9]

We reaffirmed this policy in our most recent review for Q6 (2014-2019).

We note that you considered that our 2005 consultation did not make clear whether revenues (to the extent recovered) need to offset capital costs such as the historical

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[5] See paragraphs 2.219 to 2.223 of '*Competition Commission report on BAA London airports'* Competition Commission November 2002 which can be found at http://webarchive.nationalarchives.gov.uk/20140713054907/http://www.caa.co.uk/docs/5/ergdocs/ccreportbaa/chapter2.pdf.

[6] See Annex E, paragraphs E.23 and E24 of '*Economic Regulation of Heathrow and Gatwick Airports 2008-2013 CAA decision'* CAA March 2008 which can be found at http://webarchive.nationalarchives.gov.uk/20140713054907/http://www.caa.co.uk/docs/5/ergdocs/heathrowgatwickdecision_mar08.pdf.

[7] See paragraph D.25c of the 2005 consultation (link in footnote 1).

[8] See paragraph D.25d of the 2005 consultation (link in footnote 1).

[9] See paragraph D.27 of the 2005 consultation (link in footnote 1).

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long-term costs, or just the operating costs (opex).[10] To clarify, we have never made a distinction between the recovery of opex and historical capex for aviation surface access projects because they tend to be fully financed from private sources, so we assume that total costs will need to be recovered to make them viable.

We also note that you commented on the fact that the Heathrow Spur was included within the RAB. We would encourage a degree of caution about adopting an assumption that just because a rail project is within the airport RAB, this axiomatically indicates that the project would have gone ahead without recovering historic costs through rail charges. This is because under our single till approach the airport operator will factor in that income from the project will be netted off from airport charges and that we would expect an airport operator to maximise the recovery of the costs from this income. This income stream is taken into account in the decision about whether the project provides an overall benefit to airport users and hence it influences whether the project is added to the airport RAB in the first place.

Potential implications of your proposals for airport charges

Heathrow Express has, from the start, contributed to the recovery of the costs through the single till arrangement and it was always expected that this would continue, with airport users only being required to make up any shortfall. Currently, Heathrow Express makes a negative contribution to the HAL RAB, with the airport users making up the shortfall - but this negative contribution is diminishing year on year as revenues increase and the assets depreciate. According to HAL's projections, under the current arrangements, Heathrow Express's contributions to the single till will be such that, by the time the CrossRail services begin, there will need to be very little, if any, contribution from airport users. In contrast, we understand that your proposal would preclude the recovery of historical long-term costs not only from CrossRail when it opens in 2018, but also from Heathrow Express for its current operations. This would reduce the rail users' contribution to the single till to nil and place the burden of cost recovery entirely on airport users. This could clearly have implications for our primary duty to further the interests of airport users.

We hope you find these comments helpful. Please let me know if I can be of further assistance or if you would like to discuss any point above.

Yours sincerely,

Stephen Gifford

Head of Economic Regulation

[10] See paragraph 57 of your consultation.