

## Written evidence submitted by Heathrow Airport

### Introduction & Background:

Heathrow sits at the very heart of the UK's aviation industry and, by extension, the UK economy. In 2019, Heathrow was Europe's busiest airport, and remains the UK's largest port by value. Prior to 2020, Heathrow handled over 475,000 flights with more than 1.6 million tonnes of cargo (worth over £160bn) and 80 million passengers moving through the airport annually. The airport is home to more than 80 airlines, connecting passengers to more than 200 destinations and 85 countries around the world.

As the UK's only Hub airport, over half our annual passengers travel to long-haul destinations not served by any other UK airport, plugging the gaps in the UK network to vital global trading markets. We connect all four corners of the UK to wide-ranging travel, tourism and trading opportunities throughout the world.

However, Covid-19 has had a devastating impact on the airport. Passenger numbers collapsed to 22.1m from 81m in 2019. We lost around £2bn, as our overall revenue fell 62% year on year. Government policies over the course of the year caused the UK's borders to effectively shut, and continued inconsistency over the application of the Global Travel Taskforce's (GTT) risk-based approach means the prospects for a return to growth are extremely uncertain.

Given the UK Government has made attracting inward investment a key focus of its Global Britain agenda – and achieving a NetZero economy cannot be done without an environment where sustainable investment is encouraged - it is vital that the regulatory environment that sits underneath these ambitions, is fit for purpose.

For Heathrow however, supporting the Government's ambitions is at risk of being undermined by not only an uncertain and inconsistent international travel policy, but also poor regulatory policy and decision making. It is vital that the future regulatory environment in the UK centres on long term consumer interests, not just short-term price, as well as acknowledges the value of resilience, service, financial stability and private sector funding. Furthermore, regulation must acknowledge wider social benefits such as UK competitiveness and productivity, capacity to drive competition, and social and environmental priorities that are more than the lowest possible short-term charge from the regulated company.

These driving objectives and principles should range from delivery of operational, financial and technological resilience - all the way through to climate resilience and creating economic incentives that deliver the decarbonisation of Aviation.

### Background to regulation at Heathrow

Through its price control process, the Civil Aviation Authority (CAA) sets a price cap for Heathrow determining the maximum amount of revenue Heathrow can earn per passenger in each year of its regulatory period. This is based on Heathrow's forecast costs, commercial revenues and passenger numbers. The amount Heathrow can charge annually is set out in the Licence alongside a number of conditions setting out the quality of service we are required to provide, requirements for consultation with our users and conditions relating to our financial resilience.

The Licence and regulatory framework set by the CAA therefore determine the totality of how Heathrow operates. In setting and enforcing the per passenger price cap, the CAA specifies how much Heathrow can invest in our airport operations, how much operating expenditure we can incur and the levels of service we have to provide. The price cap also, importantly, establishes the conditions and incentives for investment.

As an entirely privately funded airport, getting these conditions right is important to ensure that investment in Heathrow is financeable for our investors and affordable for consumers.

The regulatory decisions the CAA takes have real world consequences on Heathrow's ability to provide and develop its airport services for the benefit of consumers and the UK economy. If the framework does not provide for the right level of investment or prioritise the right level of service and resilience, Heathrow will not be able to maintain, develop and grow to the detriment of the UK economy and aviation consumers.

The CAA is currently consulting on the arrangements for Heathrow's next price control period, starting in 2022. This period is referred to as H7. Against the backdrop of the extreme uncertainty caused by Covid-19, this price control will be even more important in not just setting Heathrow's future but the basis for the recovery of aviation.

However, we are seeing this impacted by a regulator whose lack of clear objectives and long-term thinking risks leading to results which are not aligned with key government policies and, ultimately, the longer-term interests of consumers and the UK economy. It is more important than ever that regulation supports, rather than impedes, the recovery and growth of aviation in the UK.

### **Principles of effective economic regulation**

#### *1. Decisions made by economic regulators shape the economy*

As the NAO sets out in its principles of effective regulation, price control regulation - the form of regulation under which Heathrow operates - is one of the most intrusive forms of regulation currently implemented in the UK. It sets out how regulated companies can and should invest, the risks investors are expected to bear in making these investments and what the key outputs from the sector should be for the next five years.

The actions of the regulator and its ability to set the right conditions through its frameworks therefore control both the regulated sectors and investors' appetite to invest in them going forward. This impact is not recognised by the Government.

Government needs to ensure that these regulators have both the right objectives and skill sets to ensure they play this vital role in alignment with government priorities and in the best interests of the UK economy.

#### *2. Regulators have become increasingly narrow and short-term in their focus*

In spite of their vital role at the heart of the UK economy, regulators are more focused on maintaining their own legitimacy in the media regarding the cost of services to end users now, rather than on ensuring the long-term interests of consumers and the UK economy and furthered.

A focus purely on short-term outcomes in isolation, such as the level of the price cap, will not provide the right framework or incentives for the delivery of efficient and effective long-term solutions for consumers. This will only lead to intergenerational unfairness. While a focus on charges in the short-term may save consumers today a small amount of money on their bills, the consumers of tomorrow will suffer through lower resilience and service quality caused by the long-term underinvestment advocated by economic regulators. Ultimately the impacts of this underinvestment would crystallise in operational and financial failures, as well as inability to deliver on medium term critical interventions in technology, cybersecurity and transition to net zero.

Regulators are not taking into account the wider priorities of Government and society in their decision making. While it's true that regulators need to balance a number of competing priorities when taking decisions, regulators are choosing to narrowly define their actions through their duty to consumers, which they interpret purely as a price-based priority.

A clear example of this is the CAA's failure to recognise the importance of delivering on key priorities around carbon and sustainability. Away from its clear role and objectives on sustainability through issues such as Airspace Modernisation, in regards to economic regulation, the CAA is narrowing its actions to only those which reduce costs to consumers.

Indeed, recommendations made from the Prime Minister's Council for Science and Technology in January 2020 stated that:

*"Government should require all regulators to develop an explicit first-order objective to support the transition to net zero by 2050....This should extend to all regulators and standards bodies (including but not limited to Ofgem, the Financial Conducts Authority, Office of Road and Rail, Civil Aviation Authority and Competition and Markets Authority"*<sup>1</sup>

Despite this, the CAA has not progressed this recommendation. This threatens the timely development of net zero solutions for aviation, which are ultimately in the interest of all consumers who wish to continue flying.

We therefore call on the Government to ensure that:

- The statutory duties of sector regulators clearly define the outcomes which they should seek to achieve from their regulatory intervention to ensure that this is consistent with the long-term interests of the UK.
  - A focus on long-term investment outcomes is made clear in regulators' statutory duties and related policy guidance.
3. *Regulation is becoming increasingly complex and costly, increasing the burden on regulated companies*

Done correctly, economic regulation delivers for all parties. The NAO itself recognises the benefits of clear and stable economic regulation in facilitating the delivery of efficient and resilient infrastructure for consumers. However, it is important that the costs of regulation do not outweigh the benefits it provides. In fact, this a key principle of regulation.

Government and the regulators themselves need to recognise the burden of economic regulation and the increase in costs and complexity it drives for regulated businesses. While current Business Impact Target (BIT) reporting aims to help with quantifying the impact of regulation on business, it does not go far enough in regard to economic regulation and price control activities. Currently activities regarding price controls are excluded from BIT reporting as they are classified as pro-competition measures.<sup>2</sup> While we understand the need for regulators to be able to take the appropriate action to prevent abuse of market power, the regulatory burden of the price control process and other related activities cannot be forgotten.

In Heathrow's case, the process for setting the H7 price control has been ongoing since 2016 and is now not due to finish until mid-2022. This will mean that the process to establish the price to establish the price control will have taken longer than the period of the price control itself. This situation cannot be repeated.

In order to ensure that regulatory activity is not driving inefficiency for regulated business and ultimately consumers, the Government needs to:

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<sup>1</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/910446/cst-net-zero-report-30-january-2020.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/910446/cst-net-zero-report-30-january-2020.pdf)

<sup>2</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/872342/better-regulation-guidance.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872342/better-regulation-guidance.pdf)

- Review the current regulatory setup in the UK to understand if further consolidation is required. Where possible, regulatory activities should be consolidated to achieve economies of scale and ensure that the costs paid by regulated companies are being incurred efficiently by the regulators themselves.
  - Put the right reporting and processes in place to ensure that regulatory action is in all cases properly evidenced and aligned to the outcomes regulators are seeking to achieve through their statutory duties. This reporting should be part of the required reporting around Better Regulation and the BIT. Where regulatory actions cannot be properly evidenced, this should be subject to CMA review.
  - Put in place a clear process to review the success of regulatory settlements in delivering on the regulator's statutory duties in order to hold senior regulators to account for the quality and performance of the settlements.
  - Regularly compare the performance of economic regulation in other countries to test the ongoing performance of UK economic regulation and to learn from good ideas
4. *A number of long-standing principles of economic regulation need to be reenforced to ensure these issues are resolved.*

The NAO's principles of effective regulation set out helpful views on how regulation, in all forms, can be more effective in protecting consumers and business. The principles set out by the NAO appear to be a good starting point for ensuring that regulation is fit for purpose and can protect the long-term interests of consumers and investors.

- *The purpose of any regulatory framework or regulatory activity needs to be well defined and based on delivery of a clear set of desired outcomes*

To ensure that regulation is effective while minimising the burden on business, the outcomes of any regulatory action should be clearly defined in advance of any intervention. Only by having a clear outcome of what should be achieved by regulation can the regulator make consistent decisions over the long-term which are proportionate, in line with the interests of the UK at large and aligned with ensuring that the regulatory burden imposed on business is no greater than is necessary.

- *All decisions made by regulators should be linked back clearly to the delivery of these prescribed outcomes*

After the desired outcomes have been established, all regulators should be required to clearly set out and evidence how their chosen actions will help them to achieve these outcomes and deliver benefits to consumers. If regulators are unable to evidence this, then it is clear that their interventions are not required.

- *All regulatory decisions must be accompanied by a clear and transparent evidence base*

Ensuring that the reasons for, and potential impacts of, these decisions are set out clearly with a robust evidence base will allow all stakeholders to understand the need for the action and robustly challenge where actions are not necessary. It will also ensure that the impacts of regulatory decisions on business can be fully evaluated before potentially damaging actions are taken.

This evidence-based decision making goes hand in hand with ensuring a clear and transparent consultation process. As part of ensuring that regulators have used a robust base of evidence to make regulatory decisions they should clearly set out how they have assessed and used the evidence put forward to them by stakeholders through the decision-making process.

Regulators should not be allowed to dismiss evidence provided to them by experts without due consideration. Ensuring that regulators clearly state how they have taken evidence into account when making their decisions will ensure a more transparent and well-rounded process.

The CAA's failure to take action in the wake of Covid-19 clearly shows the impact of not implementing the key principles set out above.

- In not having clearly defined outcomes for its regulatory intervention, the CAA has been slow to take decisions. This can be evidenced by the 9-month process the CAA went through to take a view on Heathrow's application of a Covid-related RAB adjustment, which is still unfinished with any final decision likely to be taken in another 12 months' time. Through this process the CAA struggled to balance its duties and set out the outcomes it was seeking to achieve from any regulatory action. This resulted in a decision which is not supported by Heathrow, the airline community or other interested stakeholders.
- Without a clear outcome to promote long-term efficient investment, the CAA settled on a short-term focus on price to justify the decisions it has taken. This lack of long-term focus has created an even more uncertain back drop for the H7 price control review which Heathrow's investors will enter without confidence in the regulator and without the long-term certainty which will allow them to invest in the interests of consumers.
- The CAA's process for making decisions is not transparent. The CAA cannot evidence how its actions will deliver regulatory outcomes and has not been clear how it has taken into account the evidence it has received from expert stakeholders. This has led to a lack of confidence in the CAA's ability to make the right decisions and a lack of belief that it will follow a transparent process.

**Conclusion:**

At a time when the UK Government's approach to reopening international travel is ambiguous, confusing and inconsistent, it is vital that the regulatory framework that underpins Heathrow Airport fully recognises the environment in which Aviation operates. However, the regulatory framework that is being applied by the CAA – which fails to acknowledge on a timely manner the unprecedented impact of Covid-19 on Heathrow and the wider aviation industry – is undermining investor confidence and threatens the reputation that the UK has on attracting inward investment in infrastructure.

Effective decision making by the CAA in regards to economic regulation in UK aviation is long overdue for reform – and the principles outlined by the NAO must be applied to future CAA policy making as we and the UK aviation sector seek to recover from the devastating impacts of Covid-19.

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