



Imagine a world class Heathrow

London First policy conclusions

November 2008

London First has undertaken work in the last year to address the poor quality of service experienced by business passengers at Heathrow airport. The study we published in June - *Imagine a world class Heathrow*¹ - highlighted the key drivers of poor service quality and put forward a number of practical and policy proposals to tackle them. We have reached conclusions on these proposals, having consulted members and stakeholders.

There is no doubt that progress is being made on the ground. Terminal 5 is having a significant impact across the whole airport. The operator has applied considerable resource to reducing security queues and is seeking the data needed to understand how best to tackle delays throughout the passenger journey. It also recently signed an agreement with the Home Office that for the first time sets targets to reduce Immigration queues. Work is now needed from all parties to accelerate and build upon these improvements.

Put the passenger first

The Civil Aviation Authority (CAA) should have a primary duty to further the interests of passengers². This duty should be at the heart of a modernised regulatory framework, so that hard-biting penalties and effective incentives drive high quality service, especially in queuing, flight delays and terminal fabric³. The Government must also meet immigration queuing targets.

Given the airport's market power, and the complexity of the interactions and incentives that drive performance on waiting times, more sophisticated and intrusive regulation will be required in the short term.

The **Annex** (attached) sets out in greater detail the regulatory reform we think is necessary to drive and maintain improved service quality.

Don't sweat the assets to standstill

Using both runways continuously for takeoffs and landings - Mixed Mode operations - may bring around 5-10% of extra operational capacity by 2013. This must be used to reduce delays, not to increase flights - allowing enough time between take-offs and landings to bring greater reliability and improving Heathrow's ability to recover from short term disruption. The Government must set this policy objective and ensure its enforcement.

¹ <http://www.london-first.co.uk/transport/heathrow>

² The Government's current review of the economic regulation of UK airports, advised by a panel headed by Professor Martin Cave, will deliver its emerging thinking in January 2009

³ Our definition of service quality is, throughout, exclusive of Heathrow's retail offering

Do not permit any new flights until delays fall significantly

There should not be any new flights at Heathrow until a level of performance comparable to rival European hub airports has been achieved. With such high demand for limited runway capacity, airlines have been forced into 'free rider' situation because of slot ownership: marginal extra slots deliver a high positive value to an airline acquiring them, but impinge a higher negative cost on all airlines and passengers as a result of variable and excessive delays.

Scheduling and slot allocation must be managed so that runway use doesn't always ratchet upwards, squeezing in more flights and damaging reliability. A standard should be set for delays which, if breached, would require flight numbers to reduce.

In practice, this will necessitate reform of slot rules at Heathrow. If capacity utilisation is to rise and fall over time to achieve the right balance between efficient runway usage, delays and local environmental performance, then slot rules will have to allow the withdrawal as well as the allocation of slots. A market-based approach to the primary allocation of slots offers the best chance of releasing the 'ratchet effect' and achieving the most economically efficient use of scarce capacity. Such an approach should be considered ahead of the arrival of any new slots brought about by Mixed Mode - if that allows - or, more likely, with the capacity delivered by a third runway.

Introduce a ratchet down on air pollution and noise

A cap on noise and air pollution levels must be accompanied by credible, externally verified measurements. Someone other than the operator must verify noise and local pollution.

Moreover, in contrast to flight numbers, which presently ratchet upwards, noise and air pollution should be subject to a ratchet downwards, encouraging technological innovation, so that in time the local environmental impact diminishes.

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London needs Heathrow to be world class. It isn't. The measures set out by London First will deliver improvements in the short term - and will ensure that any expansion at Heathrow works in the passenger and wider public interest.

For more information, please see the proposals first put forward by our recently published report *Imagine a world class Heathrow* or contact **Rob Fox at rfox@londonfirst.co.uk (020 7665 1502)**.

Annex - Regulatory reform

Putting the passenger first

The Civil Aviation Authority (CAA) should have a primary duty to further the interests of passengers. This duty should be part of a more defined and comprehensive set of objectives in relation to its duties as an economic regulator of airports. We are not confident that airlines are always an effective 'proxy' for passengers' views. After check in, the outward-bound value chain at Heathrow is fragmented by a variety of process owners and potentially conflicting incentives. The same is true of the inbound experience. In addressing the causes of delay and variability, the airlines' incentives to bear the cost of improvements may be weakened by the difficulty of gaining competitive differentiation as a result.

Moreover, with such high demand for limited runway capacity, airlines have been forced into 'free rider' situation because of slot ownership: marginal extra slots deliver a high positive value to an airline acquiring them, but impinge a higher negative cost on all airlines and passengers as a result of variable and excessive delays and waiting times.

Given the airport's market power, and the complexity of the interactions and incentives that drive performance on waiting times, we think more sophisticated and, necessarily, intrusive regulation is required in the short term.

Regulatory tools

The regulator should *de minimis* have at its disposal all the data - quantitative and qualitative consumer research and transparent, independently-audited operational information - needed to assess the efficiency both of the operator and of the interfaces between different process owners. The regulator should seek to understand where the burden of responsibility for operational efficiency lies across the whole value chain, and it should ensure that incentives are properly aligned.

As price cap regulation is poor at acting on signals from consumers over service quality, the regulator will require information on what constitutes good passenger experience to different groups of customers - information it has only recently begun to seek⁴.

A licence-based regime that mirrors other regulated sectors would strengthen the Regulator's ability to act within each quinquennial price control, in the public interest, and reduce the potentially long period between conduct and remedy.

We are concerned that the CAA does not apply the same level of scrutiny over operating and capital costs as other economic regulators. We would welcome a requirement to review capital expenditure, operating expenditure and service provision on an annual basis - through a mixture of benchmarking, yardstick competition and bottom up assessment of costs. The airlines in particular can provide very useful insight into the merits, or otherwise, of proposed investment, notwithstanding the point made above about proxies.

⁴ <http://www.caa.co.uk/application.aspx?catid=14&pagetype=65&appid=7&newstype=n&mode=detail&nid=1651>

Having made the case for strengthening ex-ante regulation, we recognise that growing competitive forces - both from London airports under independent ownership and local European hubs - *may* provide sufficient market incentives to the Heathrow operator to provide a better, more passenger-focused service. The regulator should have a duty to promote competition and will need to deploy its ex-ante powers flexibly and proportionately to support, not slow, this development.

Finally, we would welcome the conclusions of the Government's Review on whether the interests of end-users would be best served by economic regulation being institutionally separate from other policy areas, notably safety.

Terminal fabric

Terminal 5 aside, the overall impression of old and run-down facilities undermines first impressions and contributes to a miserable travelling experience. Moreover, the benefit to passengers of a substantial increase in investment will only be felt if it is properly applied. The price control framework needs to balance incentives to minimise operating expenditure with the proper maintenance of terminal fabric; and to ensure capital expenditure is not a substitute for operating expenditure.

This requires that expenditure that does occur takes account of what matters to consumers, building on best practice in other sectors, and including a measure of the travelling environment ('ambience').

Flight delays

Our study found that Heathrow is over-scheduled and, at its current level of capacity utilisation, unable to overcome excessive and unacceptable flight delays. It concluded that Heathrow's over-stretched capacity should be used less intensely - by either reducing Air Traffic Movements or increasing capacity but limiting its use - so that average delays, variability of delay and cancellations fall to an acceptable level. This is relevant to the framework of economic regulation as there is currently no passenger-focused regulatory mechanism which seeks to balance service quality with capacity utilisation.

The Regulator's commissioned study of runway resilience concurred with London First's analysis, stating that "current regulations, slot coordination and airlines' operational performance have resulted in economically wasteful 'over-scheduling'". It found that a 'ratchet effect' is at work whereby the combination of slot regulations, slot exchange practices and the Capacity Declaration Process "creates, in effect, a 'one-way valve' with limited opportunities to reduce capacity". Passengers face unacceptable levels of flight delays in large part because economic regulation currently rewards but is unable to reverse this 'one-way valve', such that runway utilisation at Heathrow has reached a level unique to hub airports in Europe.

The Government is considering whether to introduce Mixed Mode at Heathrow: analysis suggests that a scenario giving around 10% additional capacity with Mixed Mode operations would take around four years to implement and would reduce flight delays to levels seen at comparable European hub airports⁵. NATS has reservations about the viability of introducing the maximum 15% additional capacity possible through Mixed Mode.

⁵ From Air Traffic Controls, stack holding and ground holding

We think, therefore, that Mixed Mode operations bringing around 10% additional capacity should be introduced in order to reduce delays rather than increase flights. Once a level of performance comparable to rival European hub airports has been achieved, further increases in flights should depend on finding the right balance between sweating the assets and maintaining quality.

This will require regulatory intervention and a scheduling system based on stronger governance arrangements with a clear set of performance metrics. In simple terms, a standard should be set for delays which, if breached, would require flight numbers to reduce. The thresholds for nitrogen dioxide and noise emissions should similarly, if breached, require flight numbers to reduce⁶. The regulator should be under a duty to set and enforce these performance metrics.

These metrics will in turn require capacity utilisation to flex as part of a system-wide response to overall performance - in contrast to the current "one-way valve". In practice, this will necessitate reform of slot rules at Heathrow. If capacity utilisation is to rise and fall over time to achieve the right balance between runway usage, delays and local environmental performance, then slot rules will have to allow the withdrawal as well as the allocation of slots.

We believe a market-based approach to the primary allocation of slots offers the best chance of releasing the 'ratchet effect' and achieving the most economically efficient use of scarce capacity. Capacity is declared, slots auctioned and, when circumstances necessitate a reduction in capacity, a reverse auction takes place. We would welcome views of the Cave Review, which is currently considering the economic regulation of airports, on this proposal, together with the institutional arrangements that should underpin it.

⁶ The air quality directive (2008/50/EC) came into force in June 2008