



London (Heathrow) Airline Consultative Committee

**Response to the CAA Consultation on
The Economic Regulation of Capacity Expansion at
Heathrow Airport: Consultation on Early Costs and
Regulatory Timetable**

CAA CAP 1819

22 August 2019

1. Introduction

The Airline Operators' Committee (the AOC) and the London Airline Consultative Committee (the LACC), welcome this opportunity to respond to the CAA's consultation paper on the economic regulation of expansion at Heathrow airport – early costs and regulatory timetable (CAA CAP 1819).

We have attempted to follow the CAA's structure in CAP 1819 in our response, but given the technical and lengthy nature of the CAA's consultation paper, we feel that it is worth summarising some of our key arguments here:

- The airline community supports and welcomes the CAA's review of its current Category B (Cat B) policy. We share the CAA's concerns around HAL's spiralling costs and agree with the CAA that the current policy has not been effective in containing them. We also agree that the incentives need to be sharpened significantly;
- the airline community agrees with the CAA that HAL need to establish and agree with the CAA and the airline community a credible timeline and associated capital plan for the development of the third runway. The current plan is not credible and early Cat C costs are too high;
- however, the CAA's decision on 2016 and 2017 Cat B costs seems to us to be entirely unsupported by evidence and further calls into the question the credibility of the CAA's policy and its ability to enforce efficient costs;
- we welcome the updated business plan guidance from the CAA – particularly the new transparency requirements set out by the CAA and the need for the HAL board to certify its approval (and the basis of this approval) of its FBP
- the full six months, as usual, should be allowed for Constructive Engagement. This should be easily possible within the context of the CAA requiring strict adherence to its timetable from all stakeholders
- the airlines welcome the CAA requirement that HAL and the airlines review the engagement and governance process to ensure they are appropriate for the extensive and complex work programme of H7 and Expansion.

2. Policy Proposals for Cat B Costs

The airline community has been disturbed by HALs spiralling Cat B costs. We have noted with some alarm, the escalation in predicted Cat B costs from £265m to over £500m. We share the CAA's concern with this dramatic escalation, and fully agree and support the CAA's statement that *'there is only limited evidence on the efficiency of HAL's Category B costs, and we have observed the near doubling of HAL's estimates of these costs. These factors strongly suggest that it is appropriate for us to carry out a review of our existing policy in respect [of] Category B costs.'* (page 20, para 1.17).

In responding to the CAA's proposals and in attempting to find a way to address our shared concerns on HAL's spiralling costs, it seems to us that there are three areas of concern: the proposed incentive regime above £265m; the CAA's definition of efficient costs; and the CAA's decision on 2016 and 2017 Cat B costs and the effect that decision has on the CAA's credibility and the enforcement of its policies on efficient costs (both in respect to Cat B, early Cat C and BAU expenditure). We deal with each in turn.

2.1 CAA's Cat B Policy Proposal

The airline community agrees with the broad general thrust of the CAAs policy proposal i.e. that there should be a cap set for Cat B spend and that above that cap HAL should receive a much lower return or even no return at all. However, whilst we support the general thrust of the CAA's proposed policy we have a number of issues with the detail.

The airline community agrees with the CAA that there should be an upper cap for Cat B spend. However, at this stage, and until further work is completed, it is difficult to determine at exactly what level the cap should be set. Care needs to be taken in setting the cap, and we are keen to work with the CAA to ensure that an appropriate one is set.

In our view there are three 'buckets' of efficient Cat B spend.

- i. Bucket 1 - £0-£265m – this is covered by the CAA's current policy;
- ii. Bucket 2 - £265m-Cap – efficient Cat B spend between these levels should still remunerated, but at a lower level than currently in Bucket 1. If spend reaches these levels then clearly the incentives in Bucket 1 were not sufficient to contain spend to less than £265m. Therefore incentives (i.e. the return to HAL) need to be much stronger in this Bucket (i.e. a lower return for HAL);
- iii. Bucket 3 – spend above the cap – the airline community is clear that a cap on spend is exactly that. Consequently any HAL spend above the cap should be at HAL's own expense. For the avoidance of doubt, the airline community believe that Cat B spend above the cap should not enter the RAB or be remunerated in any way.

In terms of the other elements of the incentive package above £265m, the airline community supports the CAA's proposal to remove the automatic annual approval of £10m pa of Cat B costs. We have always objected to the CAA granting HAL this spend with no requirement to spend it efficiently, and are pleased to see the CAA's change in policy.

The CAA is proposing to move away from the 85%-105% policy on Cat B. Replacing it with an 85%-100% proposal above £265m. These are proposals that we are happy to see and support (although we would be interested to explore the effects of HAL taking on more Cat B risk – for example 75%-100%). We have always thought that the 105% return in the case of a successful DCO application was entirely unnecessary and simply over incentivised HAL to spend and classify money as Cat B.

However, we note that the CAA is proposing a rider to the 85% figure applied to Cat B spend over £265m in the event of an unsuccessful DCO application. We understand that if the CAA finds that HAL have used '*reasonable endeavours*' that the 85% figure could be 100%. We strongly object to this proposal on a number of grounds. Specifically:

- i. We understand that the term '*reasonable endeavours*' in a legal sense is less onerous and more nebulous than '*best endeavours*' and therefore does not appear to be a particularly onerous hurdle;
- ii. the CAA has not defined what this term means and therefore it introduces more opacity into the regulatory regime when what is needed is more objectivity and clarity;
- iii. it potentially weakens the incentives for HAL to spend efficiently and pursue a successful DCO;
- iv. the credibility of the regime and thus the likelihood of the incentives generating the required behaviours from HAL are likely to be lower the more the room there is for CAA to 'exercise its regulatory discretion'.

We would also like to highlight the interplay between Cat B and C incentives and spend. The CAA's current policy up to £265m Cat B incentivises HAL to classify as much early Cat C as Cat B as it can (because of 105% treatment of spend if DCO succeeds). If the incentive structure changes above £265m its likely to change the incentive for HAL such that there may be an incentive for HAL to classify Cat B spend as early Cat C. And the stronger the incentive to keep Cat B spend low, the stronger the incentive to reclassify it as early Cat C. The CAA will need to be alive to this, and the airline community expects the CAA to police the Cat B/Cat C boundary rigorously and effectively.

2.2 Cat B and Efficiency

The airline community has repeatedly asked the CAA to develop an objective measure of efficiency, and we renew our calls to do so again here. We are concerned that there now appears to be multiple definitions of efficiency in play. For example, the IPCR put forward a number of tests for efficiency in their assessment of HAL's 2016 and 2017 Cat B spend and the CAA put forward another definition in their Budget Guidance to HAL¹.

We are particularly concerned with the CAA's definition as it seems both vague, subjective and unrelated to the concept of efficiency. For example the tests for efficiency are:

- i. *the programme to which they are attributable to has been set up to succeed in the early planning stages;*
Comment – what does this mean? Particularly the terms 'set up to succeed' which means what? And what is the objective test of this? How can it be tested? And also 'early planning stages' – what

¹ See footnote 16, page 18 of CAP 1819

- are these – is this a point in time or a point in the process? And what is it? And how does it relate to the previous point?
- ii. *Performance and progress are meaningfully measured to enable management intervention;*
 Comment – we note that this measure is about whether performance is measured not whether intervention takes place or whether that intervention was timely, appropriate or effective. What is the objective test?;
- iii. *An environment is created which proactively identifies opportunities to improve;*
 Comment – what does this mean? How can it be objectively measured? We also note that the test is around identifying opportunities to improve (however that is defined and whatever it means) but not around whether those opportunities were appropriate, timely, adopted and efficiently implemented and led to efficiency improvements. We also note the subjective nature of this test.

We also note that the tests do not include elements that we would expect to see in any efficiency test. For example we would expect to see:

- was the spend required at all;
- were the objectives of the spend clearly defined and were they achieved at minimum cost (for example via a competitive tender exercise);
- were the proposed benefits of the spend delivered (i.e. an ex post evaluation);
- what are the findings of post project appraisal in terms of learning's for future projects.

In short, we find that whilst we support the CAA in its view that only efficient spend by HAL should be remunerated, we see considerable problems with the way that the CAA gives effect to its policy. Part of the problem stems from multiple and vague measures of efficiency which cannot be objectively tested and indeed do not seem to us to cover many of the key elements that constitute efficient spend.

The other part of the problem is the effect a subjective measure has. It makes it hard for the airlines to enforce efficiency on HAL even if they had the data and the resources to do so. And in addition, because the tests for efficiency are nebulous and subjective they weaken the incentive on HAL to actually be efficient. In short the lack of an objectively testable and agreed definition of efficiency undermines the CAA's ability to ensure that only efficient spend is remunerated and hence the credibility of the policy.

2.3 CAA Decision of 2016 and 2017 Cat B Spend

The airline community notes the CAA decision to award HAL a little over £80m of Cat B costs incurred in 2016 and 2017 – or around 98% of incurred costs. The airline community strongly objects to this decision, and is deeply concerned with it not just because of the decision itself, but because of the CAA's logic to support its decision, and its effect on the credibility of the CAA as an effective regulator.

The airline community supports the CAA's policy to only allow efficient spend into the RAB. We are also clear that the CAA says:

- *'HAL's approach to governance in 2016 and 2017 did not meet the above objectives and requirements...'* (CAP 1819 para 1.22); and

- *'we also acknowledge that there were shortcomings in HAL meeting these tests for efficiency...'* (CAP 1819, Appendix B, para 19).

In our response to the CAA's CAP 1752 (the CAA's original consultation on these costs) the airline community were clear that our review of the IPCR's report was that none of the four tests for efficiency were met. For the avoidance of doubt our views remain unchanged.

Consequently, it seems to us that the airline community and the CAA are, to a large extent, in agreement that HAL have failed to meet the efficiency tests that they are required to meet in order for Cat B spend to be rewarded. We are therefore somewhat surprised that not only have the CAA concluded that they should award HAL the money, but that they plan to award a greater percentage of the money than they proposed in CAP 1752.

Equally disturbing is the CAA's logic. The CAA argue that *'it would not be reasonable to expect the governance processes in place at that time to have been as well developed as we would expect for reviews by the IPCR of costs incurred in later years'* (CAP 1819, Appendix B, para 19). This to us does not appear to be a tenable position for the following reasons:

- i. there is no time dependency in the tests. We are unable to find anywhere where, prior to its decision the CAA has argued that the stringency of the application of its tests would vary over time;
- ii. the experience of the airline community and indeed that of individual airlines is that their management would find it unreasonable to spend £80m without strong governance. HAL should be held to the same standards;
- iii. HAL run large complex projects every day, and have substantial project and programme management resources that could've been tasked to Cat B – they were not starting from zero;
- iv. HAL actively campaigned to be the Government's selected option for expansion. It can hardly have been a surprise to them that they were granted permission. And indeed it is unreasonable to expect that if they had thought it likely that they would not have thought to put governance in place and had time to do it;
- v. the CAA argue that an extenuating circumstance was that HAL were under pressure to move quickly. However, pace is not an excuse for efficiency. The policy is about efficient spend not speed of spend.

For those reasons we believe that the CAA's logic is untenable. We are also deeply concerned with the precedent that this sets and the impact of this decision on the CAA's credibility as a regulator and its ability to enforce a policy that only rewards efficient costs.

Credibility plays an important part in economics. Indeed, one of the reasons behind the independence of the Bank of England and the inflation target it was given was the recognition that the greater the degree of credibility a nation's monetary policy had, the lower the interest rate that was required. And indeed the less credible your monetary policy the higher the interest rate required. In our case, as the CAA's credibility declines so does trust in its ability to enforce its policies and act in the interests of passengers.

The CAA's policy is to reward efficient costs. There is strong independent evidence that the tests for efficiency are not met. The combination of this

evidence, a vague and subjective test for efficiency, and the unwillingness of the CAA to enforce its own policies undermines the credibility of the CAA as an effective regulator.

This in turn reduces the incentive on HAL to be efficient, making it more likely that spend will be inefficient and costs will spiral, which in turn further undermines the CAA's position.

In short whilst the CAA's decision in respect to 2016 and 2017 is worrying and its logic both flawed and untenable, it is a decision that has worrying longer term dynamic effects and further damages the credibility of the CAA as a regulator.

3. Early Category C Costs

The airline community shares the CAA's concern at the spiralling early Cat C costs that HAL is proposing to incur. We also agree with the CAA that there is a complex interplay between the timing of runway opening, the associated capital plan and the risk of stranded assets if DCO consent was not granted. Indeed the CAA devotes several pages to HAL's escalating costs and the difficulties of assessing whether early Cat C spend is in the consumers' interests. We support much of this analysis.

For the avoidance of doubt, the airline community supports the expansion of Heathrow airport if it can be shown to be affordable, operable and deliverable. We also accept that, depending on the runway opening date selected and agreed, it may be advisable to incur some necessary and efficient early Cat C expenditure. Our current issues revolve around the proposed end-2026 opening date as a credible option and the level of early Cat C spend associated with it.

3.1 Expansion Timing and the Need for Early Cat C

The airline community understands Government policy to be that an additional runway at Heathrow airport is needed by 2030. Consequently, we do not believe that planning to open in 2026 is necessary, and increasingly, based on the immaturity of HAL's current plans, even possible. We are also clear that if the runway were to open later (say for example end 2028) this would reduce the need for early Cat C spend, and lower the risk to our passengers of stranded assets.

We are grateful for the CAA's support in asking HAL to address some of these issues by modelling alternative delivery dates and options. Whilst HAL's engagement has not been as much as we would have liked and we have some issues with the limited range of scenarios adopted for testing, at the time of writing discussions and work are still going on. It is also clear to the airline community that there are a range of options available which have later runway opening dates that have the effect of lowering early Cat C spend and risk to the passenger, and importantly still open the runway before the Government's policy objective of 2030. A more realistic later opening date seems to us to be a pragmatic solution.

We note that HAL's CEO, John Holland-Kaye, stated in a recent interview that expansion was '*a fait accompli*'². If this is HAL's position then they would see no risk in proceeding with early Cat C spend. Arguably this means that HAL should be able and happy to proceed at their own risk. The airline community would be content for HAL to do this provided it was clear that any early Cat C spend was at HAL's own risk and would not be allowed into the RAB or remunerated in the event of a failed DCO application.

However, the airline community does see some risks to expansion going ahead and to a DCO not being granted at this time. For example, given the rising importance of environmental concerns and a change of UK Government it is likely that there is *political* risk. Second, the CAA are yet to publish firm details on the regulatory regime and key elements of the price control (e.g. WACC), and consequently there must also be *regulatory* risk. In addition, the airlines are yet to be able to test whether HAL's plans for expansion are affordable, deliverable and operable and so at this stage there is a risk, if our tests are not met that the

² <https://www.itv.com/news/london/2019-07-23/heathrow-third-runway-will-be-critical-for-new-pm-says-airport-boss/>

community might not support expansion. These are risks that the CAA rightly highlights in their analysis. We would also remind the CAA that in previous papers it has already agreed that airlines and their passengers are not HAL's risk takers of last resort.

Consequently, while HAL see no risk, the airline community does see a risk in committing too heavily to early Cat C spend. We are keen to minimise the risk and extent of stranded assets and therefore the costs that we and our passengers will be asked to bear for no benefit in the event of a failed or no DCO application.

We are keen therefore to reach agreement with HAL and the CAA on a realistic timeline and capex schedule. At present we have not been able to do that and work is ongoing. We support the CAA's policy here and are grateful for its support in this regard.

3.2 Governance of Early Cat C spend

The airline community broadly agrees with the general thrust of the CAA's policy in this regard and specifically using existing Governance processes as much as reasonably possible, and the idea of introducing a cap which if breached would result in lower (or perhaps) no returns for HAL. We would remind the CAA that however strong the governance process is between HAL and the airlines, it is the CAA that is responsible for deciding what is efficient and only rewarding efficient costs. Consequently, even if good governance is established, we expect the CAA to develop a much stronger grasp of these costs, and be much clearer and stronger in enforcing its policy on efficient costs.

In addition, as is the case with the CAA's proposals for Cat B, we have a number of concerns about the detail of the CAA's proposals.

In terms of the negotiation process we welcome the CAA's proposal to appoint an expert who would advise the CAA on the appropriateness of settlements. It seems to us that independent expert advice could enable the CAA to make sound judgements. However, the airline community is uncomfortable with the level of opaqueness in the CAA's process and our lack of access to information to ensure that only efficient costs are being passed on to us and our passengers.

We understand that there may be occasions when it may be inappropriate for individual airlines to see the detail of individual settlements. Consequently, the airline community suggests that it appoints its own independent expert, who would sit alongside the CAA's expert and attend any meetings that expert had with the CAA and/or HAL. Their role would be to assure the airlines that the settlement was indeed efficient. Given the CAA's recent use of the IPCR's evidence on Cat B spend and the lack of confidence in the CAA that this has engendered, we feel it is necessary not just to monitor HAL's activities but also to ensure that the CAA's use of independent expert evidence leads to the right decisions being made.

We are somewhat unclear about the CAA's proposals on the regulatory treatment of early Cat C. We interpret the CAA's policy position as being to treat early Cat C in the same way as Cat B. However, we are unclear whether this refers to the current policy, the CAA's new policy, or whatever the CAA's final policy on Cat B might be. However, in principle we support the idea of treating Cat B and early Cat C in the same way. And we would also be supportive of an approach which involved the setting of a cap with strong incentives to remain beneath that cap.

We also see merit in aligning Cat B and early Cat C treatment as this would remove the incentive to reclassify expenditure between the two in order to maximise returns.

We do however see a number of issues around setting a cap, and allowing efficient costs to be counted against the cap. The first issue is how would the level of efficient spend i.e. the cap be set? The CAA discusses using benchmarks, but how clear can we be that the benchmarks are appropriate and reflect only efficient costs. This is not perhaps an insurmountable issue, but it is clear that the cap would need to be set with some care.

Second the CAA place great emphasis on only allowing efficient costs to be rewarded. We have already raised in relation to Cat B our concerns with both the CAA's definition of efficiency and how it decides on what spend is efficient. We do not repeat our arguments here. However, without addressing the issues of a failure to develop an objective efficiency test and restoring the CAA's credibility in enforcing its policy to only allow efficient costs the airline community is concerned that the weaknesses and failures inherent in the CAA's existing Cat B policy will simply be replicated for early Cat C.

3.3 Recognising Cat C costs through the licence

The airline community agrees with the CAA that the sums at stake with respect to early Cat C are large and important. We also agree with the CAA that it is important that the sums are well governed and that the CAA rigorously enforces its policy relating to efficient costs.

We are agnostic to the CAA's proposal of placing the agreed early Cat C and capex timelines in the licence as a licence condition. Whilst we do not necessarily object to the CAA's proposal, we feel that it is more important, and would be more likely to successfully ensure efficient spend if the CAA:

- i. developed an objective measure of efficiency;
- ii. enforced its policy on efficient costs rigorously;
- iii. restored confidence and credibility in its ability to achieve i. and ii.

When the CAA proposed an efficiency licence condition for HAL we were keen to ensure that the CAA did not see it as a substitute for them to rigorously enforce their policy that HAL should be efficient. Similarly, with respect to an early Cat C licence condition, we wish to be absolutely clear with the CAA that we expect them to ensure that they rigorously enforce their policy that only efficient costs should be remunerated. A licence condition is not a substitute for this. If however the CAA sees it as a useful tool to help them, then this may be a more positive aspect.

However, even if the CAA were clear that such a licence condition was a useful and necessary tool that they needed, there are still detailed matters which need to be addressed. The ability of the regime to deal with licence breach depends on what is actually in the licence. So for example, a licence condition that HAL should have a Cat C timeline and capex profile is extremely unlikely to improve the CAA's or the airlines ability to monitor and enforce capex efficiency.

In short, whilst the airline community is open to the idea of an early Cat C licence condition, we would require assurances from the CAA that such a condition is an aid to them enforcing efficiency rather than instead of, and further information on the detail of what would go in and under the licence.

4. Regulatory Timetable

We have been supportive of the CAA's objectives to achieve broad alignment between the timetables of the H7 regulatory review and the programme for capacity expansion. This continues to be our position; although we agree with the CAA that the timetable for expansion is currently under pressure. Notwithstanding the uncertainties of the costs associated with expansion, we consider the CAA to be correct in proposing to retain the timetable in which HAL publishes its Initial Business Plan (IBP) in December 2019.

As highlighted by the CAA, it (and stakeholders) will be able to review the costs proposed by HAL in its DCO application and there are a number of regulatory mechanisms to analyse and address any evolving cost scenarios as expansion develops.

The airlines recognise the points highlighted by the CAA regarding the option of extending the Q6 period by another year. This is something the airlines could only consider if any proposals balanced carefully the ongoing, above forecast, benefits HAL is experiencing with an appropriate adjustment to the charges paid by the airlines. The airlines are also open to considering the length of the H7 regulatory period as long as satisfactory checks and balances are established to ensure the interests of consumers can be actively addressed if key variables diverge from anticipated forecasts.

4.1 Initial and Final Business Plans from HAL

We support the CAA retaining the requirement for HAL to publish both an IBP and Final Business Plan (FBP). This is because a specific FBP provides an opportunity for stakeholders to review the holistic aggregation of HAL's proposals in response to its engagement with the airlines in Constructive Engagement. The CAA notes there may be a case for HAL's FBP to be submitted alongside its DCO application in 2020. In our view it is crucial to ensure that there is time for the full six months of Constructive Engagement in the timetable and therefore the community does not agree that there should be an explicit link between HAL issuing a Final Business Plan to the CAA and submitting its DCO if it breaks that timetable. Under HAL's proposed timescales at the current time that would mean reducing the time allowed for airlines to conduct the full 6-month Constructive Engagement period that we have previously had in Q5 (2008-2013) and Q6 (2014-2019).

The CAA notes the risks to the regulatory timetable of requiring HAL to publish an IBP and FBP. In our view there is sufficient time available for all parties to review a HAL FBP before the CAA publishes its Initial Proposals and thereafter its Final Decisions throughout the remainder of 2020 and 2021. In coming to this view, we accept there will be a need for careful planning and strict adherence to an overall programme timetable by all parties. In particular, the CAA should highlight that a series of updates from HAL on its FBP (as happened in the Q6 Review and introduced substantial timetable pressure) will not be accepted by the CAA unless all stakeholders accept and agree the need for the update.

5. Business Plan Guidance

We welcome the CAA re-iterating the high-level business plan guidance it had published previously for HAL. In particular that the business plans should be clear, robust and well justified by supporting evidence. These requirements should enable all stakeholders to engage effectively with HAL on its IBP and FBP. We also particularly welcome the CAA's additional requirement that the HAL FBP is signed-off by the HAL Board to certify that its FBP 'reflects efficient costs and financing, is affordable, deliverable (including in respect of financeability), and reflects consumer views and preferences to the fullest extent practicable.' However, in noting this list of board certification requirements we would highlight that we do not think it is appropriate for the HAL Board to certify (or not) that their FBP is *affordable*. That is something on which the CAA should seek the views of the users and customers of HAL and something we refer again to below.

Before setting out its revised business plan guidance for HAL the CAA notes that it previously had indicated that the CAA 'would be unlikely to consider a plan high quality if the airlines, CCB and other stakeholders did not broadly support the plan'³. This position is a pragmatic recognition by the CAA that the HAL business plan does not sit in isolation; it is produced in the context of the provision of services and facilities to meet the needs of the constituents represented by a number of actively involved stakeholders. We hope the CAA continues to hold this position and confirms it again clearly.

It is helpful that the CAA has highlighted the differences between its original business plan guidance to HAL in CAP 1540 of April 2017 and the CAA updated guidance in CAP 1819. Our comments on the CAA's revised guidance are set out below under the headings used by the CAA. These comments should be read in conjunction with our comments in response to the original CAA's Business Planning Guidance for HAL in CAP 1540.

5.1 Transparency

We welcome the CAA's addition of a transparency criteria for HAL's business plans. The need for transparency is a point we made in response to the original guidance set out by the CAA. It is welcome that the CAA has particularly indicated that it will 'tend to give greater weight to information and evidence that HAL provided as part of a published business plan, rather than information that is provided on a confidential basis'. This is an important point. In the Q6 review the nature of the engagement and settlement considerations between stakeholders was substantially hindered by the sense that the CAA was responding to information provided by HAL which was specifically not shared with the airlines. Such a scenario should be avoided in the H7 and Expansion work. HAL should be expected to share widely any information it wishes the CAA to take into account in reaching a settlement decision. This is particularly the case with respect to the regulation of HAL because the CAA (as the regulator) is not able to assume that the incentive properties of comparative regulation⁴ will drive efficiencies into the business plans of HAL.

5.2 Outcomes and Consumer Engagement

³ CAA CAP 1819 – Paragraph 3.18

⁴ Where a number of regulated companies in the same industry provide business plans to a regulator at the same time for the same types of services. Thus comparative regulation enables a regulator to compare the efficiencies and effectiveness of a number of companies in parallel as well as scrutinizing each company.

We welcome the CAA's augmentation of its guidance to HAL regarding the development of Outcomes and Consumer engagement. For example, making explicit once again the need for Outcomes to build on the success of the SQRB framework. The elements of quality in the SQRB scheme were determined after consultation with passenger representative groups and have served the interests of passengers and airlines well for many years.

The CAA is correct to highlight the need for HAL to 'engage extensively with airlines throughout the process'. The airlines have always sought to do this. Although we note that much of HAL's activity so far in this area has been unilateral. Nevertheless, we will continue to seek to engage meaningfully with HAL on behalf of our passengers in the development of Outcomes which meet the needs of passengers and the operational needs of the airlines in providing air transport services to passengers.

5.3 Resilience

The updated CAA guidance to HAL on resilience is substantially more comprehensive in the latest business plan guidance. This is very welcome as it will be important for Heathrow Airport to remain resilient throughout H7 and expansion. Indeed, as highlighted by the CAA, the developments associated with expansion provide an opportunity for HAL to design in resilience in the provision of new infrastructure. The CAA has also highlighted that 'HAL must also provide evidence that it has developed and tested robust resilience contingency arrangements in collaboration with other stakeholders'. The provision of an opportunity for all stakeholders to be able to take a holistic view on the measures designed to increase resilience will be an important part of reviewing HAL's business plans.

5.4 Costs and Other Revenue Building Blocks

It is welcome, again, that the CAA has substantially augmented its business plan guidance to HAL in this important area. The nature of the guidance provided by the CAA has improved the extent to which the cost information to be provided by HAL will enable stakeholders to review HAL's proposed costs. We welcome the CAA highlighted that there should be no double counting of costs between business as usual and expansion and that HAL should demonstrate the basis of its costs allocation.

We welcome the CAA requiring HAL to set out a number of scenarios with respect to operating costs, non-aero revenues and capital costs rather than a single proposal with an associated cost. As noted by the CAA, there is a link between costs and the outcomes and we agree with the CAA that it will be important for HAL to demonstrate these links transparently so they can be objectively reviewed.

Finally, the CAA is correct to require HAL to demonstrate that it is pursuing challenging assumptions for itself on the scope of increased cost efficiencies.

5.5 Incentives and Risks

The CAA requires HAL to evidence how it has considered risks and how to mitigate them. This is an important dimension of business planning so it is welcomed by the airlines.

We particularly welcome the CAA stating that "HAL should make clear in its business plan:

- how it has consulted with stakeholders on these [risk] issues

- what comments stakeholders have made in relation to incentives and risk allocation; and
- how those comments have been taken into consideration in developing the incentives and risk allocations set out in the business plan.”

That said, we remain concerned at the CAA proposals of expecting HAL to set incentives for itself. It will be important for HAL to evidence how these incentives will work (and have worked) in practice and to demonstrate their effectiveness. Within this context it will be crucial for the CAA and all stakeholders to be able to transparently scrutinise how HAL is proposing to incentivise itself and be satisfied that these incentives will actually be effective in influencing HAL’s activities.

5.6 Financeability and Affordability

The CAA states that, “HAL should provide robust evidence that its FBP is financeable and affordable”. We can see how there is an onus on HAL to demonstrate that its FBP is financeable – albeit stakeholders should have the opportunity to scrutinise HAL’s own assessment of the financeability of its FBP. However, we do not think it appropriate for HAL to take a view on the affordability of its FBP. This would effectively place HAL in the position of ‘buyer and seller’ at the same time; a scenario which will always be sub-optimal for all stakeholders. Perhaps in recognition of this the CAA states that, “where practical, HAL should seek third party assurance if its assessment of affordability and financeability”. This proposal from the CAA needs to be much stronger. The CAA should require HAL to obtain the agreement of stakeholders that the FBP affordable and financeable – not just *seek assurance where practical*.

5.7 Cost of Capital

The CAA is correct to highlight the need for HAL to take into account the following factors when it is proposing a WACC for itself in the IBP and FBP:

- recent UK regulatory precedent published since the Q6 decision,
- market evidence on cost of capital parameters, and
- the business and capacity expansion risks it faces (where HAL should assume a WACC of no more than the efficient level necessary to compensate HAL for these risks.

The CAA notes that HAL may propose values outside of what would be expected from the above factors. However, we welcome the CAA stating that if HAL was to do so the CAA would expect ‘high quality evidence’ from HAL to support its proposal. If HAL was to propose alternate values we believe it should be required to do so transparently. In addition to this, the CAA should provide all stakeholders with an equal opportunity to scrutinise HAL’s proposals and any evidence presented by HAL.

5.8 Alternative Delivery Models

The CAA requirement that HAL should account for how it has engaged with parties on alternative delivery arrangements is supported by the airlines. We further note that the CAA has required HAL to demonstrate why its proposals would be preferred in the event that HAL does not take forward genuine alternate proposals. We think the CAA should go further than this by requiring HAL to be specific about the areas of alternate delivery proposals that it considers are less able (and why) to deliver value for money for consumers when compared to HAL’s proposals.

5.9 Scope

The scope of HAL's business plans should cover all (and only) the services and facilities to be provided by them. We agree with the CAA that the scope should also cover, "both existing operations and new runway capacity expansion". In addition to this we welcome the CAA requirement that the HAL Board certify the FBP and demonstrate the steps it has taken to assure itself of the plan's quality and that it furthers the interests of users.

6. Constructive Engagement

Constructive Engagement was an innovation in airport regulation established by the CAA to facilitate engagement between stakeholders. It replaced the approach before which was for stakeholders to make submissions separately to the CAA on each aspect of the review for its consideration. The H7 review will be the third occasion of constructive engagement and the airlines are committed to participating in it objectively, transparently and in good faith to promote the interests of their passengers.

Within this context we agree with the CAA that, 'the interests of consumers are best served when the airport and airlines are working constructively together against a backdrop of CAA regulation which is focused on supporting good consumer outcomes'. However, we would further add that the context needs to include a clear recognition that HAL is the company with substantial market power that is being regulated by the CAA. The airlines operate in a competitive environment and are consumers of the services and facilities provided by HAL. It will be important for this distinction to be clear from the outset. The airlines will always seek to work collaboratively with HAL to ensure that their multilateral engagement considers all aspects of the needs of airline passengers at Heathrow Airport. However, it will not be acceptable for there to be any suggestions that services or facilities provided by airlines should (or could) come within the scope of the CAA's regulation of HAL.

Therefore, we welcome the CAA stating that constructive engagement should, 'be focussed on HAL's business plan, and the investment and services to be delivered by HAL in the next regulatory period'.

6.1 Engaging Constructively and Constructive Engagement

At this stage we think it also worth highlighting the distinction in the nature of the engagement between the airlines and HAL before and after HAL publishes its IBP.

At the end of the Q6 review all parties agreed that it could be useful for there to be engagement between HAL and the airlines before as well as after HAL publishes its IBP. However, it was noted by the airlines that their engagement with HAL before the IBP is published would necessarily be somewhat conceptual. This is because the engagement would be on a disaggregated, subject by subject, basis without airlines having sight of how HAL was bringing all these subjects together holistically into one overall plan; or indeed how the subjects related to each in HAL's final assembly of the overall IBP. In contrast to this, the engagement after HAL publishes its IBP would be based on the airlines having sight of HAL's overall business plan based on the aggregation of their proposals in each subject area.

The nature of the engagement that all parties hoped would happen before HAL's H7 IBP became known as Engaging Constructively and the engagement after HAL publishes its IBP continued to be called Constructive Engagement. These two names were to enable all parties to recognise and appreciate the distinctive nature of both the engagement and the outputs that could be expected in each period.

The outputs of engaging constructively will be the airlines having a greater appreciation of the approach taken by HAL in each subject area and the process HAL proposes to adopt in bringing the subject areas together. The output from

constructive engagement would be a joint agreed report from HAL and the airlines for the CAA setting out all the areas of agreement and disagreement after both parties have had extensive discussions on the contents of HAL's IBP. Where there were disagreements between HAL and airlines both parties would set out, and agree, their positions and the basis of their positions. In the past both parties found that that requirement to set out and agree the nature of any disagreements was very helpful in enabling both parties to understand fully each other's positions and the reasons for these positions.

6.2 Constructive Engagement and Enhanced Engagement

As the CAA points out Enhanced Engagement is another separate and distinct concept from Constructive Engagement and Engaging Constructively. It was formed out of the request from the DfT for the CAA to report on the nature of the engagement between the airlines and HAL on expansion. A revised Enhanced Engagement Protocol was agreed between HAL and the airlines to set out the nature of Enhanced Engagement. We welcome the CAA stating that Constructive Engagement should be carried out alongside Enhanced Engagement in a way that is coordinated and 'if appropriate, integrated'. We also welcome the CAA setting out that it is for HAL and the airlines to agree the changes in the arrangements for engagement. We have meetings scheduled with HAL to commence this process and look forward to updating the CAA in due course on the four dimensions of engagement set out by the CAA. In the meantime, our high-level views on these four dimensions are set out below:

6.2.1 Scope

We consider that, as usual, the scope of Constructive Engagement should cover all the established regulatory building blocks. In addition to this, it would be good to include WACC this time to enable all parties to transparently discuss associated issues and put forward their cases. We think this would be helpful to the CAA in its deliberations and promote the transparency it is wishing to characterise the H7 review and expansion deliberations.

6.2.2 Timing

In the past 6 months has always been allowed for Constructive Engagement. This was the length of time anticipated by all stakeholders in the early stages of the H7 review. This was before the Q6 period was extended. The airlines are well on record as stating that the minimum time which should be allowed for Constructive Engagement is six months. This is still our position. At least this amount of time will be required for airlines to review the IBP, engage meaningfully with HAL on the issues, and for both parties to develop and agree the Constructive Engagement report for the CAA. As stated above, we consider that this still provides sufficient time for HAL to prepare its FBP and the CAA to publish its Initial and Final Proposals.

In the Q6 review a number of workstreams continued to meet after Constructive Engagement ended. This provided forums for engagement on emerging CAA proposals or specific requests from the CAA for stakeholders to review issues. We anticipate this occurring again if it is deemed useful by all parties.

6.2.3 Governance

The CAA is correct to note the need for HAL and the airlines to review the governance arrangements. During the Q6 review there was a specific structure for governance which worked well. However, the added dimension of the governance for expansion provides an opportunity for the airlines and HAL to

consider appropriate overall governance arrangements. The CAA has highlighted that the, 'engagement plan, and associated governance arrangements, should be sufficiently robust and wide ranging'. We agree with the importance of this and look forward to working with HAL in the establishment of engagement and governance arrangements which meet the needs of all stakeholders.

6.2.4 Information Provision

We welcome the CAA stating the importance of the, 'timely provision of high quality, detailed and consistent information on the H7 business plan and expansion'. This is the kind of information that will enable the kind of engagement envisaged by the CAA. At this point we would note that in the Q6 review such detailed information was either not provided by HAL or it was not provided on a timely basis. We hope this is not the case again. This is particularly the case when the volume of analysis to be undertaken by all stakeholders will be much greater this time. We hope the CAA establishes a clear expectation of its requirements in this area for all parties.

Signed:



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