

# Economic regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion (CAP1871)

Heathrow's response

Date: 06/03/2020

Prepared by: Heathrow Airport Limited

Status: Published

## Contents

<b>Executive summary</b> .....	3
<b>Chapter 1: the CAA’s proposals</b> .....	7
Introduction .....	7
Schedule choice.....	9
The proposals on cost recovery and treatment are not an investable proposition .....	11
The CAA’s proposals are inconsistent with their own analysis.....	11
The CAA’s proposals do not provide a “fair bet” for investors and misunderstand the risk associated to Category B and pre-DCO Category C costs .....	12
The CAA’s proposals are in clear conflict with regulatory precedent, the iH7 commercial agreement and process.....	15
The CAA’s proposals are ambiguous and lack sufficient clarity .....	17
<b>Chapter 2: Heathrow’s proposals</b> .....	21
<b>Chapter 3: Implementation</b> .....	37
The draft condition is not consistent with the CAA’s duties .....	40
Conclusion .....	42

## Executive summary

1. Expanding Heathrow is a once in a generation opportunity for consumers and the whole UK. The Department for Transport (DfT) estimates expanding Heathrow will generate £68 billion<sup>1</sup> in benefit for consumers. This benefit comes through increased competition and choice driving lower fares as existing and new airlines can grow their operations at an expanded Heathrow. Latest analysis shows this could reduce consumer ticket prices by £34 for short haul return flights and £217 for long haul return flights<sup>2</sup>. New capacity is worth over £2 billion per year to consumers calculated using a number of different methods. An opportunity such as that demands timely action from all those involved in aviation.
2. On 27<sup>th</sup> February, the Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the Airports National Policy Statement (ANPS). The ANPS is therefore suspended. A DCO submission on the timetable envisioned in CAP1871 is therefore unlikely. Nevertheless, expansion is still in the interests of consumers and there is still a need for the CAA to define treatment of pre-DCO costs. We provide our response to CAP1871 in this context and assuming the reinstatement of the ANPS.
3. With the support of the airline community and the CAA, Heathrow will evaluate the best immediate way forward that is in the interest of consumers. We will investigate all options. Key considerations will include activities, speed and phasing of the programme in addition to the expansion programme as a whole. At time of submission, we envisage minimal pre-DCO spend before there is a clearer policy and legal context to define a programme timeline.
4. The CAA in CAP1871 is right to start with quantifying the consumer benefit of earlier delivery and greater certainty and momentum. While specific estimates are always complex and can have various limitations the overall conclusion that consumers stand to benefit from billions of pounds of savings for each year of earlier delivery is sound.
5. The CAA also took a decision on schedule by supporting Option 2a in December. The economic rationale for this is debateable as the consumer evidence strongly leans toward even faster delivery. However, in practice, the decision was already a *fait accompli* as the window for an accelerated schedule has closed. The Court of Appeal decision further changes any actually practicable timelines. Despite this, the clarity of the CAA's support for pre-DCO investment in the consumers' interest and the desired pace is welcome.
6. The CAP1871 proposals for cost treatment do not work to deliver investment ahead of a DCO. This is the fundamental issue in the consultation. If the CAA was to continue with these proposals, Heathrow would have little choice but to minimise investment pre-DCO (at the cost of schedule), cease the programme and seek CMA review. We believe avoiding these steps and progressing investment at pace would be far more in the interest of consumers.
7. The CAA appears to misunderstand and misconstrue the reality of investment in expansion in general and early costs in particular.
  - a. We should not underestimate the inherent complexity of delivering new capacity. As with any major infrastructure project it requires extensive planning, iteration and

<sup>1</sup> NPV of economic benefit in NPV terms 2014p, 60 years – DfT, Updated Appraisal Report Airport Capacity in the South East, October 2017

<sup>2</sup> Frontier Economics, Estimating the Congestion Premium at Heathrow: A Report Prepared for Heathrow, May 2019

engagement. It needs momentum to succeed. All of this is particularly challenging when private investors bear the full programme costs, mitigations and risks.

- b. In the face of this complexity, the regulator has a crucial role, once it has established that pursuing new capacity is in the consumers' interests. It must simplify, clarify and provide regulatory certainty and a predictable framework to foster investment for both debt and equity. This must be the first concern, as against issues of stranded costs, governance et al.
- c. Regulatory stability is key to ensuring financeability and access to efficient debt financing. As we have set out in multiple previous submissions, investor perceptions of regulatory stability are key to the assessment of the business risk. Therefore, continuing regulatory uncertainty around the treatment of Category B and pre-DCO Category C expenditure will increase the perception of regulatory uncertainty and impact Heathrow's ability to achieve the A- credit rating required to ensure the delivery of expansion is financeable.
- d. The assertion that shareholders are taking no risk is factually untrue. Recovering the cost of new debt is not "recovering the costs of investment". It is also often forgotten that in a regulated context shareholder upside is capped and uncertain at this stage. This differentiates Heathrow from unregulated firms. It limits Heathrow's shareholders' capacity to absorb downside risks too.
- e. Our shareholders have until now pursued expansion, demonstrably in line with consumer interests and market forces, for many years, putting hundreds of millions at risk. Their good faith and commitment to the programme cannot be questioned.
- f. Similarly, our investors have carried the increasing risks of recurring political and policy uncertainty and market changes throughout this process.
- g. The regulatory approach to early costs has already increased risk with all Category A costs being written off, 100% risk on Category B costs due to an arbitrary disallowance clause and no regulatory certainty on either further pre-DCO spend or the wider regulatory proposition. The CAP1871 proposals now add a proposition with only downside outcomes and which do not even guarantee recovery of the cost of capital even if every individual aspect of Heathrow's expenditure is considered efficient.
- h. This runs directly counter to the assumptions Heathrow emphasised were important in the Statement of Principles and Relationship Framework document with the UK Government, where we stated that "*a regulatory determination which ensures that all economically and efficiently incurred costs are included in the regulatory asset base, including but not limited to planning costs or any reasonably incurred expenditure for maintaining support for and progressing the Scheme by HAL*"<sup>3</sup> and "*an overall regulatory determination that provides a regulatory framework which reflects the higher risk nature of the investment*"<sup>4</sup> was critical to deliver new capacity. Few, if any,

---

<sup>3</sup> THE SECRETARY OF STATE FOR TRANSPORT and HEATHROW AIRPORT LIMITED STATEMENT OF PRINCIPLES relating to Airport Capacity Programme  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/562175/heathrow-airport-limited-statement-of-principles.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/562175/heathrow-airport-limited-statement-of-principles.pdf)

<sup>4</sup> *ibid*

of these issues have been addressed. In addition, the timetables we agreed with Government for codifying economic regulation, including recovery of planning costs, have not been met. Collectively, these shortfalls have increased the risk of Heathrow's expansion investment.

8. The CAA must address the shortcomings of its proposals in CAP1871. As a total package, the proposals are not an investable proposition. They do not allow expansion to be delivered, let alone delivering it in line with the timetable identified by the CAA in its document as being in the best interests of consumers. No sensible investor could continue to invest in a proposition, that under the CAA's proposals (and previous decisions<sup>5</sup>) necessarily erodes value. The CAA's proposals generate a negative expected NPV outcome for Heathrow and its investors. This is unacceptable. Heathrow simply cannot continue investing in expansion unless these significant deficiencies are resolved.
9. The CAA's proposals for the treatment of Category B and pre-DCO Category C costs are flawed from multiple angles and inconsistent with its duties. Amongst the key issues are:
  - a. Inconsistency with the long-established "fair bet" principle. They propose downsides of over 50% of the present value of the investments with no upside, and in the best of all outcomes not even recovering the real cost of capital. They also appear to disregard the basic need for equity to support investment, assuming debt financing is recovering costs.
  - b. Extensive subjectivity and vagueness on decision rules and incentives – most egregiously in continuation of the CAA's proposal not to allow Heathrow to recover efficiently invested costs in the event of withdrawal from the planning process – that provides an open-ended exposure to regulatory subjectivity for very large sums running into the hundreds of millions. The subjectivity also includes vagueness on the Category C cap, recovery timing and associated returns.
  - c. Introducing arbitrary recovery caps – particularly the unjustified Category B cap and disallowing appropriate recovery of efficiently invested costs above the cap. This specifically works against consumer interests and consumer value creation.
  - d. Ignoring proper regulatory process and principles including in proposing an interim WACC for Category B and C costs for 2020 and 2021. This is based on a partially consulted estimate of WACC, where the CAA failed both to address material issues in the estimate for well over a year and failed to properly consult or take account of Heathrow's detailed response to the estimate. The CAA is currently being appealed on these very factors at the CMA. The use of an interim WACC also creates huge regulatory uncertainty, complexity in the RAB and no material or demonstrable benefit for consumers.
  - e. Furthermore, the CAA's approach in proposing an interim WACC for these costs runs counter to the basis of the iH7 commercial deal. The commercial deal was predicated on an extension of the Q6 licence, including an extension of the 5.35% WACC for the period. The CAA's proposals cut across this, setting a different WACC for part of

---

<sup>5</sup> The CAA's decision not to enable Heathrow to recover Category A costs

Heathrow's RAB in this timeframe. In addition to this clear process error, this also leads to a lower than forecasted return for Heathrow through the iH7 period.

- f. Lack of legal or process certainty, including no timetable for a licence modification and a proposal for a modification that does not even provide a legal basis for cost recovery.
10. In our response therefore, we provide alternative options for the regulatory treatment of Category B and pre-DCO Category C costs. In doing so we address the CAA's stated concerns to have an approach that ensures that Heathrow is incentivised to deliver expansion and limits the risk to consumers in the event that the DCO is unsuccessful.
  11. The CAA recognises that a licence condition is required for pre-DCO Category C costs. The scope of the licence modification should provide legal certainty regarding how costs will be recovered by Heathrow in respect of both pre-DCO Category C and Category B costs. In our response we set out proposed wording for the licence condition.
  12. We offer comments regarding each element of the CAA's consultation in the following chapters. We are keen to engage with the CAA on our response.

## Chapter 1: the CAA's proposals

### Introduction

13. On 27<sup>th</sup> February, the Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the Airports National Policy Statement (ANPS.) The ANPS is therefore suspended. This response assumes the eventual reinstatement of the ANPS when talking of a future programme.
14. The context for the CAP1871 proposals is important. Heathrow has pursued expansion by risking hundreds of millions of new capital over the last 5 years. We have maintained momentum in the programme despite political and regulatory uncertainty to ensure that we maximise the opportunity to deliver expansion and that we do so as soon as is feasibly possible – all of which stands in the interest of consumers. For example:
  - a. Heathrow invested £57m of Category A costs, that the CAA has not allowed Heathrow to recover, even though the costs clearly served a consumer purpose. Heathrow expansion was recommended by the Airports Commission and subsequently adopted as Government policy.
  - b. Heathrow has continued to invest in expansion by means of Category B costs. This has been against a regulatory policy background with the threat of a post-fact subjective disallowance of efficient costs and lack of certainty on policy persisting for years. In addition to this subjective disallowance, while the CAA recognised the important principle of providing a premium, it also introduced downside risk-sharing ranges that were very asymmetric.
  - c. In addition, in the interests of progressing delivery of new capacity for consumers, Heathrow has already started modest investment in pre-DCO Category C costs, ahead of getting any clear view of what the CAA's proposals are in this area of investment after many months of delay in clarifying policy. This was also done in the confidence that as the CAA stated in CAP1819 "it seems appropriate to continue to assume that efficient levels of early Category C spending will be recovered through HAL's RAB and there will be no additional risk sharing mechanism".
15. The business and financial risks of expansion are real. They cannot be waived away by loose assertions of 'regulated companies always getting their money back'. In addition to all the existing business risks of actual return on our RAB and disallowance of spend, there are new, demonstrable and material risks. These include political and policy risks, DCO delivery risks, new financial strains and the threat of breakup of the airport. The recent court judgement illustrates the realities of these risks in stark terms. To be clear, recovering efficiently invested costs indexed at the cost of new debt does not mean "getting our money back" - this is a very basic principle of corporate finance.
16. Furthermore, and fundamentally, Heathrow is proceeding without any real clarity on the H7 and longer-term incentives, no current recognition of the higher risks being borne and a series of increasingly punitive proposals by the CAA. We note that the 5.35% Q6 WACC was never intended to address the risks of expansion. To date, the CAA has not spent any real effort in defining a potential risk premium for H7 and beyond either.

17. As Heathrow noted in the Statement of Principles it agreed with the Government in 2016 Heathrow requires a regulatory framework that is “long-term, predictable and stable, and ensures adequate risk sharing and long-term, predictable and stable financial returns” to be able to pursue new capacity. This framework feels increasingly distant. For example, adding in extra incentives in the case of stranded costs, would need to be balanced with compensating upside potential. Likewise, a stable framework would build on existing mechanisms and proven principles rather than ever more complex additions.
18. To be clear Heathrow and its investors are not seeking ever higher returns or bonuses. On the contrary, given a capped upside to returns and long-term nature of investments, our business is best suited to stable, lower volatility approaches. For the avoidance of doubt, Heathrow does not consider penalties to be appropriate. However, if the CAA insists on adding in further penalties it must at a minimum balance these with appropriate rewards.
19. It is in this context that we call on the CAA to both focus its regulatory activity on providing a simple, viable framework that actually delivers new capacity and also to address the very fundamental issues in the proposed treatment of pre-DCO costs in CAP1871. Rational investors cannot invest in this context unless these issues are properly resolved. Our ability to continue supporting expansion without certainty about economic regulation for recovery of planning costs and expansion generally is now reaching a breaking point.
20. Another fundamental point of the context in which the CAA is setting its CAP1871 proposals is the overwhelming evidence in support of delivering expansion as soon as possible. This in turn should be the cornerstone against which the CAA should develop CAP1871. In effect CAP1871 proposals should provide clear cut incentives for Heathrow to deliver capacity as soon as feasible. Instead, the CAA appears to be more concerned about preventing consumers from paying for efficiently invested costs associated with delivering a programme that is fully in their interest. It follows that the proposed framework is built on punitive incentives that discourages investment. Unfortunately, therefore, in seeking to minimise the impact on charges in the short run, the CAA is imposing a much larger cost on consumers by failing to provide the right incentives for expansion to proceed. This is all down to the CAA misinterpreting the facts on how to further its own duty.
21. Delivering expansion is founded in clear and robust consumer benefit analysis. Indeed, the CAA in CAP1871, is right to start with quantifying the consumer benefit of delivery and greater certainty and momentum. The CAA provides good quality evidence with an unequivocal result - expansion should be delivered as soon as possible.
22. We note the strength and range of consumer value evidence presented in CAP1871. It is very positive to see that the CAA has developed thorough research and analysis in this area. There is significant evidence, based on different sources, including third party analysis, with different methodologies that indicate a clear rationale for investing to deliver expansion in a timely manner. In doing this the CAA, and its advisors, have unequivocally rebutted airlines’ representations that argued against the existence of scarcity rents. The CAA’s evidence and analysis calls for a policy proposal that prioritised speed of delivery rather than limiting short term changes to charges<sup>6</sup>. Given its own evidence and conclusions, the CAA should be incentivising Heathrow to invest more quickly, not less.

---

<sup>6</sup> To be clear Heathrow is not advocating for a blank check for recovering inefficient investment.



23. In Heathrow's view, the range of methods, sources and data sets all point in the same direction, - the existence of significant consumer benefits enabled by expansion. We are therefore concerned with the CAA's decision to undermine the findings of its own quality analysis, by deciding to use a data range based on the lower quartile of evidence. Should the CAA have decided not to skew its finding, this could have perhaps led to a different set of policy proposals.
24. Finally, as a point of context, it is important that the CAA understands how a competitive market, absent of regulation, would have operated in this circumstance. Overwhelming evidence shows that in a competitive, unregulated market a business would invest in a programme at risk where it has the knowledge that it will be able to recover at least its cost of capital from making the investment. In the case of expansion, the existence of scarcity rents evidences a clear market opportunity, meaning that an unregulated business would have the confidence to invest at risk and the incentive to deliver the investment as soon as possible in the knowledge that it would be able to benefit from the full upside generated by the investment.

### Schedule choice

25. The CAA took a decision on schedule by supporting Scenario 2a in December. Clearly new scenario planning will likely be required following the Court of Appeal decision. However, the clarity of the CAA's statement of support for pre-DCO investment in the consumers' interest and the desired pace is welcomed. Going forward this must inform the CAA's decision-making in the event of any disagreements between Heathrow and the airline community regarding suitability and need for expenditure on the expansion programme to protect the schedule. This is provided the CAA first addresses the deficiencies of its current proposals.
26. The economic rationale for choosing Scenario 2a is debateable as the consumer evidence strongly leans toward faster delivery. The table below outlines the key studies used by the CAA to conclude that Scenario 2a is better from a consumer perspective than Scenario 1. It is clear that if the CAA had decided not to use the lower quartile of the evidence provided, Scenario 1 would have been prioritised. Therefore, again Heathrow considers that the CAA should have taken greater comfort that consumers' interests are protected in a scenario with a bias towards fostering investment.

Source	Description	Estimate of congestion premium
Frontier Economics ( <i>HAL</i> )	Empirical Estimate	£2.0bn - £2.4bn pa
SEO Economic Research ( <i>Airports Council International</i> )	Empirical Estimate	£1.8bn- £5.4bn pa
EY	Estimate of airline profitability	£6.7bn pa
Additional Evidence ( <i>Confidential</i> )	Empirical Estimate	£0.9bn- £2.5bn pa

This is particularly evident from the CAA's analysis of the probabilities of DCO success that would make consumers indifferent between Scenario 1 and Scenario 2a. We note that under very conservative assumptions of £2.5bn of foregone consumer benefit per annum, consumers are better off by pursuing Scenario 1 if the probability of DCO success is greater than 33%. This in turn should have played a clear role in erring for a Scenario 1 delivery.

			Scenario preferred to S1 at P*	
	Early Cat C Costs	Opening Date	Foregone consumer benefit pa £0.9bn	Foregone consumer benefit pa £2.5bn
S1: Base	£2.4bn	Dec- 28		
S2a: Base + 1 yr	£1.6bn	Aug- 29	52%	33%

27. In addition, Heathrow rejects a number of additional arguments that the CAA outlines for deciding that Scenario 2a is a better outcome for consumers. These are discussed below:

- a. The CAA appears to assume that investing at speed undermines the ability to do so efficiently or undermines an efficiency assessment. This is simply an opinion and it is unsubstantiated by data or analysis. Investing efficiently at times involves leveraging economies of scale for Heathrow to take forward activities. The CAA has significant tools at hand to review Heathrow's progress and ensure efficiency, including the IFS, third party reviews and clear governance already in place with the airlines, in addition to licence conditions recently introduced by the CAA.
- b. The CAA considers that it is relevant to take into account that Heathrow has not been able to secure IAG's support. Heathrow rejects this view. It is clear from IAG's behaviour that it is focusing on the interest of its equity holders, which is a legitimate priority for them. However, this is not and cannot be assumed to be in the broader consumer interest. IAG has a vested interest in delaying investment to protect its market position at Heathrow and has no incentive to support expansion. This is demonstrated by IAG's media representations and regulatory representations. It is most surprising in this context that the CAA gives such weight to its representations in this area. The CAA appears to misinterpret its legal duties towards consumers as avoiding an outcome that may not align with IAG's corporate strategy.

28. However, in practice, the decision on schedule became a fait accompli as the window for an accelerated schedule closed in 2019. The nature of big programmes with interdependent activities unfortunately generates ample opportunities for unsought delay rather than opportunities for accelerating the programme. We therefore request the CAA to exercise caution when it refers to further opportunities to review the speed of the programme and possibilities for a more aggressive delivery. The opportunity is simply gone. The same logic will apply in any future decisions on timelines and programme.

29. Furthermore, the court decision on 27<sup>th</sup> February has further shifted any potential expansion schedule. A DCO application in 2020 is now extremely unlikely. Going forward the CAA, Heathrow and the airline community, need to work in a co-ordinated way to define an efficient approach, including dealing with costs incurred to date and any future 'restart' of the programme at the point the ANPS is reinstated.

30. There is a possibility that under some policy and legal contexts, limited pre-DCO investment should continue in the immediate future ahead of full clarity on ANPS reinstatement. At the

time of this submission this is simply unclear. We would therefore propose the CAA keep open the option of “Scenario 3a” or “Scenario 4” that could address this reality as/if it emerges.

31. The evidence that expansion is in the consumer interest is overwhelming. Heathrow therefore continues to advocate new capacity despite the recent court judgement.
32. The logic debated in defining the consumer benefit, appropriate schedule and the right way to translate that logic into regulatory incentives will all hold equally true at any future point were the full programme to be restarted. We therefore call on the CAA to retain the basis of the analysis, reflect the critical consumer arguments made and prepare a viable framework for any future such investment. Having this established ahead of any restart would also avoid the ambiguous, fragmentary and difficult situation that Heathrow, airlines and others have faced for the last period where regulatory treatment has not been clear even as the programme needed to progress at real pace.

### The proposals on cost recovery and treatment are not an investable proposition

33. The single biggest issue with the CAA’s proposals in CAP1871 is the proposed treatment of costs. As a total package, the proposals are not an investable proposition. The CAA’s proposals for the treatment of Category B and pre-DCO Category C costs are flawed from multiple angles and are inconsistent with its duties.
34. The CAA’s stated intention is to give much-needed regulatory certainty to supporting delivery of Heathrow expansion. The proposals achieve the opposite. In particular they:
  - a. Are inconsistent with the CAA’s own analysis
  - b. Do not provide a “fair bet” for investors and misunderstand the risk associated with Category B and pre-DCO Category C costs
  - c. Are in clear conflict with regulatory principles, precedent and process
  - d. Are subjective and expose Heathrow to open ended regulatory risk
  - e. Introduce arbitrary caps for expenditure
  - f. Do not provide legal certainty regarding Heathrow’s ability to recover efficiently invested costs

We build on these points in the rest of this Chapter.

### The CAA’s proposals are inconsistent with their own analysis

35. The CAA’s selection of Scenario 2a was based on comparing the benefits to consumers of early opening of the runway against the risk of stranded costs. This analysis assumed that the stranded costs were passed on to consumers in full and concluded that the expenditure in Scenario 2a was sufficiently low that it would be outweighed by the benefits to consumers from the earlier delivery of expansion. This means that based on the CAA’s analysis for selecting Scenario 2a, consumers **are already protected** from the risk of stranded costs through the proposed cap on pre-DCO Category C costs. Therefore, no additional protection for consumers is required in the event that the DCO is not successful.
36. The CAA’s proposed approach to penalising Heathrow in the event of failure of the DCO is inconsistent with the assumptions it made when choosing its preferred scenario. To be consistent, the CAA should have compared the benefits of earlier delivery if the DCO was

successful with the costs **less the NPV of any penalty** applied if the DCO was not successful. Had the CAA done this it is likely that its analysis would have indicated that Scenario 1 was the optimal outcome for consumers because of the punitive scale of the proposed penalty to Heathrow. Therefore, there is no lawful and rational basis on which the CAA could impose additional penalties for failing to achieve DCO.

37. The primary aim of pre-DCO Category C expenditure is to enable earlier delivery of the benefits of expansion to consumers. It is not primarily related to delivering a successful DCO. Given this, tying incentives around this expenditure to the success or failure of the DCO is not a reasonable approach. Therefore, also taking account of the protection to consumers from the cap on expenditure, full inclusion of the costs below the cap in the RAB would be in consumers' interest irrespective of the outcome of the DCO. This remains the most appropriate approach for the CAA to adopt and would give an appropriate "fair bet" to shareholders to undertake the investment and expedite delivery of the benefits of expansion to consumers.
38. Finally, in a 2R scenario Heathrow will continue to be capacity constrained. As a result, any reductions in airport charges will not be passed on to passengers but will instead be retained by airlines. The CAA, despite basing its analysis on the assumption of a constrained airport, has not taken any account of this in its assessment of the best outcome for consumers.

**The CAA's proposals do not provide a "fair bet" for investors and misunderstand the risk associated to Category B and pre-DCO Category C costs**

"Fair bet" principle

39. The CAA's latest proposals do not provide the basic risk/reward structure necessary for Heathrow to continue to invest in expansion. The proposals simply do not provide an investable proposition for Heathrow as they do not provide a "fair bet" for investors. Rational investors cannot advance the necessary investment in Category B costs and pre-DCO Category C costs against a value eroding proposition.
40. While the CAA states that it intends not to introduce further risk sharing arrangements for Category B costs above £265m and for pre-DCO Category C costs, the CAA's proposals regarding the use of different IDC's do exactly that. Furthermore, it only provides for the downside/penalty and not the upside/reward. This is a fundamental flaw in the CAA's thinking.
41. In a non-regulated environment, a rational private investor would take the risks of achieving planning consent (and associated costs) in the expectation of maximising the return associated with that investment by optimising its commercial proposition, including setting the ultimate price for its customers/consumers freely. In a regulated setting like Heathrow's current framework, Heathrow does not have the ability to freely set the prices that maximise the return on its investment. It therefore follows that, if the CAA wishes to introduce downside in Heathrow's ability to recover its efficiently invested costs (that are in the interest of consumers) in the event where Heathrow does not achieve the DCO, it must also introduce an upside scenario where Heathrow achieves a successful DCO. The CAA's proposals summarised below fail to do this:

- a. If the DCO application is successful/unsuccessful, the return is 4.83%<sup>7</sup> for expenditure up to the currently proposed respective caps on both cost categories for 2020 and 2021
  - b. If the DCO application is successful/unsuccessful, cost of new debt for expenditure above the respective caps on both cost categories but below any revised cap for 2020 and 2021
  - c. No rate of return is prescribed for any amounts over the revised recovery caps and such expenditure will not enter the RAB at all
  - d. Following DCO outcome, H7 WACC for Category B costs above £265m and pre-DCO Category C costs if DCO is successful
  - e. Following DCO outcome, cost of new debt for Category B costs above £265m and pre-DCO Category C costs if DCO is unsuccessful
42. This incentive structure, which to be clear includes a very explicit risk sharing arrangement, does not provide a fair chance for Heathrow to recover efficiently incurred investment in full (at an appropriate cost of capital). Therefore, it fails to provide incentives for a rational investor to continue investment in these costs.
43. This lack of balance is particularly acute when we compare the CAA's proposals with the CAA's own analysis concluding that Scenario 2a<sup>8</sup> is the best alternative for consumers. In the CAA's own analysis, Scenario 2a is only a better alternative to consumers than Scenario 1 if the probability of achieving a successful DCO is below 33%-52%.
44. Taking the CAA's own rationale for selecting Scenario 2a, including the implicit probabilities that justify Scenario 2a, the CAA's proposals in this area (IDC) generate an expected loss to investors in the range of c£700m and c£500m if DCO probability of success is in the range of 33% to 52%. No rational investor would invest an additional pound based on these proposals.
45. The CAA's proposals do not provide a "fair bet" in relation to cost recovery above or below the Category B and pre-DCO Category C cost caps.<sup>9</sup> Irrespective of the level at which the CAA defines the recovery caps (which we discuss in detail later in the response). The CAA caps the recoverability of costs above the cap, but does not provide the opportunity for Heathrow to retain any efficiency if outturn costs are below the cap.
46. The lack of regulatory certainty problem that this proposal generates is discussed further in the response. From a "fair bet" perspective, this proposal again only provides potential downside exposure for Heathrow. For example, Heathrow is not only exposed to the 105/85 rule for Category B costs below £265m and the different IDCs depending on the DCO outcome, both of which do not provide a "fair bet" for Heathrow, but also has unlimited exposure to its ability to recover costs if the CAA subjectively decides that Heathrow has unilaterally withdrawn from the planning process.

Misunderstanding of risk associated with Category B and pre-DCO Category C costs

---

<sup>7</sup> Concerns regarding this rate of return are further discussed throughout the paper

<sup>8</sup> Further comments on the analysis provided later on in this paper

<sup>9</sup> Further comments on the level and need for the cap provided later on in this paper

47. In addition to not providing a “fair bet” the CAA’s policy misunderstands the risks associated with these costs. The CAA proposes to use 4.83% real pre-tax as the allowed IDC for Category B costs and pre-DCO Category C costs if the DCO is successful and costs are within the respective caps. The CAA appears to base its proposal on 4.83% representing a better reflection of Heathrow’s current cost of capital.
48. Heathrow strongly disagrees with this view. It is important to note that the CAA in this proposal is not resetting Heathrow’s current cost of capital, but the cost of capital associated with these particular cost categories, since it is defining tailor made regulatory arrangements for these categories (not for Heathrow as a whole). The CAA’s own analysis to select Scenario 2a, implies that it considers that there is more than 50% chance of not getting DCO approval. Therefore, it is difficult to reconcile this underlying risk with the CAA’s proposal to reset the base from 5.35% to 4.83%.
49. We have consistently stated that the risks associated with Category B costs and pre-DCO Category C costs are not reflected in the Q6 WACC since it did not reflect expansion risk. We have nevertheless argued that in order to achieve a quick resolution on this policy the most pragmatic approach is to roll forward the Q6 WACC for these costs until the H7 WACC is fully defined. We continue to stand by this position.
50. Further, the CAA proposes to compensate Heathrow with the H7 cost of new debt for these costs in the event that Heathrow does not succeed in its DCO application. Notwithstanding that Heathrow contends that the starting point for returns on these costs should be 5.35% rather than the 4.83% proposed for the reasons outlined below - should the CAA wish to change the compensation in the case where Heathrow is not successful with the DCO it must provide meaningful upside in the scenario where Heathrow does succeed. This follows from the clear statements that achieving the DCO is not at all guaranteed. Therefore, the CAA should:
- a. Correct the base compensation to 5.35% and
  - b. Provide a premium in the case where Heathrow achieves planning consent, we estimate a total WACC in the range of [9% to 13%]<sup>10 11</sup> is necessary to provide a policy that achieves a balanced risk and reward package to Heathrow.
51. The rate of ‘interest during construction’ of 4.83% is also poorly justified. The CAA simply states that it considers the figure to be a ‘better reflection of HAL’s current cost of capital’ to address concern about over-remuneration, and to provide ‘more regulatory certainty than applying the allowed return that we will develop for the next main H7 price control’<sup>12</sup>. However, the risk of over-remuneration is not quantified; nor is there any evidence as to why the stated figure is more accurate. Furthermore, it is unclear why this cost of capital is lower than for other expenditure at Heathrow, when the CAA has acknowledged that Heathrow’s Category B expenditure has ‘additional risks linked to the possibility that Heathrow not be granted DCO consent’ but said that ‘these are dealt with [by] the incentive gain share mechanism’ which no

<sup>10</sup> To be clear, Heathrow is not advocating for implementing different WACCs based on different DCO outcomes.

<sup>11</sup> Based on a top-down calculation of return that would achieve and expected 5.35% return given the probabilities of DCO success estimated by the CAA and the assumed value of Cost of new debt.

<sup>12</sup> CAP1871, paragraph 2.68

longer exists for costs above £265m. Heathrow has previously separately commissioned a detailed critique of the CAA's proposed rate of return, which provides a more detailed set of economic criticisms<sup>13</sup> which the CAA has not addressed in proposing 4.83%.

52. In addition, the CAA has itself now issued a new consultation on cost of capital, CAP1876, which invites submissions on key components of the cost of capital. It is simply inappropriate for the CAA to offer a "near final" view on appropriate returns in CAP1871 while simultaneously inviting views on how to calculate the cost of capital in CAP1876.
53. This is further exacerbated by CAP1871 being issued while the CAA is under appeal to the CMA on the NERL cost of capital, with the CAA itself acknowledging the relevance of those parameters for determining the Heathrow cost of capital.
54. In relation to returns above the current recovery cap, the CAA has set returns at the H7 cost of new debt only. The implicit assumption is that Heathrow can fund this new investment solely as debt (including through some type of SPV with securitised debt). This appears to be highly speculative and on the face of it seems unlikely to be true; it is unclear how an SPV with costs, but no returns could have a lower cost of capital than Heathrow unless its debt was guaranteed, in which case presumably the WACC impact would be felt by the guarantor, which further erodes the cost of debt remuneration the CAA is proposing for the SPV. The CAA has not provided any evidence either:
  - a. That this expenditure can be funded solely through debt; or
  - b. That investors would want to make this highly speculative investment based on returns at the cost of debt.

**The CAA's proposals are in clear conflict with regulatory precedent, the iH7 commercial agreement and process**

55. The CAA's proposals in this consultation are in direct contrast with the CAA's own regulatory precedents.
  - a. First and foremost, the CAA appears to misunderstand the implications of CAP1871 for the design of the H7 framework. If the DCO was not to be successful, the CAA would be embarking on a H7 regulatory framework with two different WACCs and two different RABs. This is a fundamental decision to reshape a decades long regulatory construct that the CAA appears to take very lightly in this consultation paper.
  - b. The CAA continues not to allow Heathrow to recover in real time the return associated with an investment that the CAA has unequivocally termed to be in the interest of consumers. Heathrow has repeatedly argued that allowing this recovery significantly eases any financeability pressures associated with a set of costs that the original Q6 settlement did not allow for.
  - c. The introduction of recovery cap has never featured in the CAA's decision making, up to now. Indeed, Heathrow and the airline community have jointly agreed a governance and incentive framework for investment far superior than setting a cap on recovery at the early stages of the investment process. The CAA does not propose using the

---

<sup>13</sup> Reference to WACC submission and IBP materials

established Development and Core capex framework, despite Heathrow's proposal and airline support for it<sup>14</sup>.

- d. The CAA proposes the use of the H7 cost of new debt as the return for Category B costs above £265m and pre-DCO Category C costs in case of an unsuccessful DCO application. This is untested and untried regulatory practice. Let alone the fact that we disagree with the proposed approach given the unbalanced nature of the proposal, the H7 cost of new debt is not known as yet. The CAA defines a policy without articulating what is the exact value of one of the most important parameters of that policy. This is not good regulatory practice, nor consistent with precedent and is therefore unacceptable for Heathrow.
- e. In the original Category B costs policy, where the CAA introduced risk sharing arrangements, the CAA introduced downside and upside as part of the risk sharing arrangements. In the circumstances of an unsuccessful DCO, it only introduces downside. This is inconsistent with previous decisions.

56. The proposals are also inconsistent with the iH7 Commercial Deal:

- a. The purpose of the agreement between Heathrow and our airline customers (signed by airlines representing 90% of passengers at Heathrow, including IAG), was to allow the CAA (and stakeholders) to not further alter core regulatory assumptions for the period before 2022 and to concentrate on the H7 framework. The CAA consultation is proposing to change fundamental elements of the regulatory building blocks applying before 2022. As we responded to CAP1819 *"Heathrow strongly object[ed] to the option of calculating an interim WACC that is wholly inconsistent with established regulatory practice and the basis of the iH7 deal"*.
- b. The commercial deal, as signed by Heathrow and the airlines, was predicated on the requirement to extend the Q6 licence which includes amongst other things the reference WACC for the period of 5.35%. The CAA did extend the licence for the iH7 period and so extended the applicability of the Q6 WACC for the iH7 period. Therefore, its proposals to amend the WACC applied to a proportion of Heathrow's RAB through this period clearly cuts across the deal and the basis on which the rebates were calculated.
- c. Additionally, the CAA's proposals lower Heathrow's returns over the iH7 period below the level agreed in the commercial deal. The commercial deal is based on using a 5.35% WACC to adjust prices to reflect higher or lower levels of capex than assumed. In setting a 4.83% WACC for a portion of Heathrow's RAB, the CAA is effectively lowering the starting point for Heathrow's returns, thus meaning that the rebates paid by Heathrow are higher than necessary to correct for the difference.

57. Finally, the proposals suffer from significant process deficiencies and lack of due consultation:

- a. There is a clear failure to properly reflect consumer interests. For example, the arbitrary pre-defined 'caps' on expenditure are not justified based on a detailed assessment of the required activities to achieve DCO, nor are they justified based on the impact on consumers' welfare.

---

<sup>14</sup> Virgin Atlantic response to CAP1819



- b. Regarding the proposal to use a 4.83% WACC:
- i. The CAA did not formally consult on the 4.83% WACC, rather it used the number as a starting point for an analysis of the best approach to calibrate the iH7 price control. In that document the CAA nevertheless outlined the proposed next steps regarding the iH7 regulatory process, which included further consultations on all building blocks, assessment of Heathrow's iH7 Business plan and financeability assessment. All of these next steps were superseded by the Commercial Agreement signed by Heathrow and the airline community, which assumed a 5.35% WACC. This commercial agreement includes Heathrow paying rebates to airlines to reflect the difference between Heathrow's headline returns through the regulatory settlement and Heathrow's underlying revenue requirement.
  - ii. The CAA has not formally consulted on this *updated* WACC (4.83%) in the context of these policy proposals. From a process perspective, it should not take any comfort that 4.83% is an appropriate number for pre-DCO Category C costs and Category B costs just because it used the 4.83% as an *updated* WACC, 2 years ago in the appendix to a consultation.
  - iii. Heathrow has provided detailed criticism of the analysis that led to the 4.83% figure, which was only ever intended to be interim. None of that criticism has been addressed by the CAA.<sup>15</sup>
  - iv. In addition, the CAA has itself now issued a new consultation on cost of capital, CAP1876, which invites submissions on key components of the cost of capital. It is simply inappropriate for the CAA to offer a "near final" view on appropriate returns in CAP1871 which simultaneously inviting views on how to calculate the cost of capital in CAP1876.
  - v. The CAA's proposal lacks any financeability assessment. It is unclear how the CAA can satisfy itself that it has met its duties without understanding how its proposals affect the financeability and therefore deliverability of an investment that the CAA considers to be in the interest of consumers.

### **The CAA's proposals are ambiguous and lack sufficient clarity**

58. Heathrow has strongly contested the CAA's decision to reserve its discretion to reduce Heathrow's recovery to less than 85% of Category B costs below £265m. In this consultation not only does the CAA disregard Heathrow's position, but it extends this to Category B costs above £265m. The CAA's proposal is totally inconsistent with the aim of the original Category B costs policy of defining clear cut incentives to deliver a successful DCO, by linking these incentives to an objective, clear and identifiable outcome. This would set clear decision rules and support open scrutiny and assessment. The proposals move away from defining a clear outcome of whether or not DCO consent has been granted. It introduces an open ended regulatory risk by way of allowing subjective interpretation and assessment of the reasons

---

<sup>15</sup>

[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Commercial/Airports/H7/Heathrow%20Airport.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/Heathrow%20Airport.pdf).

why the DCO was not successful, in particular leaving open to interpretation what constitutes “unilateral withdrawal”<sup>16</sup> from the planning process and what the appropriate rate of recovery should be for particular circumstances. This clause alone undermines the intended objectivity of the rest of Category B costs policy.

59. The CAA does not provide meaningful analysis of how the proposed policy is in consumers’ interests, affordable or financeable. Nor are the proposed policies detailed enough to enable stakeholders to quantify it themselves.
60. There is no clear analysis/quantification of how its policies would protect the interests of consumers. This is most concerning since, if the CAA had done this analysis, it would have found that there is no need to introduce different IDCs for these costs since the expected benefits outweigh the potential stranded costs added to the RAB at a 5.35% WACC.
61. For example, the CAA does not provide any meaningful detail on how the cost of debt proposal would work in practice, what the cost of new debt is or how it would enable these costs to be financeable. Had the CAA done this, it would have found that the policy proposal for using cost of new debt as an index for recovering these costs is not consistent with financeability.
62. The CAA nevertheless qualifies its proposed policy by stating that the use of cost of new debt is subject to costs being reasonably financeable. This is simply not enough. It is unclear what this means and how the CAA would give effect to this statement going forward, given that it has not done so to date. Furthermore, it does not illustrate the analysis it would perform to ensure that the proposals are reasonably financeable.
63. Moreover, the CAA explains that its choice of scenario is subject to review, in the event that new circumstances arise. This is most problematic given that the CAA intends to codify in Heathrow’s licence that Heathrow should pursue a programme of work consistent with Scenario 2a. It therefore would introduce significant constraints on Heathrow’s ability to react to new or unforeseen circumstances. Equally, it is concerning that the CAA appears to misjudge the nature of delivering a programme of this scale. Expansion is a once-in-a-lifetime programme. It is not a tap which can be turned on and off. To give just one example, the CAA does not address the basic premise that *accelerating* programme delivery in a programme of this scale is a completely different challenge from *reducing* the speed of programme delivery. Accelerating, to be clear, is much more difficult.

### The CAA’s proposals introduce arbitrary caps for expenditure

#### Principle of the cap

64. Heathrow has previously raised extensive arguments evidencing that it is inappropriate to impose a recovery cap at all. Those reasons remain valid.
  - a. Firstly, the planning process requires fluidity and responsiveness to the needs of the process. For example, Heathrow needs to be able to genuinely take submissions into account and be willing and able to change proposals to reflect the views of community stakeholders and others that make responses during Heathrow’s consultation process. It is therefore troubling that the CAA is seeking to bind Heathrow’s expenditure to its

---

<sup>16</sup> For example, a change of political environment, regulatory or market conditions may well trigger a rational investor not to further pursue this investment. In this circumstances Heathrow should not be penalised for over and above the 85% recovery defined by the policy

current level of commitments at this stage. Indeed, insofar as the cap renders it impossible for Heathrow to properly react to the planning process (if this requires spending above the cap) and make a reasonable return on its expenditure, then there are legitimate questions about whether the cap can be consistent with the CAA's duties.

- b. Secondly, an insistence on an expenditure cap suggests that the CAA has moved away from the relevant statutory considerations. What is important is whether costs have been efficiently incurred – regardless of whether they fall above or below any arbitrary threshold – having regard to the interests of consumers and the CAA's other statutory interests. There does not appear to be any principled reason why costs that fall above a certain threshold should have a different cost of capital applied to them if those costs are efficiently incurred. Take the following hypothetical: Heathrow has spent up to the cap. The opportunity exists to make further expenditure which would be obviously welfare-maximising for passengers. However, under the CAA's policy it would generate returns at less than Heathrow's WACC – and therefore Heathrow cannot justify making the investment. The incentive on Heathrow, therefore, is not to spend the money. A regulatory regime which results in such outcomes cannot be consistent with the CA Act.

65. Aside from the substantive arguments that the cap is inconsistent with the CA Act, there is also an important procedural failing because the CAA has not properly grappled with any of the arguments raised by Heathrow<sup>17</sup>. At this stage, it appears to be treating its ability to 'reopen' the level of the cap in the future as a complete answer to this issue. The CAA not only has a statutory duty to act in a way which is transparent, accountable, proportionate and consistent<sup>18</sup> but also has public law duties to consult when proposals are still at a formative stage, give sufficient reasons for particular proposals, give adequate time for parties to consider, respond to the proposals, and conscientiously consider the responses they receive<sup>19</sup>. At the moment it appears to be falling short on all of these.

#### Level of the cap

66. The CAA's proposal of setting a £500m cap is unsubstantiated and unsustainable. The CAA appears to misunderstand two fundamentally different concepts. An overall efficiency allowance based on underlying activities, and underspends relative to a budget. This is surprising and most concerning. Without prejudice to Heathrow's firm position that there can be no basis for setting an arbitrary, ex-ante Category B cost cap. Heathrow notes that:

- a. In order to set an efficient cost allowance, the CAA should first understand what activities are needed to deliver a successful DCO. Each activity will have a cost associated to it. There is no real evidence that the CAA has undertaken any analysis necessary to support a finding about the appropriate level of Category B costs.

---

<sup>17</sup> Heathrow's response to CAP1819

<sup>18</sup> Section 1(4) CA Act.

<sup>19</sup> Known as the 'Gunning principles' or the 'Sedley requirements' - see: *R v North and East Devon HA ex parte Coughlan* [2001] 108 QB 213, citing *R v Brent London Borough Council, ex parte Gunning* [1985] 84 LGR 168.

- b. The CAA's proposed cap is calculated based on a simplistic arithmetic exercise that fails to take into due consideration the activities required to achieve the DCO. The CAA appears to simply assume that because Heathrow has underspent relative to annual budgets it should be able to underspend relative to the overall budget for delivering the DCO. But the CAA does not even try to understand the reasons for this underspend to date, which in this case are related to activities assumed within the initial budget having not yet taking place.
- c. The result of the CAA's analysis is to set a Category B costs cap below the amount of Category B costs Heathrow forecasted to deliver an efficient and successful DCO at the M4 Masterplan submission. It is important to note that this estimate is now superseded by the M5 entry budget, which incorporates the impact of the CAA's decision on timetable and the submission of the DCO moving to Q4 2020.
- d. By taking this approach the CAA is in effect, disincentivising Heathrow from delivering a high quality and successful DCO submission. Equally it is penalising Heathrow for to date spending less than the annual budget.
- e. The CAA's proposals for setting a cap of £500m do not provide any allowance for risk. Heathrow's M4 submission of £529m did not include risk (as risk is held centrally in the programme). In setting a recovery cap the CAA should take into account an appropriate level of risk.
- f. Most concerningly the CAA appears to disregard or to fail to grapple with the evidence at hand by dismissing IFS, Arcadis and Steer reviews. All of which point towards Heathrow's overall budget for delivering runway capacity by around £14bn to be a sensible forecast (it is worth noting that this forecast incorporates Category B costs) and the fact that Heathrow is working to deliver one of the most complex planning applications and construction programmes in the UK<sup>20</sup>.

67. The CAA also appears to assume away that absent an investment cap Heathrow has no incentives to seek an efficient delivery of the planning application process. This is fundamentally wrong. Heathrow is incentivised through continuous engagement with stakeholders, ex-post reviews, limited amount of equity available (i.e. the need to minimise equity injection) and the need to ensure our ability to fund Category B costs.

### **The CAA licence condition proposed by the CAA is legally unworkable**

68. In addition to the policy concerns regarding the CAA's approach, Heathrow has a number of specific concerns regarding the proposed licence condition. These concerns are described in more detail in the attached Legal Annex by our advisers, Towerhouse LLP and are summarised below. These concerns are the result of the CAA taking what appears to be a fundamentally flawed approach to amending Heathrow's licence and mean that the licence

---

<sup>20</sup> The DCO scope is unprecedented in its size, scale and complexity and will encompass numerous major infrastructure developments. These include the third runway and related taxiway system, satellite and terminal development, supporting facilities, airspace design changes, realignment of a section of the M25, local road realignments, developing an interface with Western Rail scheme, realignment of 5 river systems, achieving our surface access targets, community mitigation, noise mitigation, commercial space and housing

condition proposed by the CAA is unsatisfactory for Heathrow and its investors and we consider it legally unworkable.

The draft condition seeks to dictate Heathrow's approach to expansion, without codifying Heathrow's ability to recover its costs for those activities

69. Most importantly, the licence seeks to regulate Heathrow's pre-DCO Category C expenditure but does not give effect to the expectation that Heathrow will be entitled to recover that expenditure.<sup>21</sup> Heathrow would need to spend significant amounts on Category B and pre-DCO Category C costs to achieve Scenario 2a or any similar future scenario, but the CAA apparently expects Heathrow to do so solely based on policy statements by the CAA about how the CAA intends to allow cost recovery in the licence in future. While that approach may be tolerable for relatively low levels of expenditure, it is an unacceptable basis for spending over £2 billion in costs.
70. Because Heathrow's right to recover the majority of future expansion costs is largely a matter of CAA policy rather than being set out in legally binding form in the licence, the CAA cannot have reached any final decision on these matters. The CAA cannot rationally conclude that it is in the interests of consumers to dictate the maximum amount of early expansion costs, before it has reached a final decision about whether, how, or to what extent, those costs are recoverable from consumers. A licence modification can only lawfully seek to cap Heathrow's expenditure if it provides for that expenditure to be recoverable.

The draft condition fails to provide for recovery of category B costs above £10 million per year

71. The licence fails to deal with Category B costs at all. The obvious way of avoiding Category C costs becoming sunk and successfully obtaining DCO is to ensure that the licence does not artificially constrain Heathrow's ability to invest in Category B expenditure to maximise the prospects of development approval. It is not rational for the CAA to conclude that investors will incur the significant expenditure required to maximise the prospect of a successful and timely DCO decision, while there is no legal basis in the licence for recovering such Category B expenditure.

The draft condition is not consistent with the CAA's duties

72. Finally, the CAA's draft condition is focused solely on two dimensions of Heathrow's approach to expansion – cost and time. However, these have obvious implications for other aspects of Heathrow's approach – such as quality and environmental mitigations – which are also relevant to consumer welfare. By ignoring the breadth of the CAA's statutory considerations, the resulting draft condition is insufficiently flexible, and is unreasonable and disproportionate.

## Chapter 2: Heathrow's proposals

73. On 27<sup>th</sup> February, the Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the Airports National Policy Statement (ANPS.) The ANPS is therefore suspended. This response assumes the eventual reinstatement of the ANPS. It thus presents proposals for such future scenario.

---

<sup>21</sup> Beyond the £10 million per year in category B costs which the licence currently entitles Heathrow to recover: see C1.12.

74. Separately, should it be decided that if any or all costs incurred to date are ‘stranded’ at some future point, the CAA will need to review how those costs are treated. This should be done with due regard to the assumptions prior to CAP1871 being published and these proposals should not be assumed to be retrospectively applicable in all cases in that circumstance.
75. A final decision on the regulatory treatment on pre-DCO Category C costs and Category B costs above £265m should set strong incentives on Heathrow to ensure that investment is delivered in the best interest of consumers. When setting these incentives, Heathrow considers that the following principles should be applied:
- a. Protecting the interests of consumers – based on a factual analysis of those interests in the round, not simply focusing on minimising potential stranded costs or the impact of investment on the airport charge
  - b. Creating a ‘fair bet’ that will incentivise a rational investor to risk their investment in pursuing actions that the CAA has identified as in the consumer interest
  - c. In line with Better Regulation principles, aiming for simple and targeted interventions
76. In addition, it is important to consider that incentives for Heathrow to achieve a DCO already exist. Regulatory financial incentives on these costs are not the only lever to incentivise Heathrow and must not be defined in isolation. These incentives include:
- a. Heathrow has commercial incentives to pursue a successful DCO, and a fast as feasible programme to deliver new capacity. This is evidenced by our behaviour consistently over the last 5 to 7 years where, we have consistently and effectively pursued new capacity and advocated for faster delivery at every turn. We have done so at financial risk (no recovery of Category A costs) and with no prospect of immediate return of a significant amount of costs (Category B costs) and have continued to do so in the absence of political or regulatory certainty.
  - b. Commercial market pressures do play on Heathrow and our need for scale, flexibility and capacity to support our strategic business model. This means that both with and absent regulation rational investors have a desire to expand, all else being equal.
  - c. The reputational implications of withdrawal or DCO failure are also powerful for our investors and company and mean that we will not contemplate either for trivial or short-term reasons.
  - d. Clearly all three of the above incentives can be overridden by regulatory decisions – even though they would exist in an unregulated context. Indeed, the ongoing uncertainty the CAA has created in terms of the framework and return for expansion has significantly reduced the commercial case for investment to date. The design of regulation should consider these existing incentives rather than ignore them.
  - e. The potential Expansion Premium is also an incentive for Heathrow to pursue DCO and expansion if set at an appropriate level – elaborating on this would be a useful tool for the CAA to increase the incentive to proceed.
77. Nevertheless, our understanding is that the CAA is determined to propose further financial incentives for these costs. Taking into account both the overall principles for incentives and our understanding of the specific objectives the CAA wishes to pursue we would propose that these incentives are designed to provide sharper focus on the:

- a. Quality of our DCO application to achieve a successful DCO to enable new capacity
- b. Speed of delivery for both DCO and the runway programme
- c. Efficiency of our investments pre-DCO granting
- d. Control of total spend and adherence to governance of spend

In addition, we consider that the design of any such incentives should aim for:

- e. Simplicity in application – for arrangements that are only lasting for 2 years
- f. Predictability and objectivity in determining outcomes for all stakeholders

78. As discussed in chapter 1, Heathrow believes the set of proposals in CAP1871 fail to incentivise investment, preventing Heathrow from delivering on the outcomes described above in the interest of consumers. Guided by the principles and outcomes discussed, we outline alternative proposals for the regulatory treatment of Category B costs and a series of options for the regulatory treatment of pre-DCO Category C costs. These in our view are more likely to enable a successful DCO outcome and capacity programme.

### **Category B costs and pre-DCO Category C costs recovery up to M5 Entry**

79. The Court of Appeal concluded that the Government should have considered the Paris Agreement in its decision to designate the Airports National Policy Statement (ANPS.) The ANPS is therefore suspended. This response assumes the eventual reinstatement of the ANPS. Therefore, our policy proposals are directed to expansion related costs that are taking place and will continue to take place from 2020 onwards.

80. For investment up until the M5 Entry milestone, we assume the following regulatory treatment as outlined in CAP1871. We seek confirmation from the CAA:

- a. For recovery of Category B costs below £265m, recovery will be as set out in the CAA's policy decision in CAP1513
- b. For recovery of Category B costs above £265m and pre-DCO Category C costs incurred up until the M5 Entry milestone, all efficiently invested costs will be remunerated at 5.35% and logged in the RAB as per Figure 2.1 and 2.2 in CAP1871.

### **Unilateral withdrawal from planning process**

81. This issue is a fundamental point of principle for Heathrow. Heathrow's ability to make commercial rational decisions cannot be fettered by way of arbitrary, coercive, punitive and open ended and open to interpretation regulatory policy, especially policy which is unclear and ambiguous. We simply cannot accept this and do not believe that any global investor would do so either.

82. Defining an objective and transparent policy for the treatment of expansion related costs is instrumental to providing a fair result for Heathrow and its investors. This avoids undermining regulatory certainty by potentially creating a situation where Heathrow's ability to recover efficiently invested costs is determined by subjective interpretation after events have taken place.

83. Therefore, our proposals require that Heathrow is not further penalised (over and above the incentives we outlined in our proposals), in the event that it unilaterally withdraws from the

planning process. For clarity, this applies to our proposals for Category B costs above and below £265m and all our pre-DCO Category C costs proposals.

### Regulatory treatment of Category B costs above £265m

84. Heathrow proposes that the regulatory treatment of Category B costs above £265m builds on the CAA's original policy determination on these costs, with a number of important adjustments.

- a. We propose that the original 105/85 risk reward metric does not apply for costs above £265m. This means that Heathrow would be able to recover all efficiently invested costs (above £265m) irrespective of the DCO outcome and if the DCO is not achieved, irrespective of the reasons why the DCO has not been achieved.
- b. Introduction of a recovery cap. While Heathrow has reservations with the principle of setting a recovery cap for these costs, we understand that it may have potential beneficial properties for limiting consumers' exposure to cost escalations<sup>22</sup>. This is nevertheless predicated on the cap being set at a level that reflects the efficient costs of delivering the activities associated with developing a successful DCO. The recent Court of Appeal judgement proves that setting rigid recovery caps without a clear route to being adjusted to reflect latest circumstances, not only undermines efficiency incentives but provides artificial constraints to delivering a high-quality programme of work (whether DCO submission or Expansion programme costs). Given the implications that the Court of Appeal judgement has on our immediate steps, we are not in a position where we can advance/propose a suitable cap for Category B costs. We nevertheless can see the potential benefits of the introduction of a cap predicated on the following assumptions:
  - i. The cap needs to be based on facts, should the circumstances change the cap needs to change too
  - ii. The cap is set based on a suitable ex-ante benchmarking exercise
  - iii. The cap includes clear and reasonable risk allowances within it
  - iv. The cap is to be validated by a third party
  - v. The cap is defined relative to a clear programme of work / activities
  - vi. The cap is introduced with a clear reporting and governance process
  - vii. Following clear governance process, the cap can be adjusted up or down if circumstances change
- c. It is important that there is a clear mechanism and governance in place to adjust the cap to reflect changes in the circumstances underpinning it. This is of particular importance to manage unforeseen situations. For example, Heathrow should not be penalised in the event it is required to carry out additional activities that would support the delivery of a successful DCO, which is ultimately in the interest of consumers, and where these additional activities are triggered by events outside of Heathrow's control,

<sup>22</sup> We note that under the current arrangements, there are checks and balances in place that provide strong efficiency incentives on Heathrow providing protection to consumers, for example the CAA has already conducted 2016, 17 and 18 IPCR reviews of these costs.



like policy changes, changes to the regulatory environment or changes to schedule due to unforeseeable changes, such as the judgement by the Court of Appeal. We would see that such a governance process would include:

- i. Heathrow providing an updated forecast of total Category B costs twice a year (as proposed by the CAA).
  - ii. The costs cap would be revised in appropriate circumstances, including where this has been agreed with the airline community and where Heathrow has provided evidence that the revised forecasts are in the interests of consumers and the CAA has not taken a different view.
- d. We propose that the CAA implements a long-stop date of 2022 for the recovery of Category B expenditure. The current policy of linking recovery to DCO outcome provides continued uncertainty and instability for investors. Providing a long-stop date would provide investors with increased certainty and encourage efficient investment. We propose that from 2022, should the outcome of the DCO remain unknown, Heathrow will begin recovery of 100% of efficiently invested Category B costs with no premium or penalty applied. The premium or penalty should then be applied to the relevant proportion of costs when the outcome of the DCO is known, adjusting the level of recovery accordingly.

85. We believe that this proposal protects the interest of consumers by setting the right incentives for delivering a successful and efficient DCO. This is explained further below:

a. Quality of DCO application

It is in Heathrow's commercial interest to deliver a quality DCO so that it is approved in order to deliver expansion as soon as feasible. This is in addition to any additional regulatory incentives from the H7 regulatory design such as the Expansion risk premium.

This proposal, alongside the initial Category B costs policy provides sharp incentives for Heathrow to successfully deliver the DCO by either granting a premium/penalty on costs up to £265m when the result of the DCO is known.

b. Speed of delivery for both DCO and the runway programme

It is in Heathrow's commercial interest to deliver a successful DCO in order to expand the airport as soon as feasible. A timely DCO application process would limit the programme's exposure to changes in political views.

This proposal, alongside the initial Category B costs policy provides sharp incentives to Heathrow to successfully deliver DCO by either granting a premium/penalty on incurred costs when the result of the DCO is known. This risk sharing arrangement provides incentives for a timely delivery of the DCO, in order to minimise costs ahead of ascertaining the DCO outcome.

c. Efficiency of the DCO application

The proposal incorporates the governance and reporting arrangements proposed by the CAA, including quarterly reporting on expenditure to date and 6 monthly reporting of forecast spend. It incorporates third party ex-post reviews of spend on a yearly basis and at project completion. There is therefore clear airline, CAA and IFS oversight on the

expenditure process, that coupled with the ex-post reviews provide strong incentives on Heathrow to deliver an efficient DCO application<sup>23</sup>.

d. Controlled spend application (as against adherence to an arbitrary forecast)

The proposal accepts the potential benefits of imposing a cap on Category B costs based on the underlying activities required to achieve the DCO. Such a cap would provide incentives for Heathrow to efficiently deliver a successful and efficient DCO application. In addition, a well-defined process to adjust the cap if circumstances were to arise, enables efficient investment in the interest of consumers (above the initial cap) to take place without penalising Heathrow or undermining the success of the DCO application.

e. Simplicity in application – for arrangements that are only lasting for 2 years

This proposal builds on previous policy from the CAA. It requires minimum change other than a simple licence condition that confirms Heathrow’s ability to recover efficiently invested Category B costs and a clear process for adjusting any clear and evidence-based cap set by the CAA.<sup>24</sup>

f. Predictability and objectivity

The proposal incorporates significant governance and reporting providing predictability on spend and DCO process more generally. In addition, the proposal defines a clear process for adjusting the investment cap and for assessing the efficiency of investment aiding objectivity.

The proposal removes any perceived subjectivity on the CAA’s part of reserving the right to allow Heathrow to recover less than what it has efficiently invested in the event that Heathrow withdraws from the planning process.

The proposal builds on the original Category B costs policy enhancing predictable regulatory outcomes. It maintains the 5.35% as the cost of capital, building on the previous policy decision on Category B costs and consistent with Q6 and the iH7 commercial deal. This enhances objectivity as deciding on any other potential cost of capital would be completely arbitrary without due consultation.

86. To support comparability, we summarise our proposal following a consistent structure to the one used by the CAA in figure 2.1 of CAP1871;

Policy element	Proposal
<b>Reporting and IPCC</b>	We agree with the CAA’s reporting proposals, in particular: <ul style="list-style-type: none"> <li>• Frequency and content of the reporting. In limited circumstances where Heathrow’s audit requirement, like annual accounts publication, may not completely aligned with the propose reporting requirements timing, Heathrow proposes to find a sensible way forward in open discussions with the CAA and airlines.</li> <li>• The IPCC continues to review Category B costs.</li> </ul>

<sup>23</sup> The IPCC has performed ex-post efficiency assessment of 2016,17 and 18 Category B costs.

<sup>24</sup> This is explained further in chapter 3

	<ul style="list-style-type: none"> <li>Introducing an overarching review of total Category B costs following DCO outcome.</li> </ul>
<b>Risk sharing based on DCO outcome</b>	No risk sharing arrangements to apply above £265m
<b>Risk sharing in event of Heathrow's unilateral withdrawal</b>	Efficiently incurred costs are recoverable in full in the event of unilateral withdrawal from the DCO process
<b>Treatment of costs and Recovery period</b>	<p>First £10m per year.</p> <p>Recovered through airport charges consistent with current practice</p> <p>Above £10m.</p> <p>Investment recorded in the RAB as spent, transparently and separately identified in the regulatory accounts consistent with current practice.</p> <p>Following the DCO outcome and CAA efficiency reviews, any potential inefficient investment will be disallowed from the RAB.</p> <p>The recovery of Category B costs will commence when DCO outcome is known or by the long-stop date of 2022.</p> <p>Profile of regulatory depreciation consistent with affordability and financeability.</p>
<b>Recovery cap</b>	Recovery cap set at a suitable level following a thorough evaluation exercise based on benchmarking and factual analysis, where Heathrow demonstrates that lifting the cap is efficient and in the interest of consumers, the cap will be adjusted. This would follow a well-defined process.
<b>Interest During Construction (IDC)</b>	Efficient investment on Category B costs over and above £265m will earn an IDC consistent with the cost of capital of the prevailing regulatory period (i.e. 5.35% throughout Q6 and the H7 cost of capital throughout H7). This is irrespective of the DCO outcome.
<b>Licence modification</b>	Outlined in Chapter 3 and Annex A

### Regulatory treatment of pre-DCO Category C costs

87. As we discuss in Chapter 1, the CAA proposals for the regulatory treatment pre-DCO Category C costs do not protect the interest of consumers nor provide a “fair bet” for a rational investor. We outline below three different proposals that would provide a balanced set of incentives for taking forward pre-DCO Category C costs in the interest of consumers.
88. All the proposals for the regulatory treatment of pre-DCO Category C costs share a number of structural elements that, as described below, are fundamental to providing regulatory certainty to deliver the expansion programme:
- As the CAA discusses, in order to provide regulatory certainty and consistency ahead of a final decision on pre-DCO Category C costs, investment in these costs that has

taken place before the end of 2019 is to be logged into the RAB and remunerated at 5.35%.

- b. In addition, building on the above, investment in 2020 and onwards will be logged into the RAB as spend takes place, with a single WACC for all investment at 5.35% for Q6 and at the relevant H7 WACC for the H7 period. Both of these elements are to be codified in a simple licence condition.
- c. If any ex-post efficiency reviews find inefficient investment on Heathrow's part, the CAA will disallow investment from the RAB (i.e. it would be deducted from the RAB).
- d. Introduction of a licence condition that outlines a recovery cap on pre-DCO Category C costs with a programme of work associated to runway delivery associated to a defined date. This licence condition is outlined in chapter 3. Following the judgement from the Court of Appeal and the resulting impact on our ability to submit our DCO as planned, the use of £1.7bn in nominal terms as a cap and a date of 2029 for runway delivery may need to be reconsidered; the licence draft provides flexibility for the CAA to extend delivery or raise the pre-DCO Category C target as required.
- e. A clear governance process to adjust the recovery cap to reflect changes in the circumstances that underpinned the initial cap estimate. While Heathrow recognises that it is important to set strong incentives to control costs, we should not be penalised in the event that we are required to carry out additional activities to efficiently deliver the expansion programme, including the introduction of new policy or changes to schedule. Heathrow proposes a simple and clear governance process to adjust the cap. This is described below:
  - i. Heathrow would provide an updated forecast of total pre-DCO Category C costs twice a year (as proposed by the CAA).
  - ii. The costs and timeframe would be extended in appropriate circumstances, including where this has been agreed with the airline community and where Heathrow has provided evidence that the revised forecasts are in the interests of consumers and the CAA has not taken a different view

89. We present our proposals in order of preference, Option 1 being our preference.

**Option 1: Leverage the Development and Core framework**

90. We have consistently argued the Development and Core framework is the optimal mechanism to regulating this cost category. We firmly believe that this framework with a number of additional features like those outlined in preceding paragraphs and introducing expert reviews for the ex-post efficiency assessment, provides strong incentives for delivering investment in the interest of consumers. This is explained further below:

- a. Quality of DCO and pre-DCO Category C costs to deliver new capacity

It is in Heathrow's commercial interest to deliver a successful DCO and incur pre-DCO Category C costs in order to expand the airport as soon as feasible. This is in addition to any additional regulatory incentives from the H7 regulatory design such as the Expansion risk premium.

In addition, the incentives that the Development and Core framework sets support Heathrow to deliver value for money for consumers in each investment decision Heathrow makes. Pre-DCO Category C costs are no different in this regard.

b. Speed of delivery for both DCO and the runway programme

A timely DCO application process would limit the programme’s exposure to changes in political views.

The Development and Core framework provides for the introduction of trigger penalties for incentivising timely delivery of investment. This, coupled with the introduction of a licence condition that provides for a clear path of investment towards a defined runway operation date, as defined in CAA policy, provides strong incentives for timely delivery of Heathrow expansion.

c. Efficient pre-DCO Category C costs

The Development and Core framework provides strong efficiency incentives by means of IFS oversight, airline engagement ahead of and at Gateway 3, and ex-post efficiency reviews. This is in addition to expert oversight and review as proposed by the CAA

d. Controlled spend application (as against adherence to an arbitrary forecast)

The introduction of a recovery cap that can be adjusted given unforeseen circumstances also provides strong incentives to ensure strong cost control and efficient delivery of investment.

e. Simplicity in application – for arrangements that are only lasting for 2 years

The implementation of the Development and Core framework requires limited change to be executed, with only minimum changes to the licence (these are discussed in chapter 3 of this paper)

f. Predictability and objectivity

This would simply be a continuation of the current framework, which was always designed to cope with unforeseen circumstances and different categories of costs. This applies to pre-DCO Category C costs since they were not considered as part of the Q6 determination.

91. We outline our proposals following, where possible, the structure set out by the CAA in CAP1871, Figure 2.2.

Policy element	Proposal
<b>Reporting and IPCR</b>	<p>We agree with the CAA’s reporting proposals, in particular frequency and content of the reporting.</p> <p>In limited circumstances where Heathrow’s audit requirement, like annual accounts publication, may not completely aligned with the propose reporting requirements timing, Heathrow proposes to find a sensible way forward in open discussions with the CAA and airlines.</p> <p>We agree with the CAA’s proposal of getting expert support in this area.</p>

<b>Investment scenario</b>	We agree with the CAA. Undertake a programme of early works aimed at commencing the provision of airport operation services using a third runway and associated works at the airport to commence not later than a delivery target defined by the CAA.
<b>Governance</b>	Leverage the governance arrangements associated to capital investment delivery.  The CAA to arbitrate in cases where there is a disagreement between Heathrow and airlines, following its primary duty and consistent with Investment Scenario (i.e. Scenario 2a)
<b>Risk sharing</b>	No risk sharing will be applied in respect of the success or failure of the DCO application
<b>Risk sharing in event of Heathrow's unilateral withdrawal</b>	Efficiently incurred costs are recoverable in full in the event of unilateral withdrawal from the DCO process
<b>Recovery cap</b>	Recovery cap set by CAA.  Where Heathrow demonstrates that lifting the cap is efficient and in the interest of consumers, the cap will be adjusted. This would follow a well-defined process.
<b>Treatment of costs</b>	Investment recorded in the RAB as spent, transparently and separately identified in the regulatory accounts, consistent with current practice.  Following the DCO outcome and CAA efficiency reviews, any potential inefficient investment will be disallowed from the RAB.
<b>Start of return and cost recovery</b>	As per the Development and Core framework, Heathrow will earn a return on this investment as it takes place.
<b>Interest During Construction (IDC)</b>	Efficient investment will earn an IDC consistent with the cost of capital of the prevailing regulatory period (i.e. 5.35% throughout Q6 and the H7 cost of capital throughout H7)
<b>Depreciation (Length of cost recovery)</b>	Depreciation set by the CAA consistent with affordability and financeability considerations
<b>Licence modification</b>	Outlined in Chapter 3 and Annex A

### **Option 2: Adjustment to depreciation and timing of recovery option**

92. In developing this option, we have further investigated the possibility of introducing an SPV like mechanism. This is in order to prevent investment on pre-DCO Category C costs having a significant impact on airport charges (paid by consumers) in the event that the DCO application is not successful. We have ruled out this type of SPV-like option proposed by the CAA on the basis of the cost, complexity and likely lead times to be implemented. Introducing a mechanism like this would take time preventing a timely final determination on a regulatory

framework for expansion. As we discuss in chapter 1 introducing a SPV would require a guarantee to enable funding entirely by investment grade debt. Such a guarantee would either have to be provided by Government or by shareholders. As proposed, the SPV has no mechanism for compensating shareholders for the cost of such a guarantee and therefore the option also fails the “fair bet” principle. An SPV could potentially be implemented if it was to be Government guaranteed, however, we consider that this option is not feasible within the required timescales, nor do we think it is required if the regulatory framework is appropriately calibrated by the CAA.

93. We have nevertheless reviewed regulatory precedent and identified a solution that would prevent airport charges from significantly increasing in the event that the DCO is not granted, which involves lengthening the recovery period for these costs by way of adjusting the depreciation assumption. This is explained further below.

94. In this option we propose to retain the governance arrangements of the Development and Core framework, take on the CAA’s proposals on reporting requirements and third-party expert ex-post review of these costs; and the structural elements set out above while proposing moderate changes to the mechanics associated with cost recovery. These are:

a. Proposed changes from the Development and Core approach (Option 1):

- i. This investment would not be recovered until either the outcome of the DCO is known or the long-stop date of 2022, as set out in our proposals for the regulatory treatment of Category B costs, therefore the return (associated to the interim period between expenditure and DCO outcome) gets recorded in Heathrow’s RAB at 5.35%
- ii. In the case where Heathrow has not secured a successful DCO, we propose a longer period for recovering the costs of this investment. This can be determined by the CAA but with a maximum depreciation period of 50 years.

95. This proposal generates strong incentives for Heathrow to incur pre-DCO Category C costs where this is in the interest of consumers. This is explained further below:

a. Quality of DCO and pre-DCO Category C costs to deliver new capacity

It is in Heathrow’s commercial interest to deliver a successful DCO and incur pre-DCO Category C costs in order to expand the airport as soon as feasible. This is in addition to any additional regulatory incentives from the H7 regulatory design like Expansion risk premium. In addition, the governance in place and experts review will support a quality delivery of these costs.

b. Speed of delivery for both DCO and the runway programme

A timely DCO application process would limit the programme’s exposure to changes in political views.

The introduction of a licence condition that provides for a clear path of investment towards a defined runway operation date set out in CAA policy provides strong incentives for timely delivery of Heathrow expansion.

c. Efficient pre-DCO Category C costs

We propose to retain IFS oversight, current airline governance and engagement. This is in addition to accepting the reporting proposals from the CAA and introducing expert ex-post efficiency review over this investment. All of these would support efficient delivery of investment.

d. Controlled spend application (as against adherence to an arbitrary forecast)

The introduction of a recovery cap that can be adjusted given unforeseen circumstances also provides strong incentives to ensure strong cost control and efficient delivery of investment.

e. Simplicity in application – for arrangements that are only lasting for 2 years

The implementation of the proposal requires minimum but important changes to the licence that can be incorporated alongside the proposed licence modification set out by the CAA. These are further discussed in chapter 3.

f. Predictability and objectivity

While this proposal represents a departure from established practice, the core elements are consistent with current practice. These are RAB recognition, single WACC at prevailing Q6 value, leverage of current governance arrangement and oversight and strong ex-post efficiency review.

96. We outline our proposals following, where possible, the structure set out by the CAA in CAP1871, Figure 2.2.

Policy element	Proposal
<b>Reporting and IPCR</b>	<p>We agree with the CAA's reporting proposals, in particular frequency and content of the reporting.</p> <p>In limited circumstances where Heathrow's audit requirement, like annual accounts publication, may not completely aligned with the propose reporting requirements timing, Heathrow proposes to find a sensible way forward in open discussions with the CAA and airlines.</p> <p>We agree with the CAA's proposal of getting expert support in this area.</p>
<b>Investment scenario</b>	<p>We agree with the CAA's proposal.</p> <p>Undertake a programme of early works aimed at commencing the provision of airport operation services using a third runway and associated works at the airport to commence not later than a date defined in CAA policy.</p>
<b>Governance</b>	<p>Leverage the governance arrangements associated with capital investment delivery.</p> <p>The CAA to arbitrate in case where there is a disagreement between Heathrow and airlines, following its primary duty and consistent with the CAA's chosen Investment Scenario (i.e. Scenario 2a)</p>



<b>Risk sharing</b>	No risk sharing will be applied in respect of the success or failure of the DCO application
<b>Risk sharing in event of Heathrow's unilateral withdrawal</b>	Efficiently incurred costs are recoverable in full in the event of unilateral withdrawal from the DCO process
<b>Recovery cap</b>	Recovery cap set by CAA.  Where Heathrow demonstrates that lifting the cap is efficient and in the interest of consumers, the cap will be adjusted. This would follow a well-defined process.
<b>Treatment of costs</b>	Investment recorded in the RAB as spent, transparently and separately identified in the regulatory accounts, consistent with current practice.  Following the DCO outcome and CAA efficiency reviews, any potential inefficient investment will be disallowed from the RAB.
<b>Start of return and cost recovery</b>	Return: Following the DCO outcome or a long-stop date of 2022. Heathrow will accrue a return and log it in the RAB from when the investment takes place to when recovery starts  Cost: Following DCO outcome or a long-stop date of 2022.
<b>Interest During Construction (IDC)</b>	Efficient investment will earn an IDC consistent with the cost of capital of the prevailing regulatory period (i.e. 5.35% throughout Q6 and the H7 cost of capital throughout H7)
<b>Depreciation (Length of cost recovery)</b>	If DCO is successful – Depreciation set by the CAA consistent with affordability and financeability considerations  If DCO is not successful – Depreciation set by the CAA for a maximum period of 50 years, which the CAA may choose to set in a manner that minimises impact on airport charges.
<b>Licence modification</b>	Outlined in Chapter 3 and Annex A

### **Option 3: Milestones option**

97. This option builds on the original Category B costs policy, setting incentives associated with the DCO outcome. In addition to the structural elements shared with the other proposals, this option provides for bonuses and penalties associated with the outcome of the DCO and Heathrow's ability to meet intermediate milestones in the process of achieving planning consent.

98. The incentives defined in this proposal are calibrated:

- a. So that symmetry on risk and reward is maintained throughout, ensuring that a fair bet principle for Heathrow's investors; and
- b. With affordability and financeability in mind, therefore providing meaningful but moderate risk and reward incentives to Heathrow by means of financial exposure while not affecting short term affordability nor financeability. This is a very important

consideration since it is not Heathrow's objective to achieve windfall gains from this investment. This is clear based on our initial two proposals. Nevertheless, any incentive mechanism that provides for downside opportunity should provide for upside, unlike the CAA's proposals in CAP1871.

99. The proposal is linked to Heathrow's being sole promoter. Absent this being the case Heathrow may be unable to progress critical milestones in the Planning Inspectorate (PINS) process for reasons entirely outside its own control. The CAA will need to consider this aspect in setting its incentives framework.
100. We see four potential outcomes throughout the process for getting the DCO, each of which would warrant a different set of bonus or penalties treatment under this proposal:
- a. Heathrow achieves the DCO while spending pre-DCO Category C costs within the cap agreed in governance (and ratified by the CAA)
  - b. Heathrow achieves the DCO but exceeds pre-DCO Category C costs cap agreed in governance (and ratified by the CAA)
  - c. Heathrow does not achieve the DCO and is "at fault"
  - d. Heathrow does not achieve the DCO and is not "at fault"

We describe detail of each scenario including the bonus and penalties for each of them below:

Heathrow achieves the DCO while spending pre-DCO Category C costs within the cap agreed in governance (and ratified by the CAA)

101. Heathrow would obtain a 5% premium over the value of investment on pre-DCO Category C costs. We propose that the bonus is granted via revenue adjustment over a 5-year period.
102. Achieving the DCO means that the Secretary of State (SoS) signing of bill (i.e. not subject to JRs or other aspects of programme).

Heathrow achieves the DCO but exceeds the pre-DCO Category C costs cap agreed in governance (and ratified by the CAA)

103. Heathrow would recover the actual invested amount but would not be entitled to a premium nor it would be penalised.
104. Achieving the DCO means that the Secretary of State for Transport (SoS) has made the Heathrow Expansion DCO, and any subsequent challenge or appeal to that decision to make the DCO which upholds the decision is determined.

Heathrow does not achieve the DCO and is "at fault"

105. It is important to keep objectivity throughout the definition of all possible scenarios in order to aid transparency and strengthen incentives. In this scenario "at fault" means that Heathrow's DCO submission is rejected by PINS, any relevant appeal processes have been exhausted, and that Heathrow decides not to reapply. If this was the situation Heathrow would formally notify the CAA that it does not plan to proceed.
106. In this situation Heathrow would be subject to a 5% penalty. The penalty would be implemented via revenue requirement over a period of 5 years.

Heathrow does not achieve the DCO "not at fault"

107. This scenario is a situation where ultimately Heathrow does not succeed in the planning process but due to circumstances outside its control. In this scenario “not at fault” means Heathrow’s DCO application is accepted by PINS. This is an objective measure that demonstrates that Heathrow has done a quality job in developing its application.
108. There is a further scenario where a DCO application is not submitted to PINS. In this scenario the milestones proposed below would not be relevant. We would instead seek to work with the CAA to test whether Heathrow had progressed up to that point as expected toward a successful DCO and capacity programme. In that case, Heathrow should be reimbursed in full for efficiently incurred costs.
109. In this situation Heathrow would be subject to a 5% penalty. The penalty would be implemented via revenue requirement over a period of 5 years.
110. In addition, in the “not at fault” scenario we define intermediate milestones that, if met, demonstrate clear progress towards developing a successful DCO and capacity programme. These are outlined below:
- a. Grndon TCPA approved by Slough BC
  - b. Residential Property Bond Launch
  - c. Grndon start on site
  - d. Start of clearance for ecological works
  - e. PINS recommendation sent to SoS
111. Heathrow would notify the CAA that it has met any individual milestone. For each of these milestones that Heathrow meets throughout the DCO process<sup>25</sup>, Heathrow’s risk exposure would be reduced by 1%. Therefore, if Heathrow was to meet all of the milestones but not get SoS final DCO approval, Heathrow would be entitled to recover 100% of pre-DCO Category C costs incurred.
112. We firmly believe that this proposal provides strong incentives for delivering investment in the interest of consumers. This is explained further below:
- a. Quality of pre-DCO Category C costs to deliver new capacity
- It is in Heathrow’s commercial interest to deliver a successful DCO and incur pre-DCO Category C costs in order to expand the airport as soon as feasible. This is in addition to any additional regulatory incentives from the H7 regulatory design like Expansion risk premium.
- The bonus/penalty associated with the DCO outcome generates strong incentives to delivering a high-quality planning application. This is particularly clear where financial incentives are associated with PINs accepting Heathrow’s planning application or PINS making a recommendation to the SoS.
- b. Speed of delivery for both DCO and the runway programme
- A timely DCO application process would limit the programme’s exposure to changes in political views.

---

<sup>25</sup> We are not proposing that meeting the milestone is associated to a particular date

The introduction of a licence condition that provides for a clear path of investment towards a runway operation no later than a defined date set out in CAA policy provides strong incentives for timely delivery of Heathrow expansion.

In addition, risk and reward introduced by this proposal incentivises Heathrow to secure a DCO in a timely manner so that Heathrow’s expenditure is maintained within the cap.

c. Efficient pre-DCO Category C costs

We propose to retain IFS oversight, current airline governance and engagement. This is in addition to accepting the reporting proposals from the CAA and introducing expert ex-post efficiency review over this investment.

d. Controlled spend application (as against adherence to an arbitrary forecast)

The introduction of a recovery cap that can be adjusted given unforeseen circumstances also provides strong incentives to ensure strong cost control and efficient delivery of investment.

Equally, under this proposal we set strong financial incentives to delivering the DCO while staying within the recovery cap as defined by the CAA.

e. Simplicity in application – for arrangements that are only lasting for 2 years

The implementation of the proposal requires minimum but important changes to the licence that can be incorporated alongside the proposed licence modification set out by the CAA.

f. Predictability and objectivity

The strength of this option is that the incentives are associated with clear identifiable outcomes in the planning process, which aids predictability and objectivity. Equally, the proposal maintains core elements of regulatory design and builds on the original Category B costs policy.

113. We outline our proposals following, where possible, the structure set out by the CAA in CAP1871, Figure 2.2.

Policy element	Proposal
<b>Reporting and IPCR</b>	<p>We agree with the CAA’s reporting proposals, in particular frequency and content of the reporting.</p> <p>In limited circumstances where Heathrow’s audit requirement, like annual accounts publication, may not completely aligned with the propose reporting requirements timing, Heathrow proposes to find a sensible way forward in open discussions with the CAA and airlines.</p> <p>We agree with the CAA’s proposal of getting expert support in this area.</p>
<b>Investment scenario</b>	<p>We agree with the CAA’s proposal.</p> <p>Undertake a programme of early works aimed at commencing the provision of airport operation services using a third runway and</p>

	associated works at the airport to commence not later than a date defined in CAA policy.
<b>Governance</b>	Leverage the governance arrangements associated to capital investment delivery.  The CAA to arbitrate in case where there is a disagreement between Heathrow and airlines, following its primary duty and consistent with Investment Scenario (i.e. Scenario 2a)
<b>Risk sharing</b>	Subject to the risk sharing arrangements based on the success of Heathrow's submission and the outturn costs.
<b>Risk sharing in event of Heathrow's unilateral withdrawal</b>	Subject to the risk sharing arrangements based on the success of Heathrow's submission and the outturn costs.
<b>Recovery cap</b>	Recovery cap set by CAA.  Where Heathrow demonstrates that lifting the cap is efficient and in the interest of consumers, the cap will be adjusted. This would follow a well-defined process.
<b>Treatment of costs</b>	Investment recorded in the RAB as spent, transparently and separately identified in the regulatory accounts, consistent with current practice  Following the DCO outcome and CAA' efficiency reviews, any potential inefficient investment will be disallowed from the RAB.
<b>Start of return and cost recovery</b>	Return: Following the DCO outcome or a long-stop date of 2022. Heathrow will accrue a return and log it in the RAB from when the investment takes place to when recovery starts  Cost: Following DCO outcome or a long-stop date of 2022.
<b>Interest During Construction (IDC)</b>	Efficient investment will earn an IDC consistent with the cost of capital of the prevailing regulatory period (i.e. 5.35% throughout Q6 and the H7 cost of capital throughout H7)
<b>Depreciation (Length of cost recovery)</b>	Depreciation set by the CAA consistent with affordability and financeability considerations
<b>Licence modification</b>	Outlined in Chapter 3 and Annex A

## Chapter 3: Implementation

114. The CAA has sought views on the *'need for, content and timing'* of a potential licence condition, a draft of which is set out in the consultation paper. The condition includes:

- a. An obligation on Heathrow to carry out early expansion works in a manner "aimed at":
  - i. a runway opening date not later than 2029; and
  - ii. not incurring more than £1.6 billion in pre-DCO Category C costs;

- b. A specific provision that nothing in the condition shall require the Licensee to undertake expansion or carry out specific works; and
  - c. Provisions for the CAA to change the date and level of costs specified in the condition after a process of consultation with Heathrow, airlines and AOC where a material change of circumstances has occurred.
115. At a high level, it is welcome that the CAA has identified the importance of making changes to Heathrow's licence ahead of settling the H7 price control arrangements. The CAA has also recognised the need for regulatory certainty and we strongly agree this is critical.
116. However, we have explained in chapter 1 above that the CAA's proposals are legally unworkable. As explained in chapter 2, Heathrow also has significant policy concerns with the CAA's overall package of proposals. Chapter 2 therefore puts forward alternative policy proposals, which aim to deliver a balanced regulatory package.
117. In this chapter 3, we explain how the flaws in the CAA's approach outlined in chapter 1 above can be addressed and how the proposed condition can be amended in a manner which gives effect to Heathrow's policy proposals.

**The draft condition seeks to dictate Heathrow's approach to expansion, without codifying Heathrow's ability to recover its costs for those activities**

118. A fundamental concern is that the CAA's draft condition seeks to regulate Heathrow's pre-DCO Category C expenditure but does not give effect to the expectation that Heathrow will be entitled to recover that expenditure.<sup>26</sup> The current approach (whereby cost recovery is only a matter of CAA policy) may be tolerable for relatively low levels of expenditure, but is not an acceptable basis for spending nearly £2 billion in costs. As explained above, the CAA cannot rationally conclude that it is in the interests of consumers to dictate the maximum amount of early expansion costs, before it has reached a final decision about whether, how, or to what extent, those costs are recoverable from consumers.
119. Each of Heathrow's three proposals address this problem in different ways, by setting a legal entitlement to recover those costs. These cost recovery principles are clearly intended to extend beyond Q6 into H7. However, this is essential in order to provide the level of investment certainty needed, given the expected Category B and pre-DCO Category C expenditure will together total more than £2 billion.
120. Option 1 provides for pre-DCO Category C costs to be recorded as incurred, and then provides for such costs to be recoverable through the usual development and core capex framework, with pre-DCO Category C costs treated in the same way as core capex projects. The quantum of pre-DCO Category C costs, as a starting point, will be taken from CAP1658, which is referred to in the iH7 commercial agreement and therefore has broad agreement across industry. Heathrow would be entitled to seek any increases through the standard governance arrangements. This structure is tried and tested, and therefore combines a high degree of certainty for Heathrow with transparency and appropriate governance for airlines and the CAA.

---

<sup>26</sup> Beyond the £10 million per year in Category B costs which the licence currently entitles Heathrow to recover: see C1.12.

**Pre-DCO Category C Costs - Option 1**

Pre-DCO Category C Costs shall be recorded by the Licensee as they are incurred and reported to the CAA in a manner reasonably required by the CAA.

Conditions C1.9, C1.10 and C1.16 of the licence shall also be amended as follows:

C1.9 *Dt is the cumulative development capex adjustment, which adjusts the maximum revenue yield per passenger in Regulatory Period or Regulatory Year t to account for cumulative changes in the revenue requirement associated with development capex projects **and Early Category C Costs**. Dt shall be calculated in accordance with table C.3 below.*

...

C1.10 *The annual development capex adjustment in Regulatory Period or Regulatory Year t is an amount equal to the net difference between the development capex allowance included in the Q6 settlement and the total capex associated with new core capex projects **and Early Category C Costs** in Regulatory Period or Regulatory Year t, to be calculated as follows:*

$$dt = Ot - (Vt * Pt-1 222.80)$$

Where:

- *Ot is the total capex in Regulatory Period or Regulatory Year t associated with all development capex projects that have transitioned to core capex project status after the Q6 settlement either during or before Regulatory Period or Regulatory Year t, which includes the capital spend incurred during the development stages of projects, irrespective of whether projects have transitioned from development to core as determined through the governance arrangements, **and total capex in Regulatory Period or Regulatory Year t associated with Early Category C Costs incurred**.*
- *Vt is the development capex allowance in Regulatory Period or Regulatory Year t; and*
- *Pt-1 is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year t-1.*

C1.16 *In this Condition C.1:*

...

*(f) development capex allowance is a capex allowance included in the Q6 RAB based on the sum of development capex project P80 cost estimates as set out in the governance arrangements. **The development capex allowance in respect of Early Category C Costs shall be taken from the table D4 of the CAA's CAP1658 consultation document.***

121. Options 2 and 3 also provide for pre-DCO Category C costs to be recorded as incurred, and specifically provide that these costs will form part of the regulatory asset base and can be recovered from the time that the DCO result is known or from a long-stop date of 2022, whichever is sooner (referred to as the "Recovery Point"). This includes an adjustment (the "Expansion Recovery Amount") to compensate Heathrow for the costs not being recoverable from the point that they were incurred (unlike other costs in the RAB). It also includes provision for the CAA to disallow any pre-DCO Category C costs which it considers were inefficiently incurred after the DCO Determination Point.

**Pre-DCO Category C Costs - Options 2 and 3**

*Early Category C Costs shall:*

- i. be recorded by the Licensee as they are incurred and reported to the CAA in a manner reasonably required by the CAA through the Licensee's regulatory accounts; and*
- ii. form part of the regulatory asset base (including indexation from the time the costs were incurred to the Recovery Point, at the same rate as the rest of the regulatory asset base for that period) together with the Expansion Recovery Amount, but only from the Recovery Point (or, if the costs were incurred after the Recovery Point, from the time the expenditure was incurred).*

*The regulatory asset base shall be subject to future deductions to reflect any CAA determination made in writing, no later than [x] months after the DCO Determination Point, that any of the Early Category C Costs have been inefficiently incurred.*

122. Options 2 and 3 then differ in that:
- a. Option 2 provides for a long depreciation period if DCO is not obtained; and

- b. Option 3 provides for a series of incentives and penalties, which reflect whether DCO (and associated milestones) are reached on time and whether the pre-DCO category C spend is within budget.

The full drafting for these options is set out in the Annex to this submission.

123. All three of Heathrow’s options address the fundamental concern that regulation of Heathrow’s approach to pre-DCO Category C costs requires a final and legally operative decision to be made about whether, how, and to what extent, those costs are recoverable.

**The draft condition fails to provide for recovery of category B costs above £10 million per year**

124. The licence fails to deal with Category B costs at all. As noted above, it is not rational for the CAA to conclude that investors will incur the significant expenditure required to maximise the prospect of a successful and timely DCO decision, while there is no legal basis in the licence for recovering such expenditure. Providing a legal basis for recovering the full amount of efficient category B costs therefore clearly achieves the CAA’s objectives, minimising the prospect of planning approval not being obtained and pre-DCO Category C costs therefore becoming sunk.

125. Heathrow’s proposal is to include a specific licence condition which specifically deals with “Residual Category B Costs” (those costs above the £10 million per year currently allowed to be passed through in airport charges).

126. The condition is structured in the same way as Options 2 and 3 for pre-DCO Category C costs – it provides that the Residual Category B Costs will form part of the regulatory asset base and can be recovered from the time that the DCO result is known or from a long-stop date of 2022, whichever is sooner (referred to as the “Recovery Point”) . This includes an adjustment (the “Category B Recovery Amount”) to compensate Heathrow for the costs not being recoverable from the point that they were incurred (unlike other costs in the RAB). It also includes provision for the CAA to disallow any early Category B costs which it considers were inefficiently incurred at the DCO Determination Point.

**Residual Category B Costs**

*Residual Category B Costs shall:*

- i. be recorded by the Licensee as they are incurred and reported to the CAA in a manner reasonably required by the CAA through the Licensee’s regulatory accounts; and*
- ii. form part of the regulatory asset base (including indexation from the time the costs were incurred to the Recovery Point, at the same rate as the rest of the regulatory asset base) together with the Category B Recovery Amount, from the Recovery Point (or, if the costs were incurred after the Recovery Point, from the time the expenditure was incurred),*

*but the regulatory asset base shall be subject to future deductions to reflect any CAA determination made in writing, no later than [x] months after the DCO Determination Point, that any of the Residual Category B Costs have been inefficiently incurred.*

**The draft condition is not consistent with the CAA’s duties**

127. Finally, chapter 1 of this submission notes that the CAA’s draft condition does not reflect the breadth of the CAA’s statutory considerations, resulting in a licence condition which is inflexible, unreasonable and disproportionate.



128. Heathrow's options all address these issues in the same way – through (i) a more flexible set of targets (i.e. recovery cap or timeframe for delivery); and (ii) a defined governance and update process to the targets.

129. The proposed condition covering the targets is as similar as possible to the CAA's proposed approach while providing more flexibility for the CAA to revise the targets:

#### **Expansion Targets**

*Where the Licensee is proposing to undertake Expansion, the Licensee shall make reasonable commercial endeavours to undertake a programme of early works aimed at:*

- i. commencing the provision of airport operation services using a third runway and associated works at the Airport to commence not later than a date set by the CAA in line with national policy and schedule considerations (the Delivery Target); and*
- ii. incurring an amount of Early Category C Costs no higher than the amount set by the CAA in line with schedule considerations (the Early Category C Cost Target).*

*The Delivery Target shall not be earlier than 31 December 2029. The Early Category C Cost Target shall not be lower than [£1.7] billion.*

*Nothing in this condition shall require the Licensee either to undertake Expansion or carry out specific works in relation to Expansion.*

*The Licensee will not be in breach of Condition X.1 by incurring amounts higher or aiming at a timeframe later than the Targets, where the Licensee considers the Targets to be no longer achievable using reasonable commercial endeavours (for example, in light of any expenditure or commitments reasonably required to achieve Development Consent Success). However, the Licensee must make reasonable commercial endeavours to keep as close to the Targets as it considers prudent.*

130. Heathrow's proposal also corrects the lack of proportionality and reasonableness of the CAA's draft condition. It does so by ensuring that Heathrow will not be in breach of the licence merely because it has had to incur higher amounts or delay the timeframe. This gives Heathrow additional flexibility to be responsive to the needs of the development process – including (for example) flexibility to make additional commitments to mitigate any environmental impacts of expansion. The CAA is obliged to have regard to such considerations under the Act<sup>27</sup> and therefore Heathrow's proposal is more proportionate and reasonable than the CAA's draft.

131. Heathrow also proposes a new licence condition which provides a clear and defined set of options to seek amendments to the targets:

#### **Governance and updates to the Expansion Targets**

*The Licensee must provide updated forecasts of its performance against the Targets at least once every six months together with any other information about the Licensee's planning for Expansion which the CAA reasonably requests.*

*The Targets will be revised, and promptly republished by the CAA, in any of the following circumstances:*

- i. the revision has the agreement of the Licensee and the Airline Community;*
- ii. the following requirements are met:*
  - I. the Licensee requests the revision in a written request to the CAA;*
  - II. the request contains a detailed explanation of how the proposed revision better fulfils the Consumer Interest, and is accompanied by a recommendation by the Independent Fund Surveyor that the revision is reasonable in light of the circumstances of Expansion; and*
  - III. the CAA has not, within 1 month of receipt the written request, determined by notice to the Licensee that the revision is contrary to the Consumer Interest. The CAA may only make such determination if it considers that the revision does not reasonably reflect the circumstances of Expansion; or*

<sup>27</sup> See CA Act s 1(3)(d) for example.

*iii. the CAA determines, after Consultation, to make a revision to the Targets. However, such a revision may not bring forward the Delivery Target or reduce the Early Category C Cost Target except with the consent of the Licensee.*

132. This proposal is necessary to ensure the licence condition is proportionate, given the real possibility that costs, and time estimates may need to change in future, due to the size and complexity of the expansion project. In particular the set of change mechanism options:
- a. will allow Heathrow more fluidity so it can be responsive to the needs of other stakeholders in the consultation and planning process – knowing that there is a defined process for seeking changes, and that these can be sought promptly, if any commitments made during the planning process require changes to targets; and
  - b. is essential so that Heathrow and its investors can have a high degree of certainty that Heathrow will not be forced into a situation of regulatory non-compliance, or an inability to deliver obvious value to consumers, merely because the existing licence conditions are unduly rigid.
133. Heathrow's proposals therefore provide flexibility while also providing a clear benchmark for costs. This is essential given how fundamental the targets are to the level of risk inherent in the project, and so that the proposed condition can better reflect the breadth of statutory considerations that need to be taken into account under the CA Act.

## Conclusion

134. Accordingly, Heathrow considers that the options it has put forward can be implemented in a way that solves the legal problems identified in the CAA's draft condition. Specifically:
- a. Heathrow's proposals provide a legal right to recover efficiently incurred Category B and pre-DCO Category C costs. This is essential so that regulation of Heathrow's approach to expansion is legally robust. It also avoids arbitrarily constraining Heathrow's Category B costs, so that Heathrow can maximise the prospect of successful and timely development consent.
  - b. Heathrow's proposals introduce additional flexibility into the licence conditions, so that Heathrow is not at risk of being subject to regulatory obligations that are not possible to meet, and so that the condition reflects the possible need to change the targets in future. This better ensures the full range of statutory considerations in the CA Act can be taken into account.