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British Airways Response to CAP1951: Capital Efficiency Incentives

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out our views on the issues raised by you as requested as well as providing further comments on both this consultation and implications for the wider policy environment.

Executive Summary

The key messages from British Airways in this response are as follows:

- We are supportive of CAA efforts to enhance capital efficiency incentives over Heathrow, and recognising the limitation of existing ex-post incentives, are cautiously welcoming proposals to introduce ex-ante incentives, especially where greater clarity of scope and benefits realisation can be achieved for any capital expenditure at Heathrow.

- The existing governance framework, gateway process, and the development to core capital process has been advantageous in creating a flexible framework in Q6, and we would like to see that framework strengthened with the introduction of ex-ante incentives.

- We are aware of the natural inclination of regulated companies to game the incentive regime and caution the CAA as to some of the potential pitfalls of their proposals. We additionally highlight areas that will need to be considered in depth to ensure that the incentives remain effective as intended upon implementation.

Capital expenditure and capital efficiency: general comments

1. British Airways welcomes the CAA's approach set out in its CAP1951 working paper on capital expenditure efficiency incentives, particularly in the intent to build on the more effective elements of the Q6 framework.

2. We advocate stronger, more consistent and targeted incentives, to encourage greater focus on creating robust business cases at the planning and scoping stages, effective contract management, placing additional weight on project outcomes, and creating

strong incentives to deliver to agreed scopes. All projects should be supported by robust business cases that specify benefits both to consumers and the cost base of the airport.

3. In particular, we welcome the aim to strengthen and improve the existing capex governance process, and ensure projects are subject to appropriate stakeholder scrutiny, whilst holding HAL to the agreed costs, outcomes and deadlines.

4. In our view, whilst the core and development framework and the principles of the governance gateway process have provided significant improvement in oversight over the capital expenditure process, in comparison to that prior to Q6, it could be improved in areas as identified by the CAA.

5. It is our experience that some aspects of the present gateway process are either not fully adhered to (e.g. combined for "speed") or are not as effective as they appear on paper e.g. proper evaluation of options as a G2 including "do nothing". We therefore advocate strengthening those elements to ensure they are adhered to as the rule and not by exception.

6. To build on this base for future capital efficiency in H7, and in order to give appropriate visibility and oversight of capital projects at Heathrow, any changes implemented need to build on effective elements, avoid unnecessary complexity, and ensure incentives are better aligned, whilst fixing areas of the governance process that are ineffective in practice. Incentives should also be clear and specific as envisaged in this consultation.

7. We reiterate the view held by our parent, IAG, in response to CAP1876 that "given the high level of information asymmetry, a strict governance protocol should be put in place around any incentive arrangements that does not just incentivise delivering on budget, but also on time and to the scope required to achieve the benefits agreed"[1].

8. There are many areas of improvement within the governance process that could enhance airline oversight and engagement on capital projects and ensure positive airline and consumer outcomes. For example, more detailed forecasts of costs, and tracking of expenditure to date so that remedial action or alternative decisions can be made in advance of overspend.

9. Furthermore, existing incentives have resulted in some budget and time over-runs alongside scope reductions, for example within projects considered in the CAA ex-post review of capital efficiency in CAP1964. In such circumstances, there should also be mechanisms to reassess projects, and potentially stop the project if it no longer makes sense to continue, preventing more significant cost over-runs, delays or failure to achieve an outcome that might occur if the project continues to completion.

10. In addition, we again reiterate the IAG response to CAP1876 in relation to expansion costs, that "the behaviour of HAL in its mismanagement and subsequent inflation of

[1] IAG response to CAP1876, p3

Category B and early Category C costs demonstrate that the current mechanisms in place to promote efficient capital expenditure are not fit for purpose and are not taken seriously by HAL"[2].

11. British Airways is keen to ensure ongoing and transparent oversight of projects as it is consumers who ultimately pay for inefficient capital expenditure through charges or experience the effect of outcomes not delivered. The CAA must ensure that projects are managed and reported upon <u>on an ongoing basis</u> to specific and agreed costs, timelines and outcomes, which will enhance oversight of capital efficiency and project expenditure. We also need full transparency from Heathrow of project progression, including those that do not progress to Gateway 3.

12. Existing broader incentives result in Heathrow being led to proposing projects that are typically capital-intensive in nature and designed to use capital expenditure rather than operating expenditure to solve issues, in order to enhance the potential size of the Regulated Asset Base ("RAB").

13. This is a classic example of the Averch-Johnson effect, or "gold-plating" as it is colloquially known[3]. Projects under the "Safe to Fly" category are a prime current example, where opex solutions exist but have not been presented, in favour of capital-intensive solutions utilising assets that may quickly become technologically redundant.

14. This is not in the best interests of airlines and consumers but is an entirely rational response by Heathrow to maximise the earning potential of the RAB at the prevailing rate of return, as compared to the disincentive of exceeding operating cost allowances and reducing in-year profit margins during a control period.

15. All projects should therefore be transparently assessed for total costs and benefits for airlines and consumers to establish:
    a. What is the business need? Is there an agreement that there is a need that needs to be addressed by a project?
    b. The ultimate and specific outcomes that the project is designed to achieve, and tangible consumer benefits that will result
    c. Total estimated costs across capital and operating expenditure for all options, both before and after
    d. Cost efficiencies achieved by undertaking the project
    e. Assessment of serious alternative options, both with lower capital-intensity and under alternative asset ownership structures
    f. Regular ongoing reassessments (for larger projects) as to whether the project is still viable and meets the objectives

16. Consideration of total expenditure under alternate options must be transparently established to ensure the best solution for consumers is pursued, and that the

[2] IAG response to CAP1876, p5

[3] Averch, Harvey; Johnson, Leland L. (1962). "Behavior of the Firm Under Regulatory Constraint". American Economic Review. 52 (5): 1052–1069

incentives to increase the RAB are minimised by ensuring only appropriate costs are capitalised.

17. Capital efficiency incentives fundamentally need to be aligned to appropriately incentivise Heathrow to deliver real outcomes and best value for consumers and airlines, being blind to whether those solutions have a capital or operating expenditure outcome. Outcomes-based regulation will provide a useful framework within which these discussions can be formulated.

18. It is clear from CAP1964 and PwC's report to the CAA on Cat B costs that ex-post assessment of inefficiency is fraught with difficulty, with opacity of how decisions were reached when assessing documentation years after decisions were made. This difficulty in reaching clear conclusions introduces regulatory risk to Heathrow, raising the cost of capital by creating uncertainty for all parties.

19. The result is essentially full cost pass-through to airlines and consumers of all capital expenditure, little different than cost-plus regulation in other jurisdictions, that is not generally in line with the intent of the price-cap framework prevalent in the UK.

20. The proposal to add all costs of Heathrow's failed expansion to the RAB is only the most egregious example of this misalignment of incentives. With no economic benefits or tangible outcomes from expansion delivered for consumers, it is inconsistent that these costs should remain on the RAB and earn a return and be deemed broadly efficient. In addition, Heathrow has also written-off several projects in 2020 without consultation yet plans to earn a return from those on the RAB.

21. We need better clarity over rules to add early-stage evaluation costs to the RAB, especially where that expenditure, which per accounting standards could not be capitalised in statutory accounts, is added to the RAB through the Gateway process even when this has not resulted in a viable business case.

22. Ex-post assessments of capital efficiency in other regulated sectors typically incorporate a used-and-useful test, or some form of assessment of open market asset value to the asset. In the case of Expansion in particular, this clearly would fall short of these tests on every count, and our view remains that these costs were not subject to any airline governance and oversight and cannot therefore be judged as efficient.[4]

23. British Airways will provide further feedback on the difficulty of ex-post assessment of capital expenditure in our response to CAP1964, however it seems unlikely that any ex-ante incentive scheme would entirely eliminate the need for ex-post assessment, which would still be required on a limited basis in certain circumstances on larger and more complex projects.

24. As a result of the issues raised in CAP1964, it is therefore appropriate to assess an ex-ante regime that sets clearer incentives on Heathrow, however it should be cautioned that ex-ante regimes also have many potential pitfalls and opportunities for

[4] BA response to CAP1940, p11-12

regulatory gaming that must be seriously considered by the CAA when implementing those incentives for H7.

25. Ex-ante solutions in general provide an attractive solution to the incentive problem if they can be appropriately calibrated, however it is unlikely they will be fully effective without changes to other aspects of Heathrow's operations in practice. For example, incumbent terminal Delivery Integrators within each terminal remove competitive incentives and could result in overstatement of capital expenditure regardless of the proposed ex-ante incentive in place.

26. Furthermore, any proposals for ex-ante incentives must take account of the actual experience of airlines in considering capital projects at Heathrow; we invite the CAA to walk through our experience of those projects, alongside documentation provided by Heathrow to us throughout. This will highlight where processes diverge from those set out in the capital handbook and provide the strongest possible foundation for any proposals for H7.

27. We agree that ex-ante incentives should, in theory, provide affordability and financeability benefits as the uncertainty of ex-post assessments are reduced, and investors gain greater certainty over disallowances. The greatest protection to consumers will involve a mixture of both incentives, reducing the implicit regulatory risk applied to the cost of capital.

Criteria for implementation

28. As set out above, we agree with the CAA that the existing Q6 incentive framework does not provide sufficiently strong incentives on Heathrow. However, it is our view however that capital efficiency is <u>always</u> critical, not just in the present economic circumstances as a result of Covid-19. This is since capitalised expenditure results in charges to airlines and consumers for the entire duration those costs remain on the RAB, over many years and throughout economic cycles.

29. Furthermore, incentives should be strengthened across all three aspects of typical project assessments: time, cost and outcomes delivery. As a result of this, Heathrow will face predictable and transparent incentives to produce high-quality project plans that ensure outcomes are delivered on time (or earlier), to budget (or better), and to a pre-set outcome that is of the required scope and quality (or better) to fulfil the stated goals, which must be defined and measurable.

30. We therefore agree with the CAA on the areas of the framework that could be improved, to provide:
    a. clear and strong incentives to encourage efficient capex and delivery of benefits to consumers;
    b. predictable and transparent incentives;
    c. consistent incentives;
    d. incentives to deliver benefits on time; and
    e. effective governance throughout the project / programme lifecycle

31. The CAA should also consider practical implementation of ex-ante incentives given ex-post projects already started within iH7 and the underlying Q6 will not be subject to the same incentive mechanism. This could be up to 75% of H7 programmes depending upon circumstances in 2020-2021.

32. Flexibility will remain important for all parties due to uncertainty surrounding the exact recovery profile of the industry following Covid-19, and we endorse the CAA's aim in this area. Additionally, we agree with the CAA that airlines should play a central role within the capital governance framework, as we remain best-placed to assess the programmes implemented by Heathrow.

33. We agree that ex-ante incentives should aim to retain key aspects of the existing framework, so long as they are effective in practice. However as previously noted, it is our experience that some aspects of the present gateway process are either not adhered to or are not as effective as they appear on paper. We therefore advocate strengthening those elements to ensure they are adhered to as the rule and not by exception (e.g. lack of Gateway 8 assessments and the practice of combining Gateways, except where necessary in exceptional circumstances in agreement with airlines).

34. We should note that existing timing incentives are not one-sided as characterised at present. They do in fact compensate for projects not delivered, where benefits are not realised despite capital having already been spent. Capital should only be spent to deliver clear benefits, and triggers merely realign charges to reflect this fact.

35. Heathrow have previously provided analysis of how an indicative over-spend might already create an ex-ante incentive rate across the price control of c.13% (any only on the value of average over-spend), assuming consistent over-spend each year to the same value across the price control.

36. However, this analysis is only stylised, and could be misleading. It does not demonstrate a true incentive, since capital over-spend is still incorporated into the RAB at the end of the price control period, with minimal risk it will be struck out and Heathrow unable to earn a return in future. In addition, Heathrow's example would operate symmetrically with an under-spend, which should also be reflected.

37. Regardless, the example demonstrates that the existing framework does not provide clarity, and the CAA's aims to ensure this is the case in future are valid. However, actual symmetry of incentives should be carefully considered in implementation to avoid accentuating gold-plating incentives.

38. Since Heathrow is already rewarded on "efficient" capital expenditure incurred when it is added the RAB, it seems counter-intuitive to further reward Heathrow for capital not spent. This is particularly the case if projects are moved between categories or costs were systematically over-stated at the outset. Incentives must be designed to avoid this possibility.

39. In order to accurately assess baselines and budgets, airlines and the CAA are likely to need additional independent support, similar to that provided by the Independent Fund Surveyor ("IFS") at present, though in an enhanced role. The CAA should consider whether the IFS remit needs to cover evaluation of "value for money" and "appropriateness of the proposed solution" as well as whether the project is being properly managed. Whilst we need to ensure efficient and appropriate expenditure, airline resources and knowledge of airport construction costs are limited. We urge the CAA to ensure proposals do not create excess and unmanageable complexity.

40. We would like the CAA to explore two further changes to that we feel would lead to greater control and transparency over costs:
    a. Upon project approval, its associated risk/contingency allocation is moved to a centrally managed pot (at category level), which Heathrow can only draw upon using a similar mechanism to Change Control Requests, recognising that a risk has materialised and become an issue. This extra layer of scrutiny over spending will ensure ongoing learnings as risk materialises and ensure spend transparency, giving earlier insight into cost over-runs.
    b. That Leadership & Logistic charges are no longer fixed as a percentage of a project. Heathrow have demonstrated that they do not manage such costs on a project basis, and instead operate it as a separate cost centre. It would seem more appropriate to manage it as such, ensuring greater oversight of this spend, with an approval of actuals and a forecast reset every six months.

Balance of incentives

41. It is appropriate that Heathrow faces predictable and transparent incentives, which ensure projects are delivered on time (or earlier), to budget (or better), and to a pre-set outcome that is of the required quality (or better) to fulfil the stated goals.

42. We agree that the addition of cost efficiency and quality requirements should apply to all capex categories, filling a gap that exists at present, and which presently can result in cost over-runs and scope reduction on struggling projects. A strong incentive to match benefit outcomes with objectives stated at the outset will improve ongoing quality of capital expenditure.

43. In considering quality requirements, the proposed measures must ensure that Heathrow is not incentivised to gold-plate project specifications in a way that results in over-inflation of cost baselines. The Averch-Johnson effect remains a real possibility without appropriate controls on baseline definition.

44. We note that Heathrow makes extensive use of consultant studies and reports that are capitalised within the cost of projects, yet information within those reports is often not fully shared with airlines and has had little seeming effect on minimising cost over-runs or scope reduction. These reports charged to projects should be shared with airlines, and the objectives and scope of such reports agreed in advance to ensure they are efficiently commissioned.

45. In the development of incentives over quality requirements, the CAA should consider how Heathrow uses those external advisors, to ensure appropriate scope and focus within categories and relevant projects, with full disclosure of reports to ensure transparency over developing capital plans.

46. In assessing outcomes and outputs of projects, it is critical that Heathrow is incentivised to develop projects that have clear ambitions and delivery objectives from inception (G0/G1), firm and measurable objectives set by G3, and produce positive cost/benefit outputs that are clear to airlines operating at Heathrow. Airlines have the direct relationship with consumers and bear the brunt of negative consumer feedback howsoever caused.

47. Projects cannot be determined to be in the consumer's interests by Heathrow self-defining broad spending categories but must instead be determined through rigorous and concrete analysis of requirements based upon actual airline operating experience.

48. This will include many requirements that will not be directly visible to consumers, but indirectly manifest themselves in the consumer experience, and might include areas such as safety, operating efficiency, resilience, regulatory requirements, capacity upgrades, and enhancing value of existing assets.

49. The timing of project delivery remains critical in delivering outcomes to airlines and consumers. The CAA states that cost incentives will align with timing incentives as delay is normally associated with overspend, however this appears to confuse correlation with causation. <u>Cost and timing are distinct elements of any project and must be incentivised appropriately within the framework</u> to prevent unintended consequences.

50. It appears sensible to apply any cost incentive across categories to ensure it is simple to understand and administer, removing gaming incentives on categories, though that is reliant on category definitions being robust enough to prevent re-categorisation to avoid triggering an incentive.

51. We agree that categories in a two-runway environment should be well-understood and highly controllable by Heathrow, being the expert on its own existing infrastructure base, allowing a strong and targeted incentive to apply on cost.

52. Benefits realisation is key to delivering consumer outcomes at Heathrow and ensuring quality and value for money. This will require more extensive input up-front in project definition but will remove risk from projects as they become better-designed.

Defining cost categories

53. Defined cost categories should help to establish the estimated size of the capital programme for H7 and beyond, assist in prioritisation, and allow flexible development of specific projects within those categories.

54. In defining manageable cost categories, "maintain" and "improve/create capacity" appear to be a sensible broad split, if then followed by categories based upon common deliverables surrounding key common objectives e.g. operational resilience. Within the context of outcome-based regulation, that appears a better approach than splitting by delivery year, particularly if retaining flexibility within the framework is more important to all parties.

55. We support the requirement to define cost categories, particularly those that are at the forefront of an agreed strategic plan, material in cost or deliver significant consumer benefit. However, we must warn against forcing projects into a category where there is no benefit in doing so (i.e. low cost, strategic importance, delivers minimum noticeable consumer benefit). Experience suggests that this will cause unnecessary distraction and distort measurable inputs and outputs.

56. We must note that airline and consumer priorities for H7 will be based upon recovery from the economic effects of Covid-19, and there is little appetite to plan for any capital programmes beyond the minimum level of asset maintenance. Airline industry balance sheets are expected to remain extremely weak for several years, and any capital expenditure beyond core maintenance will quickly become unaffordable for airlines and consumers. Robust governance is required around project prioritisation in the recovery from Covid-19.

57. "Tramlines" may provide some flexibility within the plan, but we need to better understand the mechanics of this alongside a developed maintenance capital plan to be able to judge the effect of this approach.

58. Following our observations of opacity of Heathrow's cost categorisation in expansion between Cat B and Cat C, we urge the CAA to ensure the rules around definition and recategorization are clear to prevent gaming and avoiding an appropriate incentive from taking effect if triggered.

59. However, flexibility will clearly be key to H7: with airline agreement and on an exceptional basis, there should be appropriate mechanisms in place to allow some flexibility, building on the existing framework of Q6.

Cost efficiency incentives

60. The CAA's broad approach to setting capital efficiency incentive rates appears sensible, particularly in its objective to retain simplicity and operate in a consistent way to meet financeability objectives, and particularly to reduce gaming incentives.

61. In design, we agree with the CAA that under a two-runway airfield whose requirements should be well-understood by Heathrow, that a stronger incentive rate should apply to a more controllable and lower-risk capital programme.

62. Furthermore, the application of a single incentive rate across all categories reinforces the simplicity in application of such an approach where they face the same of broadly similar risk profile.

63. The difficulty in setting such an incentive is that symmetrical application may excessively reward Heathrow for under-achievement of baselines if those baselines themselves are not adequately controlled. As per our response to CAP1940, "We are concerned that symmetrical financial incentives simply place more cost on consumers and airlines in funding additional bonuses to HAL for delivery of investment, whose risk they have already been fully remunerated for through airport charges."[5]

64. Due to information asymmetry, Heathrow are likely to hold far more knowledge than both airlines and the CAA, and the potential to game this should be recognised by design within the incentive. As a result, an asymmetry may be more appropriate to avoid over-remunerating Heathrow when under-achieving cost baselines.

65. We recognise the CAA position to conduct calibration on such incentives will ensure Heathrow are appropriately remunerated in combination with the WACC, and we advocate the greater modelling of over- and under-achievement cases to fully understand the effect on returns, charges and financeability.

66. The CAA raise a valid question over the comparison to totex approaches operating in other sectors, since the consideration of all expenses – whether operating or capital – may become more appropriate within an outcomes-based regulatory framework.

67. Whilst we recognise that this is an evolutionary process to re-design capital incentives, the CAA should consider the incentive inherent in not considering all categories of expense together. The CAA should fully consider how incentives offer an appropriate balance between capital-intensive and operating expense-based solutions to ensure the best value-for-money outcomes for airlines and consumers in all circumstances.

Setting delivery obligations

68. We agree with the CAA assessment that benefits realisation has not always been clear under the existing incentive framework, and it is rare that we see such assessments as part of a Gateway 8, since the existing framework is not fully adhered to. This must be addressed as part of any changes implemented for H7.

69. We therefore welcome the proposal to introduce Delivery Obligations and quality requirements, along with adjusting cost baselines for any failure to deliver outputs and benefits. However, management of this process within capex categories needs further clarification and refinement to understand practical implementation.

70. Whilst number and granularity of quality requirements will depend on the capex category in question, we agree that such requirements must be tailored to each category, since these might be very different in nature.

71. More prescriptive output requirements are clearly best suited to established and repeatable capex categories (along with which, we note that cost efficiency of

[5] BA response to CAP1940, p8

delivery should improve with each iteration of any repeatable project, and a baseline budget efficiency requirement be placed on any such project).

72. A flexible approach to more complex or unique projects, incorporating financial and non-financial delivery obligations, appears sensible as an initial approach, however specific output requirements would surely become more applicable as project design maturity evolves. It may be better to reduce large projects into manageable chunks to ensure appropriate obligations are introduced at an appropriate level of granularity.

73. Non-delivery on any aspect of a complex project has a greater proportionate impact on airlines and consumers due to its size, so whilst flexibility of approach is acceptable, outcomes still need to be developed to hold Heathrow to account. Careful scoping of delivery obligations and quality requirements will be critical to prevent gaming on larger projects, and where information asymmetries continue.

74. Setting specific delivery obligations with three core elements (delivery, timing and quality) are welcome, particularly over all core capex plans and those that move from development to core.

75. However, we expect delivery obligations to become increasingly complex on technical projects, requiring specialist expertise to ensure the appropriate obligation is placed on Heathrow. Management of this would suggest specialist surveyor expertise may be required to ensure they are appropriately tailored to real-world outputs of specific construction projects.

76. Furthermore, dispute resolution is likely to be required on an ongoing basis where perspectives on requirements and actual deliverables differ between airlines and Heathrow. The CAA note their expected role as arbiter in this arena, however it should be aware of the sheer number of capital projects in progress and likely level of involvement before committing to this regime.

77. We must emphasise that any delivery obligations set for capital categories must be reflected in all impacted areas of the licence and regulatory settlement, whether in Service Quality Measures, Operating Costs and Commercial Revenues. Capital expenditure must be fully integrated across Heathrow's business plan to ensure consistent and clear incentives are set. For example, a capital plan the promises to deliver a particular Outcome with service quality and opex benefits must do so, revising baselines and measurement of those metrics in its implementation.

Timing incentives

78. Timing of project delivery is often critical to airline operations, allowing planning to take place and resources to be allocated to infrastructure availability and design. Proposals not to incentivise timing, whilst understandable in avoiding complexity, may have unintended consequences.

79. We believe that trigger payments will be necessary even with ex-ante incentives being introduced. Trigger payments are not punitive charges on HAL to deliver projects on

time but are reimbursements to airlines for over-paying on an incorrect capital spend profile. They are to reinstall a neutral position.

80. We would not disagree with the IFS comment that trigger payments should be symmetrical. However, a financial benefit to Heathrow should only be applied where a clear benefit can be agreed to have been achieved by early delivery, without compromising the integrity of the operation.

81. We would agree that a trigger should be aligned to the delivery of an outcome or benefit rather than for just completing a project that does not complete its delivery obligations. This is a change we would welcome in H7.

82. However, there are projects that will not have a clear and measurable benefit and we must maintain the current mechanism on those if they fit the agreed criteria for a triggered project.

83. It is our view that Heathrow should have management control and influence over all project integrators and contractors at the airfield, and that any failure by those contractors to deliver or perform remains within the control of Heathrow regardless of who is actually performing the task. Heathrow's ability to undertake contract management is core to the success of any project.

Setting cost baselines and dealing with uncertainty

84. We agree that a capex envelope needs to be set in order to calculate a baseline profiled cost per passenger. However, only a core capex baseline needs to be set as it is only capital projects that pass G3 that earn a return on the RAB.

85. We support developing a baseline for development capital as this is necessary to forecast a transition into core capital. However, in line with the existing treatment of core capex, this should be incorporated within the calculation for the H7 price control at the outset, but adjust the core capital envelope when it moves from development to core capital.

86. Given uncertainty over the Covid-19 recovery, British Airways would support a Capital Programme of minimum maintenance required to allow Heathrow Airport to operate to the standards achieved in 2019.

87. The airlines and HAL have jointly developed an agile capital framework that allows capital spend to both increase and decrease from the initial capital envelope set at the beginning of the regulatory settlement period. We propose using this to manage appropriate reward/reimbursement to HAL if capital expenditure is required above the regulatory forecast as confidence and volume returns to our industry.

88. We support HAL developing capital plans at differing levels to sit alongside the minimum capital plan for H7. We would encourage the CAA to use this to develop

their categories and delivery objectives and ambitions to be included in the final H7 settlement.

Reconciliation of efficiency incentives

89. Our preference is for an annual review of incentives. This will ensure that the right colleagues and stakeholders, with the required knowledge and accountability will be able to feed into the process. Waiting until the end of a regulatory cycle (5-8 years) risks a less than optimal review where the consumers will suffer.

90. We would support annual reviews of incentives, and therefore an annual reconciliation where any adverse or favourable findings are reflected in pricing in the subsequent years, and that any adjustments required should be NPV-neutral.

We welcome working with the CAA on the implementation of new incentives over the coming months as proposals become more fully formed and can be better assessed against Heathrow's revised business plan due in November 2020.

Our view may therefore develop considering changing circumstances, and this paper reflects our opinions as at the close of H7 Constructive Engagement.

Yours sincerely,

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