

# Guidance for Heathrow Airport Limited in preparing its business plan for the H7 price control

Heathrow's response  
CAA-H7-059

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## 1. Executive summary

1. Economic regulation that is predictable, simple and that generates commercial incentives to produce the results sought for passengers by the CAA will be the key to a successful H7. Regulation must balance the needs of all involved at the airport. Affordability and financeability are both instrumental to practical delivery. We are responding to the CAA consultation *Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control (CAP1540)* in this context.
2. Heathrow has two main views on the guidance as proposed:
  - a. Firstly, the timetable for business planning needs to be resolved immediately. Expansion has added complexity to the timetable because of the need to align political, policy, legal, planning, regulatory and physical development processes. Heathrow has some sympathy for the need for pragmatism on all sides to make this work logically and efficiently so that we deliver for passengers as fast as possible at the lowest possible cost.

However, neither the airport, airlines, passengers nor potential investors are served by a vague and constantly shifting process. There must be clarity and certainty. Heathrow has repeatedly sought for the CAA to define and adhere to a timetable. For example, we spent considerable effort defining a co-ordinated high level timetable with the Government in the Statement of Principles in 2016. The CAA was an observer to that process yet has not progressed the timings and steps laid out in it. Similarly, we noted earlier in 2017 to the CAA that there were emerging issues with a December 2017 business plan given the uncertainty regarding the National Policy Statement (NPS) designation and the lack of substantive feedback on the regulatory framework for H7 and beyond. It would have been helpful to have this resolved earlier.

In defining a sensible timetable given recent developments we believe that:

- i. H7 is inextricably linked to the options for expansion at Heathrow. We need a regulatory process that fully integrates expansion planning and decision making. Since as the CAA rightly states, expansion is not a 'business as usual' investment option this means we need a period to define the regulatory framework for airport and airlines before detailed business planning, which should be published after the NPS is designated.
- ii. Heathrow agrees that a December 2017 business plan would be sub-optimal. However, we remain prepared to produce a business plan at any point based on the best information available.
- iii. Given the need for momentum and certainty we are attracted to the idea of a compressed timetable that would still allow H7 to begin in 2019. However, this timetable is still problematic on a number of fronts – not least not allowing sufficient time to consult on the regulatory framework nor for reviewing initial and final proposals.
- iv. A further extension to the Q6 period is a last resort. For investors, and indeed airlines and passengers another extension year would mean yet another departure from the Q6 price setting exercise. 2020 will carry particular risks, it

is the year of Brexit and Crossrail coming to the airport, and this should be recognised by the CAA.

- b. Secondly, timely and reasonable decision making is what our passengers, our community, the airlines and Heathrow need from the CAA. Heathrow urges the CAA to provide substantive feedback in its June consultation and lay out a comprehensive timeline of events where policy decisions will be taken. We consider that the June document should provide meaningful policy steer regarding the need to ensure that the runway is delivered and that it is delivered as soon as practicably possible. It should also provide meaningful feedback regarding the treatment of early Category C costs, and the concepts of affordability and financeability.

## 2. Aligning regulatory and business planning timetables

3. The H7 regulatory process needs clarity, certainty and simplicity. H7 offers a huge opportunity for consumers to deliver the first new capacity in London airports for a generation. That also makes the overall timetable more complex and dependent on design work, policy and planning processes and other variables. The CAA has an important role to ensure that the regulatory process fits logically within this timetable. It is also important that the CAA provides everyone with clarity as early as possible. The current timetable does not work in the broader context. This would ideally have been resolved earlier. We strongly urge the CAA to avoid further uncertainty by making a clear decision now in June 2017.
4. This decision should provide:
  - a. A timetable that ensures that Heathrow's business plans are as well informed by the NPS, planning and airline design engagement process as possible and allow for some further variation in processes not within the CAA's, Heathrow's or airlines' control.
  - b. The space for the CAA to provide substantive feedback on the regulatory framework before Heathrow publishes its Initial Business Plan (IBP) – we have been calling for this since at least the Statement of Principles signed with Government and it is unacceptable for a major regulatory update to be proposed between the IBP and the Final Business Plan (FBP).
  - c. Time for a high quality business plan to be produced, the Consumer Challenge Board (CCB) and Constructive Engagement (CE) to operate well and shape H7 plans
  - d. Clarity for everyone as to the terms and conditions of any extension period – this cannot simply be left until later, especially in a highly volatile period around 2019/2020.
  - e. Simplicity so that everyone is able to focus on the crucial decisions for H7 which will shape Heathrow for decades to come - rather than complex arrangements for Q6

We urge the CAA to ensure a decision on the timetable by June 30<sup>th</sup> that is robust, complete and clear in this way.

5. In our response to the CAA's paper *Economic regulation of the new runway at Heathrow Airport: consultation on CAA priorities and timetable* (CAP 1510), we already noted important shortcomings with the timetable, these were:

- a. *The Initial Business Plan (IBP) would be published before Government and Parliament have confirmed the National Policy Statement (NPS). Based on feedback from other schemes developed under an NPS we understand that there is real potential for significant changes.*
  - b. *The inconsistency between the IBP publication and the feedback gathered by Consultation 1. This would not allow Heathrow to build the IBP based on our Preferred Option for Expansion influenced by stakeholders' feedback. Equally it would not enable an efficient CE process between Heathrow and the airline community.*
  - c. *Airline concerns regarding their ability to engage effectively in the various governance fora throughout 2017.*
  - d. *The IBP is meant to be a high quality plan. We support that aim and it would be efficient for the constructive engagement that would follow publication. But at the time the business plan is created Heathrow would not know the scheme that will be presented to the planning inspectorate. The plan has by definition important implications to every single building block of Heathrow's business plan. We are concerned we will be unable to provide the detail and precision required for effective constructive engagement.*
  - e. *Heathrow currently plans to launch Consultation 2 in summer 2018. The Final Business Plan (FBP) under the current regulatory timetable is September 2018. This again represents a timetable inconsistency since it would not allow Heathrow to incorporate Consultation 2 feedback into our FBP nor potentially for the CAA to consider in its Initial Proposals.*
  - f. *The CAA is also due to give a further regulatory update in the middle of 2018 just a couple of months before Heathrow publishes its FBP. We stated that this causes great concern to us. This update appears to have disappeared from the CAA's timetable (CAP1540 page 34, table 3). We did not and do not agree that a further update to the regulation of Expansion should be given 2 to 3 months in advance of Heathrow's FBP. We do consider that a further update is required. We therefore request the CAA to clarify when this update will be provided.*
  - g. *There are inherently higher risks for locking in specific regulatory variables too early in the process. Absence a detailed plan of what needs to be regulated, we consider that being too prescriptive regarding regulation will not support delivery or clarity of decision making for all parties.*
  - h. *Furthermore, an April 2018 submission would allow more time to fully develop an outcomes based regime, working with the airlines and the CCB.*
6. A further complication to the planning process was created by the recent announcement of a General Election. This could add some more changes to the timing of the NPS which would need to be taken into account in the regulatory timetable.
  7. Heathrow therefore agrees that a December 2017 business plan would be sub-optimal. However, we remain prepared to produce a business plan at any point based on the best information available and as definitive set of options as possible.

8. We welcome the flexibility shown by the CAA in finding ways to compress the regulatory timetable to permit a March 2018 business plan. We support this pragmatic flexibility. We would encourage it in future thinking too. Reluctantly however, in this case we think it will still be sub-optimal in that:
  - a. There may still be a gap between the NPS process, and thus Heathrow's Consultation 1 and selecting among basic expansion options and producing the IBP. This could mean a less useful IBP for all concerned
  - b. It leaves limited time for the CAA to define and consult on the regulatory framework which needs to be done well before the IBP
  - c. It compresses the opportunities for reviewing the CAA's initial and final proposals. We welcome this move toward simplicity. However, as H7 is likely to be one of the bigger and more complex settlements of recent times this feels inappropriate in this case.
9. Therefore, against this background, a 12 month or potentially even an 18 month extension appears to be the last viable option. It would allow the CAA to give effect to its policy intentions for H7 and better align with the Expansion timetable since:
  - a. It allows time for the statutory process to develop, with Consultation 1 and NPS designation taking place before Heathrow submits its IBP. The IBP would, at the very least, incorporate any NPS conditions and feedback received from Consultation 1 and potentially feedback from Consultation 2. This would also enhance the FBP.
  - b. Realigning the timetable reduces the time elapsed between the regulatory decision making process and the start of major construction. This reduces the risk of cost uncertainty and thus forecast errors for all parties and consumers.
  - c. It will allow the CCB to become fully embedded which would enable it to better influence the implementation of the Outcome Based Regulation (OBR) framework.
  - d. Realignment also introduces some contingency time in case delays were to take place in the statutory process.
10. Another extension year would mean yet another year of drift from the Q6 price review. 2020 will carry particularly large risks. It is the first full year of Brexit, meaning Heathrow will be particularly exposed to traffic, commercial and legal risk. Crossrail will be fully operational in 2020 which will likely have a significant but hard to predict impact on Heathrow Express. This higher than usual uncertainty reinforces the need for a clear decision now on the terms of any extension. It also cautions against attempts for partial re-opening of the settlement elements.
11. One issue sometimes raised is that current passenger numbers are higher than those assumed by the CAA in its Q6 decision. The level of variation is far below that seen in Q5 when passenger numbers were lower than the forecast and an extension was implemented. For consumers this is also in a context of an airport charge falling in real terms by 1.5% each year and record levels of satisfaction with the airport - Heathrow has achieved the highest satisfaction of any hub airport in Europe on ASQ and has been judged by Skytrax to be the best large airport in Western Europe in recent years.
12. Furthermore, variation on passenger forecasts is against a background of volatile passenger volumes. Even the IT failure over the last weekend provides a reality check as to this volatility.

As an illustration the impact of major unforeseen events on Heathrow's passenger volumes from the recent past is set out below:

- a. Foot and mouth, 2001 – 1.9m passengers
- b. SARS, 2003 – 1.8m passengers
- c. Security heightening, 2006/7 – 2.2m passengers
- d. Volcanic ash, 2010 – 1.2m passengers

This is before accounting for volatility driven by the economic cycle. The UK economy is buoyant now, but all market forecasts predict a more difficult period in the next 3-4 years. It is quite plausible that traffic volumes will be lower than the implied forecast in 2020.

13. Variation on any particular element of the forecast is not therefore a rationale for complex or vague extension decisions. If these variations are of such concern, then the CAA should instead focus its efforts to deliver a full settlement review now – while still ensuring that substantive feedback is provided on the H7 regulatory framework before an IBP and that sufficient allowance is made of the resulting variations in the H7 forecasts because of the relative immaturity of the expansion process.
14. A reasonable and proportionate solution is needed immediately, by no later than 30<sup>th</sup> June. The approach must be simple and provide certainty to Heathrow, investors and airlines.
15. The CAA discusses the option of an approach in which the price per passenger for 2020 would be calibrated throughout the second half of 2019, yet making the extension decision in 2017. This is simply not acceptable to Heathrow. It does not provide any regulatory or business certainty. It will be impossible for Heathrow and the airlines to plan their activities ahead with an acceptable degree of confidence. It will distort the focus and dynamics of CE. Equally it will significantly disrupt the Expansion process, with Heathrow and the airline community having to allocate substantial resources to the price setting exercise.
16. Any solution must set clear price and service conditions for the extension period. Heathrow will not agree to an extension without a clear definition of the price and conditions by which it would be implemented. It is not acceptable to decouple the extension decision from how it is going to be implemented.
17. We have also reviewed most recent regulatory precedent regarding how extensions to price control conditions have been implemented:
  - a. The CAA has recently extended 3 different price control periods. Q5 was extended for Gatwick and Heathrow and Q6 for Heathrow, all of which included price and conditions at the time in which the extension was decided.
  - b. Ofgem decided to extend gas and electricity transmission price control 2007-2012 (TPCR4) by one year (to 2013). The decision was taken to enable the full design of the current Revenue Incentives Innovation Outputs (RIIO) framework. Ofgem

effectively implemented 4 price control extensions<sup>1</sup> for 2013 defining the price and conditions in 2010.

- c. Northern Ireland (NI) Utility Regulator, has extended the price control conditions of Power NI from 31<sup>st</sup> March 2017 to 31<sup>st</sup> March 2019. In its consultation document it provided clear guidance as to how the extension would be implemented, price and conditions included.

18. Discussing the option of extending a price control without outlining under which conditions it would be implemented is clearly inconsistent with best regulatory practice. The analogy of a CMA appeal period following a price review is incorrect.

### 3. Guidance and incentives for high-quality business plans

19. We generally welcome the CAA's guidance for developing a high quality business plan. We agree with the CAA that a high quality business plan will enable better conversations throughout CE which are more likely to be in consumers' interests and efficient for all parties. We believe that Heathrow has a strong inherent incentive to produce high quality plans.

20. Heathrow believes that the proposed business plan criteria are a sensible selection. These criteria will be most effective supporting a high quality business plan if the regulatory timetable is adjusted to reflect the overall context in which Heathrow is operating (please refer to the previous section for a fuller discussion on the timetable). The CAA would be missing a great opportunity to give effect to its policy regarding high quality business planning if it were not to change the timetable.

21. The business plan criteria defined by the CAA is open ended and subject to interpretation. We think this a sensible approach provided that the CAA and the CCB are proportionate when they assess the quality of our plan. Heathrow strongly recommends a degree of pragmatism in assessing Heathrow's plan. It is important that the assessment avoids a '*tick box exercise*'. A sensible, proportionate approach will review the plan in context and consider the overall outcome. In H7 a key outcome will be timely delivery of affordable and financeable capacity.

22. We also note the CAA does not have the opportunity to compare Heathrow's business plan with other airport business plans. Therefore, it cannot use comparison to test the relative quality of different plans, as Ofwat or Ofgem have done in their regulatory decisions. This difference is important both in terms of a general assessment of quality and in the way any financial incentive might work.

23. We strongly disagree with the role given to the airline community by the CAA's statement that "*It is important to underline that we would be unlikely to consider a plan high quality if the airlines, CCB and other stakeholders do not broadly support the plan*". This potentially fosters the wrong behaviours, incentivising airlines to not support Heathrow's plan irrespective of the quality. History shows that constructive engagement and the regulatory process already creates some dynamic toward antagonistic positions at certain points. The incentive would be all the greater if the CAA was to offer financial incentives for a high quality business plan. We believe that the CAA and the CCB are the right parties to assess the quality of Heathrow's plan. That is in line with the CAA's primary duty. It matches the CCB remit since assessing Heathrow's plan is part of its scope of work. We request that the CAA confirms that airlines, as an interested party, are not best place to formally assess the quality of Heathrow's plan.

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<sup>1</sup> National Grid Electricity Transmission Limited (NGET), National Grid Gas Limited (NGG NTS), SP Transmission Limited (SPTL); Scottish Hydro-Electric Transmission Limited (SHETL).

24. Heathrow has received inconsistent messages from the CAA regarding who should sign the Final Business Plan – the Heathrow Executive management or the non-executive Board. Simply for the purposes of certainty we therefore seek formal clarification. In any case, Heathrow's Board and Executive Committee are fully engaged in the business planning process. Our Board or Executive Committee will be able to certify that the FBP is based on efficient costs and financing, that it is affordable and financeable and that consumer views and preferences are reflected to the fullest extent practicable.
25. It is in Heathrow's commercial best interest to develop a high quality business plan. The business plan is the document that explains our vision, our strategic objectives and the plans to accomplish them. It is also one of the key submissions to the regulatory process to define the service and price conditions for H7. A business plan that is based on insufficiently considered proposals, or that it does not accurately reflect our passenger or airline needs, or that assumes unrealistic operational forecasts, will only set Heathrow up to fail.
26. In their previous price control decisions, Ofwat and Ofgem have granted financial incentives to delivering high quality business plans to their regulatees. We note and welcome that the CAA is open to exploring how features of other regulatory frameworks can be best implemented in our industry.
27. Our understanding is that it is unclear from other sectors that the financial incentives for high quality plans have generated the outcomes desired such as sparking competition amongst regulatees in the best interest of consumers. This can be the case due to the practicalities of its implementation or simply because regulated companies are already developing high quality business plans without the need to provide further financial incentives.
28. It is also not clear that consumers benefit from paying for additional incentives for a high quality business plan if it is possible to deliver such a plan without financial incentives. The CAA needs to carefully consider the relative impact against the strong incentives that already exist in the regulatory process for Heathrow to produce a good plan and work hard to outperform.
29. Heathrow at this stage is open to exploring the idea of introducing financial incentives for high quality business plans. This is nevertheless subject to the following observations:
  - a. The financial reward should be simple and explicit enough to provide a meaningful incentive. To that end we consider that the best approach is to set an ex-ante fixed financial sum allowance.
  - b. Good quality engagement, before and through CE should be considered as another feature of a high quality business plan. Engagement, from any stakeholder, that is not constructively in the best interest of passengers, will need to be singled out and not rewarded or indeed penalised.
  - c. The assessment of the plan must be objective and consistent based on the criteria set out by the CAA. It must be done by the CAA and CCB. This is indispensable to the credibility of this as a potential new regulatory feature, especially as the CAA is not able to simply compare business plans like in other sectors.

30. We agree CE should be focused on Heathrow's IBP. CE should build on existing governance groups. In advance of the formal CE process we have commenced engagement with the airlines and the CCB to inform the content of our IBP.

31. Heathrow will respond to the CAA's consultancy studies once these are published.

#### **4. Outcome-based regulation (OBR) and resilience**

32. We are pleased that the CAA recognises Heathrow's wider role in delivering great service to passengers. The end-to-end view of service has helped transform passenger service at Heathrow. In Q1 2017 we achieved an ASQ of 4.16, the highest ever score for Q1. 83% of passengers rate their overall airport experience as 'excellent' or 'very good'. We also recognise and welcome the CAA's consistent policy messages regarding OBR.

33. It is therefore right that the CAA's seeks an outcomes based regulatory scheme that encompass the whole passenger experience. We agree that the services we provide to airlines should remain a key part of any future outcomes incentive scheme. We also think there are other services provided directly to passengers by Heathrow, or by other stakeholders, that are as important to passengers and are not covered by the current scheme.

34. We believe a more comprehensive view of the passenger journey in the OBR scheme could support collaboration between parties at the airport to deliver excellent service. This leads to a focus on outcomes irrespective of the party that provides the service to passengers. The financial or other incentive around measurement can vary depending who delivers the service.

35. Recent CAA research on Network Resilience shows where collaboration by industry experts has worked well. It also evidences where regulatory intervention has not been needed.

36. The research revealed that stakeholders view Heathrow's management of runway demand and capacity as world class. The research also revealed that consumers are generally not willing to trade fewer flights for resilience. The CAA itself has provided positive reports to the Transport Select Committee and Heathrow on Heathrow's operational resilience plans.

37. Further evidence of where collaboration has worked well without the need for regulatory intervention comes from initiatives such as APOC, A-CDM, winter resilience, Time Based Separation (a world first), enhanced ILS (a UK first), the baggage resilience review and airspace and airfield redesign. We can see the value for resilience for passengers in the reduction by over half over the last 4 years in the number of days where Heathrow Command and Control functions have been stood-up to cope with disruption. It can also be seeing the gradual improvement in departure punctuality, currently around 80%, despite increasing pressure on capacity. That means more people travelling without disruption to their journeys.

38. It is clear from the evidence that neither the industry nor passengers have an appetite for reducing flights to increase resilience. A reduction in capacity would lead to a reduction in choice, increased prices to passengers and reduce commercial opportunity for airlines. Arbitrary capacity reductions are unnecessary for resilience. They would be complex to implement. The industry, passengers and the CAA would be far better served focusing on creating new capacity on the ground and in the air as quickly and efficiently as possible.

39. The silver bullet to address operational resilience is airspace change. This has been said many times by Heathrow, airlines and others. The CAA and Department for Transport have a

major role in driving this change. We urge the CAA and the DfT to progress work in the airspace design to enable an improved level of resilience at all UK airports.

40. In summary, operational resilience is a critical factor to delivering a great service to passengers. Incentives should build upon the success already achieved. They should foster collaboration between all parties, take into account industry feedback and be underpinned by robust consumer evidence on what passengers are willing to pay for. We will explore how resilience could be more closely aligned to an outcome based approach to regulation. We do believe that unilateral regulatory interventions developed without the engagement of industry experts will not deliver the outcomes that consumers want.
41. We also want to highlight to the CAA that there is a clear link between resilience and costs. Heathrow will illustrate this important relationship as part of our business plan submissions. There is a good case for investment to eliminate excessive or unnecessary disruption.
42. Finally, we note that the CAA puts the onus on Heathrow regarding the initial development of OBR and engaging with airlines. We recognise the reluctance of the airline community bodies to move away from the current Service Quality Rebate Bonus (SQRB) scheme. However, we are concerned about an apparent inertia regarding OBR engagement and tendency to focus only on tweaking existing elements directly within Heathrow's control. The CAA can only regulate Heathrow. But we can only deliver great service to passengers if all parties collaborate. Outcomes based regulation also offers an opportunity to look at higher level measures afresh in a less complex framework than the 15-year-old SQRB. We would urge the CAA to encourage senior operational and commercial airline engagement on the OBR and support Heathrow's approach of an end-to-end view of passenger service.

## **5. Consumer engagement**

43. Heathrow considers the guidance on consumer engagement helpful. We are pleased to see that our plans on engaging consumers are consistent with the CAA's expectations.
44. We acknowledge the guidance given to the CCB. In particular, it is helpful to clarify when the CCB's reports are to be published and the areas that are explicitly outside of the CCB's remit.
45. Heathrow agrees that detailed scrutiny of Heathrow's efficiency is outside the CCB's remit. There is nevertheless a clear connection between Heathrow's future expenditure (operational or capital) and the delivery of outcomes and resilience. Cost trade-offs affect both the choice and level of outcomes to be delivered. It is important for Heathrow that the CAA and the CCB are clear on this fundamental interaction from the outset. Any decision regarding the efficient level of future spend should be consistent with the service aspiration defined in the OBR.