

# Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable (CAP1819) Heathrow's response

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## 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 £2billion per year to consumers calculated using a number of different methods. An opportunity such as that demands commitment and timely action from all those involved in aviation.
2. We cannot underestimate the complexities of delivering expansion. Heathrow has previously been challenged by the Secretary of State (SoS) to bring in a new runway by 2026, with consent achieved by 2021, while maintaining airport charges close to 2016 levels in real terms. All of that is to be fully privately funded. The wider impacts and mitigations are to be funded privately too. As with any major infrastructure project, this requires extensive planning, iteration and engagement. It also requires decisive action and a mindset of simplifying rather than further complicating, if the programme is to be successfully delivered.
3. Heathrow is thus working to deliver one of the most complex planning applications and construction programmes in the UK. We are doing this while operating the busiest hub airport in Europe with record numbers of passengers who are reporting high levels of satisfaction. Heathrow is working towards meeting the SoS challenges in terms of delivering a timely, affordable and financeable expansion. But we cannot do this alone. Gaps in the basic elements of the regulatory framework for expansion help no one, particularly consumers.
4. We therefore support the CAA's consultation as some progress toward a definitive view on the most immediate pieces of the regulatory framework - pre-DCO Category C costs and Category B costs. The CAA has also at least set out a timetable to provide clarity. Pre-DCO Category C costs are on the critical path for a timely expansion programme. They are also important so that our community is fairly treated given the impacts an expanding Heathrow would have on them. Airport and airlines do not need a detailed decision on schedule and or a once-and-for-all sign off of all investment from the CAA. We just need clarity on the framework to proceed. It is vital that basic policy clarity is established by October at the very latest.
5. Heathrow supports the CAA's recognition that we should be able to recover efficiently incurred pre-DCO Category C costs. We also support the view that these costs should not be subject to additional risk sharing arrangements. This is the only practical way of financing them and reflects the actual financial risk and reward. Heathrow strongly believes that building on the established development and core capex regulatory mechanism is the best approach for all stakeholders for regulating these costs. Development and core provides the flexibility to react to a changing environment or unforeseen circumstances. It allows for robust stakeholder scrutiny and ensures that Heathrow is remunerated only for actual investment not a forecast. It thus is a good way to reduce the risks of stranded costs and to adapt the programme in light of information available at various points in the next few years. Heathrow considers a relatively

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

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

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

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simple licence modification would be a positive next step to providing regulatory certainty and legitimacy on cost recovery and the programme going forward.

6. On Category B costs, the CAA's proposals are not consistent with established regulatory practice at Heathrow in the way it proposes setting a recovery cap and disallowing recovery of potentially efficiently invested costs above the cap. It restricts Heathrow's ability to react to changes in the planning application process, most particularly those driven by third parties. It harms the chances of achieving planning consent, an outcome that all stakeholders agree is in the interest of consumers. The CAA's proposals are fundamentally inconsistent with the long-established regulatory principle of a "fair bet" determination<sup>3</sup>. The CAA has created a negative NPV outcome for Heathrow and its investors by asymmetrically removing the risk/reward arrangements for costs above £265m. This is not acceptable to Heathrow.
7. The CAA consults on the appropriate WACC for pre-DCO Category C and Category B spend for 2020 and 2021. Heathrow strongly objects to the option of calculating an interim WACC. that is wholly inconsistent with established regulatory practice and the basis of the iH7 deal. Firstly, it is in effect setting different WACCs for different investment categories eroding much required regulatory certainty and predictability. Secondly, the range proposed by the CAA is based on PwC analysis, an analysis that the CAA itself has described as initial work and just another input into the final H7 WACC determination. Heathrow has also expressed very material issues over the lack of analytical robustness and economic integrity<sup>4</sup> of this work. The CAA has largely failed to substantively address any of our points. A determination made on the basis of a single, weakly defended and highly unorthodox consultant's analysis would lack any process legitimacy. Setting a WACC within the PwC range would also set a base for an H7 WACC that is unfinanceable. At a minimum, should the CAA want to update the WACC, it should include the expansion premium associated with pre-DCO Category C expenditure. However, it has not developed its thinking sufficiently to do so. Thirdly, this approach of multiple WACCs is hugely complex yet has very limited practical consumer impact, positive or negative. The CAA has far better ways to set incentives for the outcomes needed. The only defensible and practical solution is to use the Q6 WACC for 2 years and then implement an appropriate H7 WACC.
8. More generally, Heathrow is concerned with the CAA's approach in developing its proposals in this consultation. The CAA is required to comply with its statutory duties, including its primary duty to further the interests of users. Putting the interests of consumers first does not necessarily mean achieving expansion as cheaply as possible, maximising scrutiny on Heathrow or focusing all efforts on identifying inefficiency. Not does it simply mean testing for compromise between airport and airlines. Rather the CAA should ensure expansion is delivered in a way which maximises consumer benefits while ensuring Heathrow is able to finance its activities, incentivises economy and efficiency, and ensures transparency, consistency and proportionality. This calls for stability in the regulatory framework, taking clear and timely decisions based on objective evidence and creating simple incentives.

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<sup>3</sup> Competition and Markets Authority, SONI Limited v Northern Ireland Authority for Utility Regulation (Final Determination, 10 November 2017) para 7.237. The CMA in that case said that 'remuneration of each distinct area of SONI's portfolio of responsibilities should be structured in such a way that each element of the package represented a 'fair bet' for SONI' and that a fair bet meant SONI was entitled to an uplift on its costs as a 'risk premium' and to ensure a balanced risk and reward profile for SONI's investors (see para 12.109).

<sup>4</sup> The CAA has not publicly addressed our comments before publishing PwC's range in this consultation

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9. The CAA already has the powers and the tools available within the current regulatory framework to address any potential Heathrow inefficiencies. For example, the CAA can and does disallow investment from being added to Heathrow's RAB. Endless tinkering with Heathrow's regulatory framework is unnecessary. Material changes to core elements of the regulatory framework, such as reassessing Heathrow's WACC midway through a price control for some elements of the RAB, can have a trivial impact on the airport charge, let alone the air fares consumers ultimately pay. But they have a highly detrimental impact on investor confidence, putting consumers at long-term risk of lower airport investment.
10. The CAA should focus on providing regulatory certainty - confirming fundamental elements of the regulatory framework for Heathrow expansion and relying on simple incentives for efficiency. In that context we welcome the clarity the CAA is proposing on the regulatory timetable and its openness to considering greater longevity for elements of the price control for H7. We encourage the CAA to provide regulatory certainty over the development and early operation of expansion to support financeability and affordability.
11. 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 as soon as possible. We also note the separate submission already provided to the CAA on the schedule and cost options<sup>5</sup> and subsequent additional information and updates. Any discussion of pre-DCO investment is intrinsically linked to schedule and therefore this information also forms part of our response.

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<sup>5</sup> CAA-H7-283 - Timetable for Capacity Expansion at Heathrow Airport and Pre-DCO Category C Spend

## Policy Proposals for Category B costs

12. Heathrow supports the CAA's decision to maintain its original policy for Category B costs under £265m. Consistency and stability of policy making is important to deliver the programme. This is notwithstanding our longstanding concerns regarding the asymmetric nature of the risk sharing arrangements, and more significantly the discretionary powers the CAA provides to itself to judge appropriate cost recovery in case Heathrow withdraws from the planning process. As we have discussed in previous responses this is inconsistent with setting an outcomes-based policy (DCO approval or otherwise). Additionally, given the subjectivity of the outlined intervention, it exposes Heathrow to significant financing risk.
13. Before considering the regulatory treatment of Category B costs above £265m, it is important that the CAA has an in-depth understanding of what is required to submit a planning application for expanding Heathrow. Amongst other things, it is important that the CAA is familiar with the different strands of work required to achieve a DCO, the risks associated with preparing this type of application and the calibre and number of professionals needed. We think it is important that the CAA spends some effort to understand this, independently if need be, to make an informed policy determination. Such an understanding of the requirements and dynamics of planning costs should be the basis for regulatory treatment, and any differentiation in regulatory treatment, rather than an arbitrary financial amount.
14. Heathrow has submitted its own independent benchmarking and assessment report prepared by Steer to the CAA that confirms that:
  - a. Heathrow is preparing one of, if not the most, complex planning application programmes undertaken in the UK
  - b. Heathrow is leading a programme that maximises the probability of achieving a positive planning outcome
  - c. Heathrow's projected Category B investment sits well within relevant benchmarks for this stage of the programme
15. Treating Category B investment differently depending on whether it is above or below £265m is not warranted. Given what we now know from the Steer report and the detailed understanding that Heathrow now has on planning costs, it is clear that £265m is not a meaningful figure to set incentives. Perhaps with the benefit of hindsight, both Heathrow and the CAA should have undertaken an independent review of how robust was the £265m initial forecast in order to inform the policy decision.
16. Heathrow therefore strongly advocates the CAA either runs an independent benchmarking or inform its decisions on Category B costs above £265m using the findings of Steer report.
17. Having said that, Heathrow agrees with the CAA that it practically needs to review its policy for Category B costs above £265m since it clearly signalled that it would do so in its original Category B cost decision document. While we do not wish to create further uncertainty with changes to policy below £265m, to be clear, neither do we advocate simple application of the risk sharing and other incentives to a higher figure. That might fail to address apparent concerns over Heathrow incentives and also will create counterproductive complexity and investment risk given the other market, regulatory and delivery risks we face.

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**Strengthening governance arrangements****Recovery cap.**

18. Setting a recovery cap is a significant departure from the CAA's policy on the recovery of investment. Heathrow is not prepared to accept this departure. There is no recovery cap when it comes to business as usual investment nor regarding Category B costs up to £265m. The CAA's approach up to now has focused on providing the right framework to deliver a successful investment programme and planning process by allowing the recovery of efficiently delivered investment. This is different to a policy of delivering investment or a planning application for a particular cost. It is a fundamental change that will without doubt affect the likelihood of achieving a positive outcome from the planning process.
19. The CAA should consider how the introduction of a recovery cap and the rules associated to the recovery of costs above this cap further the interests of consumers. Heathrow considers that a recovery cap does not support a successful DCO outcome and hence it is fundamentally not in the interest of consumers, since:
- a. Planning application processes are by definition complex and fluid processes subject to changes triggered by third parties. The forecast costs are always associated to a given schedule of activities. These activities are legally a function (amongst other things) of the feedback received by consultees or the Planning Inspectorate (PINS). The schedule and activities can change. Therefore, defining a hard threshold of cost recovery affects Heathrow's ability to react to unforeseen events, which in turn affects Heathrow's ability to achieve a successful DCO.
  - b. Setting a hard threshold of costs recovery defines an asymmetric incentive. Heathrow would be penalised if costs are above the threshold but does not benefit from costs being below the threshold. This exposes Heathrow to further financial risk without compensation. It does not mimic the incentives of an unregulated firm.
  - c. It is not clear how the CAA would set a meaningful cap that provides Heathrow a fair chance to meet it. As discussed above, setting a premature threshold for reviewing Category B costs policy has already proven detrimental and burdensome. Absent detailed review and consideration, and third-party expertise being provided to the CAA, there is a significant risk that the threshold is set at the wrong level. Equally, as discussed above, it is likely that the underlying assumptions used to calibrate a threshold become obsolete due to changes in the programme. The CAA would have to adjust the cap every time there is a change in the programme introducing further rigidity and uncertainty in the process, potentially slowing delivery.
  - d. The CAA argues that Heathrow should seek airline agreement to recover costs above the cap. Requiring airline agreement to recover above the cap implicitly assumes that the airlines are a proxy for consumers and that the airlines have an understanding on how a planning application programme should be run. Both of which are not true. This again appears not to be in the interest of consumers.
  - e. Allowing cost recovery at the relevant cost of debt, simply penalises (and discourages) investors, not enabling full recovery for costs that may well be efficiently incurred.
20. In its original policy on Category B costs, the CAA recognised that it should not pre-judge the future circumstances in which Heathrow's projected Category B costs might exceed £265m. This was the right approach and the same approach should also be taken when defining a

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policy decision for costs above £265m rather than defining an arbitrary cap for recovery. Heathrow thus considers that a better approach is to set a reporting cap rather than a recovery cap. This would in effect:

- a. Require Heathrow to report against the cap on a systematic basis, providing clarity and transparency to stakeholders, supporting stakeholders' understanding of the overall Category B investment.
- b. Enable Heathrow, the CAA and the airline community to have meaningful discussions around potential changes to the programme and how it affects ultimate costs. This should allow us to identify opportunities to reduce costs and also reflect legitimate shifts in activity should they occur.
- c. Enable Heathrow, the CAA and the airline community to interrogate and review most significant activities of work.
- d. Coupled with existing efficiency reviews and governance processes it would provide a clear incentive for Heathrow to deliver an efficient planning application. These processes have been shown to have traction and drive our behaviour toward efficiency in investment already made to date.

### Reporting requirements

21. Heathrow considers that reporting requirements are important and recognises the value of airlines' input and third-party reviews. It is worth highlighting that we are already subject to IPCR reviews, IFS reviews and on-going engagement with the airlines on Category B activity.
22. Adding more reporting requirements is not necessarily going to support the delivery of an efficient DCO programme. Nevertheless, we recognise that most of the reporting requirements to date are mainly backward-looking reviews. It is a sensible requirement for a programme of Heathrow's size to provide more regular forward-looking stakeholder updates.
23. There is a balance to be struck between the value of more forward-looking information and the time and costs of extra reporting and governance requirements for Heathrow, airlines and the CAA. We think a quarterly cycle of reporting would in effect mean that Heathrow, the CAA and airlines would be in a continuous cycle of reviews. We base this on the experience of existing governance arrangements and the pressure this puts on resources. We fear this would inhibit effective and meaningful stand back reviews of Category B expenditure. Heathrow therefore proposes biannual reviews based on the requirements outlined by the CAA. As an additional benefit, this would also be consistent with Heathrow's proposed reporting frequency of pre-DCO Category C, allowing Heathrow and the airline community to review the early years of the programme holistically.

### Cost scrutiny

24. It is not clear to Heathrow what the CAA proposes to do over and above the cost scrutiny proposals. As discussed above, Heathrow considers that a positive step forward in this area is for the CAA to develop independent benchmarking work to understand the relative magnitude of Heathrow's proposed costs and other planning application processes.

### **Recovery mechanism: WACC and Cost of Debt**

#### WACC.

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25. The arguments hereafter apply to both Category B and pre-DCO Category C costs, given the CAA discusses using the same WACC indexation for both so as not to distort incentives.
26. Heathrow is very concerned by the CAA's discussion in this area. We find concepts of differential WACC's counterproductive, lacking in due process and regulatory principle and excessively complex. At this stage, the only approach in the genuine interest of consumers is to apply the existing WACC and then make an appropriate decision on the H7 WACC in due course. Our reasons for concern are:
- a. Changing the cost of capital for any new expenditure (Category B or pre-DCO Category C) poses risks for the stability of the regulatory framework and increases perceptions of instability. The proposal to use a different WACC from that used in Q6 before a new decision is made for H7 is contrary to the Better Regulation Principle of consistency. Regulators should not undermine previous decisions by arbitrarily introducing changes in their approach at inappropriate times. Not only would this be bad regulatory practice for this decision, it would also signal to debt and equity investors that the CAA will change its policy critical parameters part way through a regulatory period. It fundamentally undermines their views of the predictability of the regulatory regime and increases an already rising perception of regulatory risk. The CAA appears to recognise this in its document, stating that retaining the 5.35% WACC would 'promote regulatory stability'<sup>6</sup>. It cannot underestimate this effect.
  - b. The CAA's proposal to adopt a new estimate for WACC for a sub-category of expenditure also falls short of due process in a number of ways:
    - i. The PwC report is being used by the CAA for a purpose for which it was never intended. PwC's initial November 2017 report<sup>7</sup> is described by the CAA itself as offering no more than 'initial estimates'<sup>8</sup>. Similarly, when the CAA published the PwC February 2019 report, it acknowledged that 'we will need to consider further evidence that emerges before taking a final view of Heathrow's cost of capital'<sup>9</sup> and in particular pointed to a need to consider future consultation responses and wider information such as information on market trends. It also continued to describe the report as 'only one of a number of inputs to the consideration of Heathrow's cost of capital for the next price control period'<sup>10</sup>.
    - ii. From the above, it is clear that the CAA commissioned the PwC report only as an input. The CAA represented that stakeholders would have future opportunities to comment on the cost of capital, and that the CAA would undertake further internal work and commission further consultancy. By its own representations, the cost of capital was not intended to be finalised until 2021.
    - iii. It is also the case that Heathrow has provided a detailed critique of the February 2019 PwC report and the WACC range it puts forward. There is no evidence that the CAA or PwC have taken any regard of Heathrow's representations in this regard, simply dismissing them without evidence.

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<sup>6</sup> CAP1819, page 25, paragraph 1.26

<sup>7</sup> 2 PwC, Estimating the cost of capital for H7, November 2017

<sup>8</sup> Cap1762, page 4, paragraph 1.3.

<sup>9</sup> Ibid, page 6, paragraph 2.4.

<sup>10</sup> Ibid, page 5, paragraph 1.7.

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- iv. It is therefore wrong for the CAA to take a single input to a future price control, and 'transplant' the result on to a different category, and to apply it from a much earlier point than originally intended. This is suboptimal practice since the CAA is ignoring the need for additional inputs. It raises questions about the CAA's commitment to due process and the extent to which its previous statements to the industry can be relied upon.
  - v. To date, the CAA has only presented views of WACC by PwC and has not yet set out its own views. Moreover, it has not responded to the substantial material Heathrow has provided to the CAA in response to the PwC papers. Nor has it sought input from other or more credible experts for a highly controversial approach. There is lack of maturity in the CAA position on WACC and a lack of time to undertake a proper process on this issue ahead of decisions on Category B and pre-DCO Category C expenditure. The CAA is being premature in proposing the possibility of using an alternative WACC.
- c. If the CAA was to use a different WACC to the Q6 WACC, then investors would see the proposed WACC as being a precedent for H7. Levels in line with the PwC reports published by the CAA would inevitably result in an appeal and likely lead to significant delay to the expansion of Heathrow or no expansion at all.
- d. Heathrow strongly contends that the CAA should not reassess the WACC until it makes its decisions for the H7 period. This is in the spirit of maintaining consistency. If, nevertheless, the CAA still considers that a reassessment is required, Heathrow has the following points to make<sup>11</sup>;
- i. If a different WACC was to be used for Category B or pre-DCO Category C expenditure, then our view is that such a WACC must be higher than the Q6 WACC. Although the cost of debt has fallen slightly since Q6, this is more than offset by the cost of equity used in Q6 being too low. Moreover, there is a need to take into account a premium for the additional risk of expansion that will materialise ahead of the DCO given the high levels of proposed Category B costs and pre-DCO Category C expenditure.
  - ii. We have provided significant evidence that the cost of equity should be higher than the 6.7% allowed in Q6. International comparisons show that the typical cost of equity for airports is around 9% on a real CPI stripped basis, equivalent to 8.0% real on an RPI stripped basis.
  - iii. In addition, nominal returns of around 10% (around 7% on an RPI stripped basis) for the cost of equity are available on lower risk energy assets in North America. We have provided evidence from NERA that suggests the cost of equity for Heathrow is well above 8% on an RPI basis.

Cost of debt

27. Heathrow contends that a recovery cap should not be implemented but instead a reporting cap that could be adjusted as discussed above. The CAA's proposals on remuneration of

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<sup>11</sup> Refer to Heathrow's responses to CAP1610, CAP1762

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costs exceeding the cap appear to be based on the presumption that costs above this notional cap will not be efficient nor support achieving the DCO. This is not acceptable.

28. In addition, the CAA's proposed cost of debt is completely arbitrary and falls short in process as discussed in the preceding section. It is again based on the work that PwC has done. Again, the CAA indicated it is just one of a number of inputs that would inform its decision-making for the H7 period and the major issues in PwC's work have not been addressed.
29. Finally, the CAA has undertaken no assessment as to whether it is proportionate to introduce this level of complexity to the RAB. Proportionality is a statutory consideration for the CAA in its decision-making. This is also an incredibly complex intervention, resulting in a potentially small class of costs being given a different WACC than the others. The overall impact of this additional complexity is likely to represent only a tiny proportion of the overall airport charge.

### Risk sharing of costs above £265m

30. For the avoidance of doubt, Category B costs escalation from the original estimate in 2017 has nothing to do with the risk and reward arrangements set up by the CAA. Heathrow has not engineered any cost increases in Category B to maximise its ability to earn a premium over and we do not seek such a premium. This is reinforced by the findings in Steer's report.
31. Heathrow nevertheless understands that, given the cost escalation, the CAA wants to withdraw the premium on costs above £265m. But, as we have discussed and submitted to the CAA in our response to the original Category B costs policy, the CAA needs to set up a policy mechanism that provides a 'fair bet' for Heathrow.
32. It is a widely accepted principle, across all UK regulated sectors, that when being required or encouraged to take risks, investors are entitled to a 'fair bet'. This means:
- a. Providing appropriate levels of certainty that Heathrow will make a return on its investment, in order to reduce regulatory risk and put downward pressure on the cost of capital; and
  - b. Ensuring that risks that are not inappropriately 'asymmetrical'. This reflects that investors in an unregulated environment will weigh risks and potential rewards when making investment decisions. They will not take risks that have greater downside than upside. To compensate for such asymmetrical risks will simply require a higher cost of capital.
33. The CAA's proposal does not maintain the 'fair bet' principle, given it removes the upside and maintains the downside<sup>12</sup>. This is in addition to both the CAA's intention to use cost of debt for costs over a new cap, and that there is a demonstrated likelihood that cost disallowances will occur.
34. The CAA's disregard of a 'fair bet' is in stark contrast with recent CMA determination in the System Operator for Northern Ireland (SONI) case. This determined that 'remuneration of each distinct area of SONI's portfolio of responsibilities should be structured in such a way

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<sup>12</sup> Simply by comparing the initial policy with, the proposed policy it is clear that in the new policy provides an NPV negative outcome for investors

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that each element of the package represented a ‘fair bet’ for SONI<sup>13</sup>. In that case, the CMA determined that SONI was entitled to an uplift on its costs as a ‘risk premium’, and to ensure a balanced risk and reward profile for SONI’s investors.<sup>14</sup> We expect the CMA to apply this principle on appeal. Therefore, we urge the CAA to both reconsider its proposed policy to providing Heathrow a ‘fair bet’ for its Category B expenditure.

35. Heathrow strongly argues that the “fair bet” principle should be maintained, therefore should the CAA want to remove the 5% premium for cost above £265m it should also remove the - 15% penalty.

**Heathrow’s proposal for the regulatory treatment of Category B costs above £265m**

36. We summarise our views of the regulatory treatment for Category B costs above £265m:

| Treatment of costs  | Incentive arrangements   | Governance process   |
|---|--|--|
| Continuation of original CAA’s Category B costs proposal of cost above £10m, including:<br><br>1) Use of 5.35% WACC for cost above £265m during the iH7 period<br><br>2) Use of H7’s WACC for the H7 period | Risk sharing.<br><br>Removal of 105/85 risk sharing arrangement for costs above £265m.<br><br>No introduction of recovery cap and associated proposed recovery mechanisms. | Continuation of reporting and ICPR arrangements as per original policy.<br><br>Governance arrangements as per the Enhanced Engagement protocol (agreed with the airline community)<br><br>Introduction of reporting cap to review progress against it planned Category B costs expenditure |

**Next steps**

37. Heathrow is unclear of how the CAA is going to give effect to its Category B costs policy. It would be helpful for the CAA to clarify this given the substantial changes proposed, for example, by modifying Heathrow’s licence. Unlike Category C costs, a licence change appears disproportionate for Category B but in any event, clarity provides Heathrow and airlines the opportunity to respond to CAA’s decision in this area.

**Early Category C costs**

**The need to assess the benefits that expansion provides for consumers**

38. Expanding Heathrow is in the interest of consumers. The CAA has consistently stated its support for additional capacity on the basis that it would prevent consumers experiencing higher airfares, reduced choice, lower service quality and a reduction on operational resilience. Equally, the CAA acknowledges that a benefit of Heathrow’s proposal to bring forward pre-DCO Category C spending is that it will promote ‘timely delivery of new capacity

<sup>13</sup> <https://assets.publishing.service.gov.uk/media/5a09a73ce5274a0ee5a1f189/soni-niaur-final-determination.pdf> paragraph 7.237.

<sup>14</sup> <https://assets.publishing.service.gov.uk/media/5a09a73ce5274a0ee5a1f189/soni-niaur-final-determination.pdf> paragraph 12.109.

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at Heathrow airport that would benefit consumers by promoting choice, greater competition between airlines and increasing resilience.<sup>15</sup> However, the CAA does not provide an estimate of this consumer benefit.

39. We have requested the CAA to provide this type of quantification consistently over many opportunities over the last few years. We have provided our own evidence in the form of a report from Frontier Economics showing that air fares are already affected by a shortage of capacity and hence that delivery in a timely way would have significant consumer benefit.<sup>16</sup>
40. At the moment, the CAA goes no further than to accept that expansion would put downward pressure on fares<sup>17</sup> while questioning the estimates provided by Heathrow. This is not sufficient since the CAA does not present alternative analysis and results, nor has it considered in detail the Frontier Economics report.
41. It is true that these assessments are complex and subject to interpretation. They are still feasible and if done thoroughly can provide good assessments of the general level of benefit even if not precise to the last pound. It is essential for the CAA to properly fulfil its statutory functions that it conducts such an assessment. Without this important quantified information, the CAA is operating in a vacuum when deciding what is a reasonable risk weighted investment to deliver expansion in a timely way.
42. The CAA is right in characterising the trade-off between the consumer benefits of timely delivery of expansion and the potential for sunk investment if Heathrow expansion does not proceed. This is an issue for both consumers and investors.
43. The CAA encourages Heathrow and the airline community to find a solution that both parties can support and that it is in the interest of consumers. We have responded, with extensive discussion of the options with airlines focused around scenarios for investment and schedule.
44. As requested by the CAA, we carried out an assessment of the four, principal strategic choices regarding the schedule in regard to the phasing of pre-DCO Category C costs. Our assessment, submitted to the CAA, reviews the impact of each of these scenarios on the expansion schedule in order to inform the choices around pre-DCO Category C spend. The analysis also reviews the impact of a range of other sensitivities on the expansion timeline in each of these scenarios. This is in recognition that any delay to the expansion schedule due to changes in the phasing of pre-DCO Category C spend would be independent of any other programme risks, such as those highlighted by the IFS.
45. In carrying out this analysis, Heathrow has engaged extensively with the airline community in good faith. Heathrow and the airline community have had detailed discussions on the approach to the assessment of scenarios, including on the range of sensitivities used to assess the impact of other potential delays, as well as the risks and opportunities associated with each scenario and the presentation of the assessment. This engagement has taken place multilaterally in multiple airline forums and also bilaterally, to better understand the concerns and focus areas of individual airlines. The resulting input has helped to inform

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<sup>15</sup> CAP1819, page 8, paragraph 6

<sup>16</sup> Frontier Economics, 'Estimating the Congestion Premium at Heathrow: A Report Prepared for Heathrow' (May 2019)

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

<sup>17</sup> CAP1819, page 36, paragraph 2.12.

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Heathrow's analysis. These discussions continue even as we make this submission. We indeed expect schedule reviews to be ongoing as we work with airlines on the programme.

46. Our assessment shows that there are pros and cons for each of the different choices. Opening the runway by the end of 2026 delivers the most consumer value, estimated at around £7.4 billion<sup>17</sup> NPV (to 2035) compared to a 2027 opening date. The value results from fare savings for existing passengers and benefits gained by new flyers. Furthermore, while moving the runway opening by one year reduces the spend on pre-DCO Category C spend, it also materially increases the total cost to consumers by creating extra programme costs for a prolonged and less efficient programme. Prolonging the programme also does not appear to help the average charge in H7 or H7-H9 in terms of affordability.
47. Heathrow's preferred option is thus still to invest in pre-DCO Category C costs so that capacity is provided as soon as possible. This is in the best interest of consumers.
48. Heathrow's preferred option may not be supported by the airline community or individual airlines. In the case where Heathrow and the airline community have divergent views, it is even more important that the CAA has its own evidence on the benefit of expansion for consumers. This allows it to fulfil its primary duty by resolving any divergence of views in the best interest of consumers with clear guidance and framework as a basis to proceed.
49. The Consumer Challenge Board's (CCB) views in this area are also worth considering. The CCB rightly highlights the need to better understand the notion of affordability to inform any decision on trade-offs highlighted by the CAA:

*"As the CCB understands it, the planned speed of development of terminal and other infrastructure to enable capacity expansion may be constrained by the "affordability challenge". It is not apparent to the CCB that any consumer engagement has taken place around the speed of additional capacity coming on stream. It may be that consumers would countenance a certain increase in passenger charge, if that resulted in more quickly delivering benefits of increased choice of flights and carriers, and a resulting reduction in fares. Such a reduction, driven by increased competition at the airport, might well be considerably greater than any increase in passenger charge which enabled it"*<sup>18</sup>

50. Heathrow thus plans to engage with consumers to better understand what affordability means to them. This will inform our business plan and provide further clarity on the quantum and profile speed of pre-DCO Category C costs and how it will support an affordable outcome for consumers. It is worth noting the CCB's position regarding how consumers assess cost and value, "*Much research undertaken by HAL demonstrates that consumers look at the total journey cost in judging value*", implying that affordability should not be limited to an assessment of resulting airport charges.
51. If the CAA is unable to complete such a benefits analysis in the necessary time, it should not second-guess Heathrow's evidence, especially where these have been appropriately informed by input from consumers and Government. Any CAA decisions that have the potential to discourage Heathrow from making prudent investments now, so that additional

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<sup>18</sup>[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Consumers/Report%20by%20Heathrow%20Consumer%20Challenge%20Board%20on%20masterplan%20For%20website%205%2006%2019.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Consumers/Report%20by%20Heathrow%20Consumer%20Challenge%20Board%20on%20masterplan%20For%20website%205%2006%2019.pdf)

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capacity can be made available to consumers as quickly as possible, need to be taken only after very careful and quantified analysis.

### Regulation and governance arrangements of pre-DCO Category C costs

52. The CAA recognises the need to finalise its policy for the regulatory treatment of pre-DCO Category C costs and sets out an outline timetable for it. October must be a decisive milestone to finalise a minded to decision in this area or the programme will be materially impacted.
53. Heathrow's view is that the CAA's minded-to decision regarding the regulatory treatment of these costs should include the following elements – (i) RAB recognition and investment recovery, (ii) efficiency assessment and (iii) governance.
54. The established development and core framework for the recovery of capital expenditure addresses each of these elements. The development and core framework was designed to provide flexibility for dealing with unforeseen investments during the Q6 price control. It was also designed to give airlines a strong role in the investment process and a clear incentive for Heathrow to efficiently deliver investment in the interest of consumers.
55. Heathrow's proposed regulatory treatment for pre-DCO Category C spend thus follows the principles of the development and core framework i.e. flexibility to adapt to unforeseen circumstances, open consultation between Heathrow and airlines, incentives to ensure efficient delivery in the interest of consumers. In addition, it provides further assurances on risk mitigation as decisions on spend are made in tranches and at the appropriate times. We provide detail of Heathrow's proposed regulatory mechanism below:
- a. **RAB recognition and investment recovery:** Heathrow agrees with the CAA that efficiently incurred pre-DCO Category C spend should be added to the RAB. As is the case with all capital expenditure, pre-DCO Category C spend would be added to the RAB as it is invested.

These costs would be remunerated at the relevant WACC for Heathrow's RAB at any given time. This would mean a WACC of 5.35% for investment up to the end of 2021 (i.e. until the end of the iH7 period), and then at the prevailing WACC in H7, in line with the current framework. A single cost of capital and a single RAB are important in terms of sheer regulatory simplicity, consistency and financing - core to the regulation of Heathrow for decades. This benefit of consistency has been highlighted by the CAA from early in the process to establish the H7 framework, '[t]he RAB is well understood by stakeholders and debt providers and has a long track record of successful use in UK airport regulation'<sup>19</sup>.

The annual airport charges consultation process would permit for Heathrow's proposal to recover the return associated with pre-DCO Category C spend as investment is taking place. This would reduce financeability risks by providing short-term cashflow to support the financing of pre-DCO Category C spend. Equally by recovering costs throughout the investment we avoid significant hikes in the aeronautical charges associated to accrued return not recovered until a particular milestone is met.

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<sup>19</sup> CAP1510, page 29, paragraph 5.14

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Under this approach, Heathrow would only be remunerated on expenditure actually incurred (i.e. not based on forecasts that have been provided). This would ensure that Heathrow, consumers and airlines are fairly treated. It ensures that consumers do not pay for forecast investment and means that if there are unforeseen changes investment could be reprogrammed, redirected or curtailed with consumers receiving all the benefits from that change.

- b. **Efficiency assessment:** Heathrow proposes to build on the current practice by continuing to use the IFS to review pre-DCO costs. In addition, Heathrow has agreed with the airline community in the Enhanced Engagement Protocol how the efficiency assessment should be carried out for pre-DCO Category C spend given the particular nature of some these costs<sup>20</sup>. If, following the process as described in the protocol, the CAA comes to a view ex-post that any particular elements of the investment are not efficient, the CAA would have the ability to make a deduction from Heathrow's RAB.
- c. **Governance:** Heathrow has proposed a governance process for pre-DCO Category C spend to airlines. The process is based upon seeking agreement with airlines on spend on a six-month cycle and follows the agreed Enhanced Engagement protocol.

The proposed governance path uses the existing Expansion fora. On a quarterly basis there will be an extension of the C&BWG that will focus on pre-DCO Category C spend. We will seek agreement from airlines on a rolling six-monthly budget for pre-DCO Category C spend from which Heathrow would draw money. The C&BWG will scrutinise the proposed six-monthly expenditure and will be supported by the IFS who will undertake a review of actual and forecast pre-DCO Category C spend. Agreement for the proposed six-monthly budget will be sought at the subsequent JEB and sanction of this investment will be sought at the following CPB.

The CAA's appointed IPCR would then undertake an annual ex-post review of the expenditure. However, review of pre-DCO Category C spend associated with displaced uses (major commercial settlements) would be undertaken by the CAA's appointed property expert given the specialist nature of this investment.

Airline governance would allow scrutiny of spend both against the business case and the risks identifiable based on information available at that point in time.

- 56. We would emphasise that, under this approach, the CAA does not have to define as a one-off choice in 2019, a total quantum of pre-DCO Category C investment – for example the amounts forecast in any of the schedule scenarios. Rather it can set a general intent for the programme and use an established framework for decision-making and incentives. The CAA, airlines and Heathrow can then collectively course correct in light of major new developments. This is a critical way in which we can reduce the risk of stranded costs.
- 57. We have proposed some additional ways to reduce the risks of stranded costs in our previous submission.<sup>21</sup> Our proposed measures are designed to reduce the consumer impact of stranded costs and provide transparency and assurance for such costs. In the event that expansion did not proceed, Heathrow would be required to maximise the value of recovery. We would do this by producing a comprehensive plan for realising value from any stranded assets. This plan would then be agreed and reviewed by both airlines and independent

<sup>20</sup> For more detail refer to Enhanced Engagement Protocol

<sup>21</sup> CAA-H7-283 - Timetable for Capacity Expansion at Heathrow Airport and Pre-DCO Category C Spend

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experts. As value was realised this would immediately be cycled back through the single till to the advantage of consumers.

58. In addition to these proposals, we would like to explore options with the CAA to address any potential stranded costs where asset value cannot be realised for the benefit of consumers. In particular, we can see value in either an ORC-style annuity or some form of insurance model that would 'buy-out' these costs. This could mean that consumers could benefit from lowered costs from that point onwards as investors no longer needed to be compensated for the financing costs of these investments. It potentially ensures there is no possible incentive for increasing the quantum of stranded costs. This approach could also facilitate financing.

### A licence condition for pre-DCO Category C costs

59. The CAA raises the option of recognising pre-DCO Category C costs via a modification of Heathrow's licence. It suggests that this condition could include a high-level description of the programme and confirm the principles of the governance arrangements.

60. The CAA is required to carry out its duties in a proportionate, targeted and consistent way. It is also incumbent on the CAA to ensure that licence modifications are appropriate for ensuring its objectives and that the condition goes no further than necessary to achieve that objective.

61. Heathrow agrees that a recognition of pre-DCO Category C spend through the licence could be beneficial. However this should be targeted to include only the content necessary to codify the treatment of the spend and ensure that the appropriate regulatory treatment can be enforced through the licence.

62. We do not consider that a prescriptive or detailed definition of a programme – which may be what is implied by “*a very high level description of*” the programme of spending or including references to other documents is necessary, appropriate or would produce actual advantages for consumers. Our principal concerns are:

- a. Any programme detail provided would have to be sufficiently high-level in order to ensure flexibility and prevent the need for redrafting should changes occur to the baseline programme. This would naturally mean that the level of programme included would have to be limited. This in turn would make the drafting at best open to different interpretations subsequently or potentially ineffective in providing any level of programme control; and
- b. Should a more detailed description be provided, this could serve to restrict the ability to make any required changes to the programme or create an increased regulatory burden in the form of increased licence modifications in order to ensure that any programme information remains fit for purpose. The history of large, long-term programmes is full of examples of fixing variables early to later regret.

In summary, the inclusion of general information on the shape of the programme, would serve no purpose in clarifying the treatment of these costs, is not targeted nor necessary to achieve the CAA's objectives. On the contrary, it could serve to add increased process complexity should any changes be required and be approved by the appropriate governance process.

63. In regard to governance, it is not clear to us that further licence modifications are required. Heathrow's licence already contains consultation conditions at Part F. These conditions set out the topics on which Heathrow should consult relevant parties, alongside an obligation to

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establish and agree a protocol as to how this consultation will be carried out. We consider that the obligations under this condition and the agreed Enhanced Engagement Protocol, which already includes governance principles for pre-DCO Category C spend and on which we propose to build on in collaboration with airlines, already provide a clear base for implementing agreed governance around this spend:

- a. Condition F1.1 sets out that, as a minimum, Heathrow must consult relevant parties on *"its proposals for future investment in the short, medium and long term that have the potential to affect those parties"*. This would include any pre-DCO Category C expenditure.
- b. The recently agreed Enhanced Engagement Protocol sets out the process for assessing the efficiency of pre-DCO Category C spend.

64. The CAA notes that one of the benefits of introducing a licence condition is the right of parties to appeal the decision to the CMA although it could potentially impact the timeline for an effective decision should an appeal be made. We consider that providing regulatory certainty is instrumental to delivering expansion, including making targeted and proportionate licence modifications, should these be required. It is also important that all parties have the opportunity to appeal important decisions such as this. Nevertheless, Heathrow believes that if the CAA carries out an open and transparent process to set its policy, making a decision in the interest of consumers, then the risk of appeal would decrease. The risk of delay can therefore be managed by the CAA being clear and decisive in its policy position in September or October and codifying this in the licence in a targeted manner.

65. In its document, the CAA asks whether it would be appropriate to set out guidance in case of an appeal to allow Heathrow some comfort on *"elements of spending where there appeared to be a particularly strong and compelling case that such spending would be in the interests of consumers"*. If it is the case that the CAA sees areas of spend where there is a "compelling case" that the spend would be in the interests of consumers, it should confirm a detailed policy on these areas as soon as possible, rather than wait for any appeal to provide the certainty required to develop new capacity in the interests of consumers. To hold back on any such confirmation would be in contravention of the CAA's statutory duty.

66. We would welcome further engagement with the CAA regarding the drafting of a licence condition modification for pre-DCO Category C costs. We believe we should investigate the option of a licence modification to enable regulatory treatment for pre-DCO Category C costs consistent with the development and core framework and that generates minimum changes to the licence. We would like to engage as soon as possible with the CAA on this matter.

## Timetable and business plan guidance

### Regulatory timetable

67. Heathrow supports a January 2022 start to H7. It is not possible to perfectly align the planning, construction and economic regulation processes, as we have said in previous responses. The CAA can provide certainty about the timetable and next steps for H7. This reduces uncertainty for all in other areas and is important in maintaining regulatory stability,

68. We welcome the decisions that CAA has taken in regard to the H7 timetable. Namely, confirming December 2019 as the submission date for Heathrow's IBP and recognising the

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need for and confirming the submission of a final business plan (FBP). This decision reflects the common view of all stakeholders and helps to provide increased certainty.

69. Heathrow notes that some uncertainty remains regarding both the timetable for the H7 process and the start date of the regulatory period. While we understand and support the need to ensure flexibility in the regulatory process to react to changing circumstances, it is important that the CAA provides as much certainty as possible to allow the regulatory process to progress. It is highly unlikely that the planning and price control processes will perfectly align. Rather than seeking perfect alignment either in the run up to H7, or in H7 itself we would urge a pragmatic approach that aims to close out areas of uncertainty. Therefore, the CAA needs to take decisions on matters within its control to avoid the regulatory process grinding to a halt and perpetuating a lack of clarity on the regulatory framework.
70. We consider that confirming a general milestone for submission of the FBP would provide more certainty on the regulatory process without compromising flexibility in the CAA's decision-making on the H7 framework. The CAA should take a view on as soon as possible to provide a clearer view of the H7 process.
71. As identified by the CAA in its document<sup>22</sup>, there are a number of mechanisms available to the CAA to retain flexibility in the regulatory framework while continuing to develop the H7 framework to meet a 2022 start date. We consider that these mechanisms alongside others would facilitate the required flexibility within the framework should the planning process not align with the CAA's final determination. In Heathrow's view, the key mechanisms to implement a flexible framework would be:
- a. Continued use of the development and core process for capital investment;
  - b. Use of trigger based regulatory adjustments to deal with fundamental issues that will not be fully resolved by the end of 2021. For example, the release of 25,000 additional movements and any conditions put on Heathrow as a condition of the DCO process could be dealt with in this way; and
  - c. Implementation of pass through and risk sharing mechanisms so that Heathrow does not benefit from windfall gains or suffer from losses where it has little or no ability to affect the outcomes, for example the existing mechanisms in place for business rates
72. We welcome the CAA's intention to consider different durations for the H7 regulatory period. The CAA outlines that it could investigate the option of setting a price control for six, seven or eight years. We see the length of the regulatory period as one of the key levers for defining the optimal regulatory framework for delivering expansion. It is of particular importance that when the CAA considers the most appropriate length for H7 it assesses how different durations facilitate meeting affordability and financeability considerations.
73. Investigating a longer price control is fully consistent with the guidance provided by the NPS: *"The Government designated the Airports National Policy Statement (the "NPS") in June 2018. The NPS states that an applicant for development consent "should demonstrate in its application for development consent that its scheme is cost efficient and sustainable, and seeks to minimise costs to airlines, passengers and freight owners over its lifetime."* Heathrow has been investigating the appropriate regulatory framework for delivering expansion

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<sup>22</sup> CAP1819, page 52, paragraph 3.9

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including the length of the regulatory framework. Our analysis demonstrates that (i) regulatory stability and predictability is fundamental for delivering a programme as complex and as capital intensive as expansion (ii) longer term certainty on key investment parameters can *ceteris paribus* reduce the cost to consumers by ensuring efficient financing and (iii) affordability for such a programme is helped by being able to lengthen the period – indeed it is economically impossible to avoid spikes in prices with only 5 year periods and significant upfront capital investment. We thus consider that a standard five determination would not suffice to provide the certainty required to deliver an affordable and financeable programme. We believe that regulatory predictability is required at least through the delivery phase and early operation of expansion, i.e. over the next 15 years.

74. The CAA rightly highlights that flexing the duration of the price control comes with benefits and drawbacks. The CAA's discussion identifies that the longer the price control the more opportunity there is for under and overperformance for consumers or investors. Conversely a shorter period hinders efficiency incentives. We agree with these observations.
75. We nevertheless believe that there are solutions that can address such concerns. For example, operational variables like operational expenditure, commercial revenue and passenger forecasts could be reset more frequently. Thus the CAA might define clear milestones throughout the price control to reset assumptions for these variables. This would ensure that neither consumers nor investors are unduly exposed to these variances and be in the long-term interest of all stakeholders. Equally by defining clear milestones for review at sensible times within the price control, the CAA would ensure that Heathrow maintains strong enough incentives to seek operational efficiencies. These milestones could be every 5 years or be varied (e.g. every 4 years or every 6) on this basis.
76. Therefore, a longer price control need not, indeed should not, fix all elements of the regulatory building blocks for the period. Rather it could provide some longer-term stability for a few elements that would most benefit consumers from being held stable - the regulatory treatment of capital investment and the financial conditions associated to delivering expansion; WACC, expansion premium, RAB indexation and so on. A longer price control would enable the CAA to a) provide a lower (than otherwise) expansion premium for a longer period and b) smooth airport charges to meet affordability and financeability considerations.

### Business plan criteria

77. We note the CAA's intention to pull together policy points and guidance that have been established since publishing the CAA's business planning guidance. However, even after compiling these elements, the guidance remains vague in key respects given the lack of policy certainty in many areas. It is a case of extra detail not necessarily providing further clarity.
78. The CAA's process for defining the H7 framework is out of step with established regulatory practice. The CAA continues to change the goal posts by (i) not having a defined framework for Heathrow to build its IBP and (ii) expanding its criteria for a high-quality business plan based on its initial views without having taken into account or properly addressed Heathrow's or airline responses. This is a clear consequence of the CAA's lack of effective decision-making, as noted by Heathrow in our response to CAP1782.
79. The importance of regulated companies understanding the rules of the process upfront and the certainty this provides is better understood by Ofwat in its PR19 process. In 2017, Ofwat published its final methodology for the 2019 price review which clearly set out detailed expectations and requirements for companies preparing their business plans and how these

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expectations form the basis of assessment of plans.<sup>23</sup> In this final methodology, Ofwat also specified the monthly and yearly deadline for each step of the process: submission of business plans, Ofwat's initial assessment of business plans and categorisation of plans, early draft determinations, other draft determinations and final determinations.<sup>24</sup> Ofwat's early transparency as to how companies will be assessed is notable: it has publicly engaged in Q&A regarding its methods for assessing business plans<sup>25</sup> and has a dedicated section of its website containing accessible updates and explanations on the business plan process.

80. This is particularly apparent in the CAA's guidance and criteria surrounding incentives, where, in its document, the CAA states that Heathrow should take into account the CAA's emerging view on capex incentives and, in its criteria, states that Heathrow should explain any differences in its proposed capex incentives versus the CAA's latest view. However, the CAA's latest view on capex incentives is unclear at best, with no formal decisions being taken and only limited work having been carried out. It is therefore difficult for Heathrow to take any meaningful account of the CAA's current view in its business plan, meaning that Heathrow can focus only on evidencing the framework that it believes will work best in the interests of consumers and to ensure effective working with stakeholders.
81. A further example of this is the CAA's criteria on affordability and financeability. In its document, the CAA states that Heathrow should assess affordability and financeability in building its plan and provide robust evidence that the business plan is financeable and affordable. However, the CAA has not yet defined the notion of "affordability" or guidance on how this should be assessed. This does not provide Heathrow with a clear view of how its business plan will be assessed in regard to these criteria and therefore continues to perpetuate uncertainty and the perception of heightened regulatory risk.
82. Heathrow also has a number of concerns in regard to the CAA's updated guidance on the outcomes framework and service quality. Overall, we are disappointed in some of the CAA's clarifications. While some additions help to clarify the evidence required to justify the proposed outcomes-based framework, the updated business planning criteria also serve to minimise the scope of changes that could be made to the framework to the benefit of consumers, instead putting the focus on the views of airlines.
83. Elements of the updated criteria continue to retain a large focus on the current service quality regime, stating that Heathrow should retain many of the current SQRB metrics. Heathrow agrees that many of the measures included in the current SQRB scheme are important to ensure that the airport and airlines can operate in a way that meets consumer requirements. However, our consumer insights and engagement with the CCB tell us that some alternative measures, or changes to some of the current measures may be beneficial. It is therefore important that the CAA clarifies that, while the outcomes framework should build on SQRB, it should not be constrained by it. To do so would be to undermine or predetermine the outcome of the systematic process we are following to establish the service quality measures for the next price control, taking into account the views of consumers.

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<sup>23</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Final-methodology-1.pdf>

<sup>24</sup> Ibid

<sup>25</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2019/02/Initial-Assessment-of-Business-Plans250319.pdf>

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84. It is also striking that the CAA has not included any reference to ensuring that performance measures capture the whole passenger journey and not just elements for which Heathrow has direct responsibility. Much of the CAA's recent consumer programme, as well as the DfT's aviation strategy, has focused on ensuring that consumers have the information they need to take informed decisions about their choice of journey. Failing to codify the provision of information across the passenger journey within this guidance is a missed opportunity for the CAA to further the interests of consumers.
85. In regard to resilience, the additional criteria do not evidence a full consumer focus on resilience. Heathrow is carrying out consumer research to assess what resilience means to consumers, which will be used to guide our approach to resilience. We would have expected a focus on a consumer definition of resilience from the CAA as the basis for its criteria.
86. This approach appears to show a worrying move away from the consumer focused, outcomes-based framework set out by the CAA at the start of the H7 framework development. Instead it appears to be moving back to its previous approach of relying on the views of airlines to understand consumer interests. As set out in the CAA's decision-making section of this response, it appears to show a misrepresentation on the part of the CAA of its primary duty.

### Category B costs incurred to date

87. We welcome the clarity provided on the bulk of Category B costs and acknowledge the improvements in the review process. The CAA's practice in relation to recovery of Category B costs that have already incurred is important. This is the key way in which Heathrow can obtain certainty that Heathrow's expansion costs today will be recoverable in the future.
88. The CAA is proposing to disallow £1.4 million of low value invoices for post 26 October 2016 Category B costs, unless Heathrow can provide further supporting evidence within two weeks of the date of the consultation paper.<sup>26</sup>
89. This is inconsistent with the CAA's own policy. In the Planning Cost Recovery Policy Statement, the CAA states that Heathrow must record the expenditure on planning costs on a monthly basis (with any items over £100k itemised individually) together with a reconciliation against budget.<sup>27</sup> The CAA does not ask that items under £100k be itemised individually, and the balance of these low value invoices consists of a large quantum of small value invoices falling under the £100k threshold.
90. Furthermore, the Planning Cost Recovery Policy Statement provides that Heathrow must provide an annual statement of its planning costs in sufficient detail to allow for effective scrutiny<sup>28</sup> and in some cases with relevant supporting documentation.<sup>29</sup> The CAA has never set out the required detail expected for this supporting evidence and it is not appropriate or efficient to dedicate significant resources to these invoices given the small values.<sup>30</sup> In this context, the two week deadline seems especially arbitrary.

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<sup>26</sup> CAP1819, page 69, paragraph 26

<sup>27</sup> CAP 1513, page 29, paragraph 5.13

<sup>28</sup> Ibid

<sup>29</sup> CAP 1651, page 13, paragraph 4.11

<sup>30</sup> 2016 and 2017 IPCR report

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91. For the reasons outlined above, we request that the CAA reconsiders its proposal to disallow these costs. Failing this, if a final decision is made by the CAA, Heathrow will be forced to consider its options.
92. Furthermore, the CAA is setting a precedent about how feasible – in practice – it will be for Heathrow to meet the CAA's requirements for recovering its efficient expenditure. It is critical that the CAA understands that setting inappropriate timelines or evidentiary thresholds at this stage, sets a precedent which will impact investors' views about the regulatory risk and their appetite for investment across the whole expansion programme.

### CAA decision-making process

93. The CAA is required to comply with certain basic principles in its decision-making including; complying with its statutory duties; observing procedural fairness; and ensuring any new regulatory obligations and burdens are necessary, proportionate, transparent and consistent. Heathrow is concerned that the decision-making process apparent in the CAA's consultation paper is not in line with these principles.

### Furthering the interests of users of airport operation services

94. The CAA's primary duty is to further the interest of consumers, meaning that consumers' interests should be at the centre of the CAA's policies and decision-making. However, the CAA's document includes many references to the need for Heathrow to obtain agreement with the airlines in order to define an outcome that is in the best interests of consumers.<sup>31</sup>
95. As well as being inconsistent with its statutory duties, this approach is inconsistent with the CAA's initial approach to H7. This approach acknowledged the need to measure outcomes against consumer needs directly and saw the introduction of outcomes-based regulation and the CCB to ensure that the views of consumers were properly represented and considered. It is disappointing that the CAA appears to have reverted to its behaviour under the previous Act, the Civil Aviation Act 1982, of relying primarily on input from airlines to take decisions on the regulatory framework.
96. It is concerning that the consultation paper suggests that the key criterion on agreeing a schedule for expansion is that it is an option 'that both Heathrow and airlines can support *and is also in the best interests of consumers*'<sup>32</sup>. This statement is wrong. It gives the impression that consumers' interests are a secondary consideration, and that airline buy-in is the primary criteria to assess proposals. This is based on legal, economic and factual errors:
- a. It is wrong as a matter of law to simply assume airlines and consumers interests are aligned. The Civil Aviation Act 2012 (CAA 2012) puts consumer interests first. The Act was a deliberate move away from the previous statutory regime, which put airlines' and consumers' interests on equal footing. At the time the Act was adopted, the CAA supported this move and set out why airlines' interests could not be necessarily assumed to align to those of consumers; and

<sup>31</sup> E.g. the CAA states that Heathrow would need to attempt to obtain airline approval, in the first instance, for any future category B planning costs that exceed the new recovery cap (para 1.23(ii)); Heathrow would need to actively seek agreement with airlines on timeline options (para 2.17); and Heathrow must seek agreement from airlines on the need for and timing of expenditure for early category C costs – going so far as to suggest this is codified in a licence condition (paras 2.26, 2.37 and 2.48).

<sup>32</sup> CAP1819, page 38, paragraph 2.17 (emphasis added)

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- b. It is wrong as a matter of fact, and from an economic perspective, to adopt airline interests as a proxy for consumer interests. In doing so, the CAA assumes perfect competition down the entire value chain and ignores that there are services consumers highly value which offer no competitive advantage to airlines.

97. Heathrow expansion increases the gap between the interests of airlines and the interests of consumers, making the CAA's desire to see decisions relating to the delivery of expansion agreed with airlines increasingly out of line with its duties:

- a. Expansion is a long-term, capital intensive programme. By contrast, airlines are increasingly, and explicitly focused, on short-term profitability, as evidenced in recent responses to CAA consultations.<sup>33</sup> There is nothing illegitimate in this from their commercial point of view. However, airlines may therefore tend to avoid capital expenditure, even if long-term interests of consumers support new investment, to protect short-term profitability.
- b. Not all airlines equally share in the benefits of expansion. The CAA itself has referred to situations 'where competition is constrained, for example by capacity'<sup>34</sup> and where 'incumbent airlines might have an interest in keeping airport charges low and thus restricting further infrastructure investment, even where this could have adverse longer-term effects on competition and consequently consumers'.<sup>35</sup> It is therefore concerning the CAA suggests we base decisions on the delivery of expansion on agreement with certain airlines.

98. At root of these issues is a failure to quantify the benefits of expansion for consumers. The CAA continues to lack either any meaningful evidence on the quantification of consumer benefits provided by Heathrow expansion or endorsing others' sources of evidence. It is essential that the CAA carries out this work to fulfil its statutory duty. It is particularly important that this is carried out before the CAA takes decisions that could have the impact of delaying expenditure and consequently delaying consumers' enjoyment of the benefits of expansion. Without this fact base, the CAA is operating in a vacuum when it comes to deciding whether to support delivering expansion as quickly as possible.<sup>36</sup>

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<sup>33</sup> For example, in its response to the CAA's CAP 1658 (published 6 July 2018) the Airline Operator's Committee stated that: 'the demands of our passengers mean that airlines have a strong preference for cash now rather than in the future'.

<sup>34</sup> As an example, capacity constraints lead to increased risks and consequences of disruption at Heathrow. But airlines will be concerned only to mitigate the interests of their own customers as a whole – which may, for example, mean that choose to allow greater disruption at Heathrow in order to avoid flow-on impacts at other airports where they have customers.

<sup>35</sup> CAA submission to the Competition Commission, 'The Competition Commission's Market Investigation of BAA Ltd: A submission by the Civil Aviation Authority on Economic Regulation of UK airports' (February 2008). These points were emphasised in other CAA submissions, eg, CAA submission to the Competition Commission, 'The Competition Commission's Market Investigation of BAA Ltd: The Civil Aviation Authority's response to the Emerging Thinking' (May 2008) and CAA submission to the Competition Commission, 'The Competition Commission's Market Investigation of BAA Ltd: The Civil Aviation Authority's response to the Provisional Findings and Remedies Notification' (September 2008) [http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/response\\_pf\\_caa.pdf](http://webarchive.nationalarchives.gov.uk/20140402141250/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/inquiry/ref2007/airports/pdf/response_pf_caa.pdf).

<sup>36</sup> For example, the CAA acknowledges there is a benefit to bringing forward category C spending to promote earlier delivery of expansion, and that this will benefit confusions. But without quantifying the

## Having regard to other duties, including Better Regulation Principles

99. In addition to its primary duty to further the interests of users, CAA 2012 places further duties on the CAA. One of these duties is to have regard the need to secure that the licence holder is able to finance its provision of airport operation services.
100. An important aspect of securing financeability is ensuring that the CAA sets an appropriate level of return that is reflective of market conditions and the level of risk being taken by investors. Without this, investment becomes unfinanceable for debt and equity.
101. The CAA's proposal to implement alternative WACCs undermines this duty. In its document the CAA proposes to implement a revised cost of capital for the recovery of Category B costs over £265m and pre-DCO Category C spend in 2020 and 2021. The CAA proposes to use a cost of capital figure consistent with that set out by PwC in its previous report for the CAA. The CAA characterised this report as only one input into the process of establishing an appropriate cost of capital for Heathrow for the next price control period. If this proposed level of return is used in this context, it sets a baseline for the level of returns over the period of Heathrow expansion. Consistent with the representations we have made to the CAA in previous consultations, a return at the level proposed by PwC would mean that expansion would not be financeable. This proposal, therefore, runs contrary to the CAA's financeability duty.
102. In addition, the proposal to use PwC's findings as the basis for its proposed changes to the cost of capital does not follow correct procedure and evidences a clear lack of transparency. This report had previously been presented as one input into the CAA's decision-making process. However here, it is being used as the single source of evidence for the CAA's decision-making, without taking into account the representations made by other stakeholders.
103. Under CAA 2012, the CAA also has the duty to carry out its regulatory activities in a way which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. Adhering to these principles is important to secure regulatory stability, minimise uncertainty and provide clarity for consumers, airlines and investors. Failing to adhere to these principles can negatively impact the view of regulatory risk and ultimately lead to higher costs for consumers, impact on financeability or cause delays to investment<sup>37</sup>.
104. Delaying decision-making on items such as policy issues and timetable, and therefore delaying provision of regulatory certainty, should not be treated by the CAA as a legitimate or 'safe' option. This is neither transparent nor consistent and the resulting lack of clarity and heightened perception of regulatory risk will ultimately lead to increased costs for consumers as well as delaying, or even preventing, the delivery of benefits.
105. Likewise, excessive complexity is detrimental to effective action for consumers. In the space of a year the CAA is in danger of going from one single till RAB with one well established governance process to creating three separate investment governance and scrutiny processes, up to 5 or 6 different levels of financial remuneration for investment or levels of

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benefits of expansion, the CAA cannot make a properly informed judgement about the benefits of a regulatory regime that incentivises Heathrow to bring spending forward

<sup>37</sup> This impact of uncertainty in the regulatory framework was recognised by the National Audit Office in the case of Thames Tideway. Here it was determined that regulatory risk, uncertainty and the possibility of not having a fair opportunity to achieve projected returns raises costs for consumers

## Heathrow's response to CAP1819

WACC, and multiple complex and overlapping incentives. We would urge a far greater focus on simplicity and end objectives in the CAA's approach.

106. We have previously set out to the CAA our concerns that it is failing to comply with these principles in its consideration of the H7 framework. In its document, the CAA continues to delay decision-making, absolves itself of the need to establish a robust evidence-base for taking these required decisions and fails to respect due process through transparent consultation. This prevents the CAA from being able to make transparent, consistent and proportionate decisions which are consistent with its duties.
107. The CAA's proposal for a recovery cap for Category B costs shows both a failure to act transparently and a failure to have regard to the principle of proportionality. As we have set out in previous responses, before the CAA imposes new regulatory burdens, it is required to demonstrate (i) why the currently system of regulation is insufficient to address a problem the CAA has identified; (ii) why a new burden is necessary to address that problem; and (iii) that the new burden proposed is the least intrusive way of addressing the problem compared to alternatives. This basic framework for justifying new regulatory proposals is still generally absent from the CAA's consultation, particularly this proposal. The CAA has not evidenced its thinking that spend beyond the recovery cap would be inefficient, nor proposed a cap set on the basis of any benchmarking or objective evidence.
108. It is helpful for the CAA to consolidate statements made in its different policy documents in its update of the business plan guidance and criteria. However, the CAA still does not provide a great degree of certainty on how Heathrow's business plan will be assessed. Due to a delay in decision-making on numerous topics, the CAA is unable to provide meaningful certainty on the policy background for many of its criteria. This increases the possibility that subsequent CAA decisions will cause unpredictable late changes. Heathrow is now unlikely to be able to take account of such changes in its business plan submission in December. This again evidences a lack of transparency and predictability in the CAA's working.

### Next steps for process and decision-making

109. For the above reasons, Heathrow considers that the CAA's 1819 consultation continues a worrying trend in the CAA's approach to H7. The CAA has turned away from the statutory principles which should be guiding its approach. It has adopted processes which reduce predictability, certainty and transparency. This is not in the interests of consumers, nor helpful for airlines or Heathrow. It sets a poor precedent given the many important regulatory decisions still to come on Heathrow expansion.
110. We therefore request that the CAA reviews its approach to ensure that consumer voices are given priority in this process. The CAA needs to ensure that it has identified the interests of consumers, through clear and evidence-based analysis or accepting research submitted by Heathrow and others. This should then be used to inform policy proposals and subsequent decisions about actions in the consumer interest.
111. The CAA should also ensure that it is cognisant of all of its duties when making decisions on the H7 framework. It is of utmost importance that it does not continue to delay important decisions or perpetuate the current climate of regulatory instability. Expansion is increasingly a reality not a theoretical debate and it is important that the regulatory process pragmatically supports delivery.