

# Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable

Heathrow's response

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Prepared by: Heathrow Airport Limited

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## Executive summary

1. Delivering Heathrow expansion is important to consumers. New capacity at the UK's hub airport will create services, choice and competition that will benefit consumers and the whole UK. Heathrow expansion was needed years ago. Consumers are already paying a price as airlines are unable to expand or meet their needs. The overriding priority must be to make expansion happen in a timely and straightforward manner. That will take airline support, community support and also investor support. But it cannot be "expansion at any cost" for any of those stakeholders. We welcome that the CAA continues to make progress on defining how regulation and financing can work and call on it to focus on building confidence, momentum and clarity for all involved.
2. We should not assume that the delivery of expansion is inevitable. All involved need to understand the scale of the undertaking and risks involved. Many similar scale projects have failed to find funding or failed to achieve it without government support. Heathrow and its investors stand ready to deliver expansion with the equity and debt required to fund it privately. We build from the strength of an existing business, funding platform and regulatory framework. To succeed however we need to develop regulation that is:
  - a. Predictable, builds confidence and is consistent with regulatory precedent
  - b. Simple and effective rather than trying to be too clever
  - c. Creates clear positive commercial incentives not using coercion and bureaucracy to drive the behaviour the regulator seeks
  - d. Follows a pragmatic and clear timeline that enables informed decision making in the context of other developments
3. Heathrow and its investors will ultimately need an overall settlement that provides a regulatory framework which reflects the higher risk nature of the investment. It needs to be long-term, allocate risks appropriately, with predictable and stable financial returns that ensures that all economically and efficiently incurred costs are included in the Regulatory Asset Base (RAB). As the CAA has said it will need to balance affordability and financeability throughout.
4. Affordability is important to airlines and for Heathrow. We have taken the message on charges on board. Heathrow will aim to achieve the lowest possible charge. The Secretary of State outlined his expectation that we aim to keep landing charges close to current levels. We will engage fully and in good faith with airlines, the government and the CAA to make progress on reducing costs as we can only achieve success working jointly with all involved.
5. The CAA also needs to recognise that affordability is not the only gateway criteria. Any programme must be acceptable to the local and national community. It must also offer a balance of risk and reward that attracts private funding. The needs of passengers, including future passengers, must also be considered. There are huge opportunities to bring the level of charges down, working with airlines, but affordability and value for money need to be considered in the wider context.
6. Regulation should facilitate engagement between airport, airlines, investors and community. It should not be a distraction from the vital conversations around the design of the future airport. As such it needs to be fit for purpose and sit in a common sense timetable that takes account of the timing of key decisions and constraints on all stakeholders involved.

## Affordability and financeability

7. Heathrow seeks to deliver an expansion scheme, and wider airport plan, that is affordable and financeable. We note that the CAA's priority variables for regulating expansion are designed to enable the delivery of an expansion that is both affordable and financeable. We think that setting high-level policy outcomes to support the development of regulatory policy is the right approach.
8. While we support the principle of affordability and financeability, these outcomes should not be achieved at the expense of providing a fair deal to our local community or developing a socially or environmentally sustainable scheme. The aviation industry, including Heathrow, needs to address these longstanding issues as a gateway issue too if it is to sustain public and policy support to grow.
9. We note that the CAA has not prescribed a formal definition of affordability or financeability. We understand that in subsequent discussions, policy consultations or decisions the meaning of these concepts will become clearer.
10. Regarding the concept of affordability, we would like to make the following observations:
  - a. The CAA's primary duty is concerned with furthering the interest of consumers. Therefore, the affordability assessment should start from the consumers' perspective. The CAA needs to satisfy itself that Heathrow expansion will provide value for money to consumers.
  - b. The CAA states that there would be higher airfares in the absence of expansion. If true, that in turn could generate an affordability problem for the consumers. This is an important consideration to bear in mind when making regulatory decisions.
  - c. A cursory review of regulatory precedent reveals that Ofwat and Ofgem have a statutory duty on affordability to protect the interest of vulnerable consumers. Given the 'first need' nature of the services provided by their industries this has led to the different definitions of affordability on each sector and the specific response to address vulnerable consumers' affordability situation. Air travel services are important in our society. But they cannot be understood as 'first need' services similar to potable water, electricity or gas. That is why the CAA does not have a specific duty regarding affordability or vulnerable consumers. The CAA should test if it is mistakenly using the concept of affordability when a concept that might better reflect its primary duty, would be the need of providing value for money.
  - d. Affordability can also be assessed from the airlines' perspective. In this case, it is important not to mistake the concept of affordability with the aspiration of maintaining airport charges as close to current levels as possible. An assessment of the affordability of the expansion scheme from the airlines' perspective involves projecting not only the direct cost but the cost savings and revenue that the airlines will generate through expansion. As stated above this does not imply that Heathrow is not working with all endeavour to find a path to charges close to current levels in each year of the expansion period. The lowest possible charge is after all in Heathrow's commercial interest all else equal. But this cannot be confused with an apriori cap by assertion.
11. As stated above, financeability is an outcome that we support too. The ability to privately finance a scheme of the size of Heathrow expansion is intrinsically linked to the way in which

risk is recognised, allocated and valued. Heathrow believes that acknowledging the increased risk that investors will face throughout the delivery and operation of expansion is the first step to ensuring that expansion is financeable. We urge the CAA to recognise this in future consultations.

12. We would like to highlight to the CAA that the complexity of financing expansion should not be underrated and that any future regulatory mechanism should build on the strength of current regulatory practice under which Heathrow has been able to fund Terminal 5 and Terminal 2. Heathrow considers that simple and predictable regulation can only help to achieve a financeable scheme.
13. In addition to issuing considerable amount of new debt and refinancing current levels of debt, financing expansion will very likely require additional equity commitments from Heathrow's shareholders. Rational debt and equity investors will commit resources in a long-term investment like this only if the balance of risk and reward is commercially viable. The regulator will set the balance of risk and reward. Again, we urge the CAA to build on existing strengths in the framework. We also urge it to focus on positive inducements to rational commercial behaviour rather than attempts at compulsion or penalty.

## Review of the CAA's priority issues

14. In general terms Heathrow agrees with the intent of the four priority issues defined by the CAA. We will work to meet the different objectives set out by the priorities.
15. Heathrow believes that the CAA has omitted an important priority. Namely ensuring that new capacity is actually delivered. The four priority variables describe how expansion should be delivered. But none of them include the overriding objective of delivering expansion in consumers' interests.
16. Absence the actual delivery of expansion, none of the objectives that the four priorities are intended to achieve are meaningful or in turn would be accomplished. Heathrow considers that a formal recognition of the need to deliver expansion is wholly aligned to the CAA's primary duty.
17. A formal recognition of this additional priority would call for simplicity and stability in the application of economic regulation to expansion. It would call for pragmatism in engagement and decision-making and for a realistic timetable for business plans and scrutiny. It would allow for the right balance between time and consumer benefits when making decisions.
18. The CAA states as part of priority 1 that *"In developing its plans HAL should also bear in mind the significant benefits for consumers in the timely delivery of additional airport capacity in the South-East of England"*. We would like to reassure the CAA and the airline community that Heathrow is fully aware that capacity is needed now and that the lack of capacity is creating a suboptimal outcome for current passengers. We estimate that delaying the runway opening by a year will result in a reduction of the passengers' economic benefits of at least £1.61 billion<sup>1</sup> in net present value terms.
19. We would also point to the history, at least in the UK, of major schemes being delayed for excessive periods of time by overly complex reviews, structures or legal and funding schemes.

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<sup>1</sup>The reduction in passengers' economic benefits is measured as the difference in net present value of the original stream of benefits and the revised stream of benefits, discounted as prescribed by the HM Treasury's Green Book.

Arrangements that genuinely create better aligned incentives, reduce risk, or place it more effectively are welcome. Arrangements that simply add innovation or intricacy for the sake of it are more likely to delay or prevent a scheme. This is not a theoretical point but the pragmatic observation of similar projects in the UK. The CAA has an opportunity to avoid this risk. Explicit acknowledgement of its priority to progress pragmatically in the consumer interest would be helpful. It would also be helpful to acknowledge that this is not the duty of the airlines nor of the airport or its investors – all of whom are private entities making commercial decisions.

20. We urge the CAA to formally recognise the need to ensure that capacity is delivered in its consultation document in June. We are at the CAA's disposition to engage on this topic. In following paragraphs, we offer detailed comment on each of the CAA's priority issues.

**21. Priority 1: HAL must develop a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders on the potential options, costs and value for money**

22. Heathrow concurs with Priority 1 as defined by the CAA. We understand that it is in ours and the airlines' commercial interest to develop a scheme that meets consumers' expectations.

23. We believe the only way of ensuring that the design, delivery and operation of an expansion scheme that furthers the interest of consumers and provides value for money to every stakeholder, is to engage with our airline community and other stakeholders in a transparent and effective way.

24. This is demonstrated by the significant effort and countless opportunities that we have provided to our airline community and other stakeholders to engage. These started well before the CAA published this document or The Secretary of State asked the CAA to prepare a report under Section 16 of the 1982 Act. Related to this priority, we note the CAA's letter to the Department for Transport regarding its initial views on the engagement to date on the capacity expansion process. We accept the recommendations put forward by the CAA.

25. Heathrow is keen to ensure that the Consumer Challenge Board (CCB) has the opportunity to engage in the expansion process as soon as the Board is formed. To that end we welcome the CAA's recognition that the CCB will be a vital stakeholder in the process in order that Priority 1 is achieved.

**26. Priority 2: Heathrow must develop robust cost estimates and we (the CAA) need to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way**

27. We note Priority 2 and understand the CAA's motivation to define it. We, nevertheless, consider that the CAA has not fully appreciated how important it is for Heathrow (without the need for the CAA to mandate it) to develop robust costs estimates.

28. Heathrow is about to deliver an investment that will double the size of the current airport RAB. It will expand the airport capacity and operations by close to 50% with the associated risks that a project of this nature entails. It is in Heathrow's commercial interest to deliver an expansion project in a timely and efficient way. Developing robust costs estimates is just the first step in doing so. Indeed, robust cost estimates are the minimum that we are striving for so that we can efficiently and effectively develop expansion while managing the risk associated with it.

29. We would note that truly robust cost estimates for a programme of this scale will take many months or years work. Furthermore, this is on a scale that it is only now possible for the airport to fund. This work is progressing now, but we would seek to dispel the idea that cost estimates have been or should be finalised at this stage. We are as yet at the stage of early design, including looking at all options proposed by airlines, and costs will therefore continue to need to be refined.
30. We note the CAA's discussion that regulatory arrangements need to be developed to incentivise efficient and timely delivery of expansion. Heathrow believes that a number of overriding principles should guide the development of any cost recovery framework:
- a. Any cost recovery framework is an integral part of the whole regulatory framework. It will have an impact on the way that risks are allocated within the regulatory framework and therefore will be reflected in the cost of capital.
  - b. Any framework should build on well established and tested approaches.
  - c. Positive and simple incentives rather than punitive and complex arrangements will drive the right economic behaviour. They will avoid unnecessary disruptions to the regulatory or Development Consent Order (DCO) process.
  - d. Any cost recovery framework should reflect the nature of the cost that it is aiming to incentivise.
31. Heathrow as any other private developer has clear incentives to provide value for money in its investments by optimising cost, time and quality elements of its projects. Any potential regulatory response should not change these standard incentives.
32. The CAA discusses the merits and shortfalls of different approaches to incentivising cost efficiency. In general terms, Heathrow agrees with the discussion and the need to find the right balance between ex-ante / ex-post mechanisms and risks. Heathrow's proposed principles should help find the right balance.
33. Heathrow would like to highlight to the CAA that the introduction at the beginning of the current price control of a number of efficiency arrangements such as the Independent Fund Surveyor (IFS), Development and Core approach to capex alongside the different governance fora have been a significant step forward to delivering value for money. This has been acknowledged by all stakeholders in the recent review of the framework performed by the CAA.
34. We are deeply concerned by the CAA's discussion regarding enhancing the confidence in Heathrow's procurement process. The CAA's rationale appears to be based on perceptions rather than facts. It is inconsistent with the Better Regulation principles which describe the way in which the CAA should discharge its duties.
35. The CAA states that *"in the past they have relied on assurances given by HAL and its obligations arising under UK and EU procurement law. We note, however, that the airlines have expressed concern whether maintaining this approach is appropriate for such a significant expenditure programme as required to support the capacity expansion at Heathrow airport"*. We have a number of observations regarding this assertion:

- a. Our procurement process in Q6 was discussed and agreed by Heathrow and the airline community throughout Constructive Engagement. It was then openly run in accordance to UK and EU procurement law.
  - b. In addition, Heathrow has to publish a procurement code of practice as prescribed by our licence.
  - c. The latest IFS reports demonstrate that Heathrow's procurement strategy is realising value for money.
36. In addition to these best practice safeguards, the assertion that related party's involvement in the supply chain may lead to uncompetitive tendering ignores the actual economic and fiduciary interests of all Heathrow's shareholders and the legal governance of the company's articles of incorporation. No single shareholder holds a controlling interest in Heathrow, and no shareholder would be able to drive a particular procurement outcome that ran contrary to the interest of all the shareholders and the wider company. This is enshrined in legally binding voting procedures.
37. We are also concerned that at a very practical level, a regulatory interference based on a *concern* unsupported by any evidence, will eliminate competition and access to leading global or UK practice in the supply chain. The only outcome will be higher tender costs, poorer build quality and less choice in suppliers. This is the exact opposite of the what is in passenger, airline, Heathrow and indeed Heathrow's shareholders' interests.
38. The CAA provides two examples of regulatory precedent where additional safeguards for transaction with related parties have been introduced. We have looked in detail into both of them:
  - a. We analysed the Thames Tideway Tunnel (TTT) precedent. While it is true that Thames Water (TW) related parties were not allowed to participate in the tender process for the Infrastructure Provider (IP) as prescribed by legislation, TW related parties were allowed to participate in the bidding process for construction contracts. TW related parties just happen not to have the appropriate expertise to undertake the construction contracts. This is at best a very tenuous analogy to Heathrow's situation.
  - b. Regarding the reference to Ofgem, we note that the adjustment mechanism was included in the electricity distribution price control for the period 2010-2015. The regulation prescribed that profit margins from related parties are normally excluded from the Regulated Asset Value (RAV) calculation. However, the following exception is allowed - *"the related party concerned earns at least 75 per cent of its turnover from sources other than related parties and charges to the licensed entity are consistent with charges to external customers"*. This exception appears to be analogous to Heathrow's situation.
39. Given the concerns of regulatory principle and practical procurement regarding this issue Heathrow opposes any blanket prescription on supplier choice at any level of the supply chain. However, Heathrow and the airline community have jointly extended the current IFS remit to cover expansion related activities. This in turn will provide additional safeguards and assurance regarding Heathrow's procurement process.

40. Heathrow would like to engage with the CAA and the airline community on different regulatory approaches to incentivise timely and efficient delivery of expansion in advance of the CAA's further expansion consultation in June.
- 41. Priority 3: Heathrow must develop proposals for efficient financing and we (the CAA) need to develop the regulatory framework in a way consistent with efficient financing, affordability and financeability**
42. We note Priority 3. We are open to engaging with the CAA over the coming months regarding the regulatory framework to regulate expansion. We agree that the CAA needs to develop the regulatory framework consistent with efficient financing that attains an affordable and financeable capacity expansion programme.
43. Although we recognise that the regulatory framework needs to be developed and that significant analysis, research and thinking needs to be advanced we would like to highlight to the CAA a number of initial considerations:
- a. We are not starting from scratch. There is a well established regulatory framework in place that up to now has provided a robust cornerstone to support Heathrow in becoming the best hub in Europe.
  - b. The regulatory framework, amongst other factors, has enabled Heathrow to successfully make significant investments, both in scale and complexity.
  - c. It is instrumental that the CAA's decision-making regarding regulatory matters reflect the maturity of the expansion programme. In recent analysis of the TTT precedent, it was apparent to us that although meaningful feedback and high level of regulatory predictability is needed soon, it is not ideal to prescribe the detail of the regulatory framework without a clear view of the scheme that it is being regulated. For example, TTT's long term regulatory framework was only defined once the DCO was obtained.
  - d. Heathrow would urge the CAA to make decisions regarding the regulatory framework in a staged logical sequence. This would start with principles, followed by a review of the actual programme and finally the regulatory mechanism that would give effect the principles whilst reflecting the nature of the expansion programme.
44. We would like to confirm to the CAA that we are open to engaging with the CAA and airlines over the coming months on how to design a regulatory framework that meets the objectives described by this priority. More detailed commentary and feedback regarding specific elements of the regulatory framework is provided in the following section.
- 45. Priority 4: Heathrow must develop coordinated proposals for existing operations (i.e. for the H7 price control) alongside its proposals for the capacity expansion, so that its overall business plan is affordable and financeable**
46. Heathrow agrees it will be important to think of H7 and capacity expansion as a single plan. Physically, operationally, commercially and financially they closely intertwined. Attempting to separate the two will be complex, artificial and likely confuse the airport, airlines and investors. Consolidating into a single discussion as soon as possible will also practically reduce the burden of consultation, publication and design for ourselves and the airlines.

47. We do not see a business plan for H7 as a “business as usual” plan with an expansion overlay. Nor do we see expansion as some completely unique and separate exercise. Rather we should see it as an integrated programme for review. This does not imply that either airlines or investors are already committed to this programme in part or in full. The final decisions for both parties cannot be taken until all the policy, planning and commercial implications are clear. And these decisions will be taken in stages over many years. But they must be reviewed at each stage as a whole. We therefore agree with the CAA that we will have to make integrated proposals for H7 and Expansion.
48. These links become very practical in H7. For example, decisions about whether to first create new terminal capacity in the western or eastern campus will have knock on effects on how long Terminal 3 needs to survive and which airlines and passengers Terminal 3 will serve. This in turn implies very different amounts, timing and nature of investment in Terminal 3 to be efficient. There is no such thing as a Terminal 3 investment plan in isolation. The same is equally true of many aspects of H7, H8 and beyond. We would be missing opportunities to invest more efficiently, grow revenues faster and reduce ours and airlines’ costs if we did not produce an integrated plan. Ultimately that will only lead to a higher charge.
49. Furthermore, expansion is already happening in Q6. Hence the need to update a number of elements of the regulatory framework such as the CAA’s recent policy decision on Category B costs and the discussion on early Category C costs. H7 will be the second price control in which expansion is a factor.
50. We are unsure that the timetable is workable, as laid out by the CAA. We are not sure how it allows for the priorities in this consultation to be met. We are also concerned about it making it more difficult for Heathrow to develop a high quality Initial Business Plan (IBP) which the CAA has emphasised is important in previous consultations. A key reason for our uncertainty is the interaction between regulatory business plans, the DCO planning process, wider government policy development and airline/airport engagement on design. We would highlight the following inconsistencies or complexities amongst others<sup>2</sup>:
- a. Heathrow will almost certainly be finalising its IBP 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 – for example to cost assumptions or the rate or timing of growth that can emerge as an NPS is finalised.
  - b. Likewise, Heathrow would only be receiving responses to its own local Consultation 1 at the same time as we would have to be finalising the IBP. This would mean we could include the range of say 6-8 masterplan and operational options for beyond 2021 that we had consulted upon with the public. But we would not be able to narrow this down to a proposed preferred option.
  - c. We also hear the airlines’ concerns that the engagement process leading into the DCO consultation is challenging for them. We continue to believe a consultation on the timeline we have proposed is possible with good engagement. But it does not appear possible to accelerate it and we wish to allow for the possibility for further discussion if absolutely required.

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<sup>2</sup> An illustration of the regulatory and DCO timetable is provided in appendix 1.

- 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. The CAA is also due to give a further regulatory update in the middle of 2018 just a couple of months before Heathrow publishes a revised business plan. This also causes us great concern. It is not best regulatory practice to consult regarding the regulatory framework in between business plan submissions. It also makes it practically difficult to provide airlines and investors reasonable certainty in broad terms of risk allocation, reward, incentives and charges. In short, we first need the framework then the content.
- f. 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 everyone. It may be helpful for the CAA to outline its views on the order in which regulatory elements should be set.
- g. We can see some options to resolve this clash. For example, if we published our IBP in April 2018 we should, on the current timetable, be able to provide a plan, and choices, built around one consistent future for the airport. While all the aspects of policy and planning would not be complete, this would at least allow the CAA and airlines to review and engage on a consistent underlying proposal.
- h. Furthermore, an April 2018 submission would allow more time to fully develop an outcomes based regime, working with the airlines and the CCB.
- i. We are aware that this revised timetable might cause issues with later steps in the regulatory timetable and would welcome the chance to discuss the CAA how this might be addressed.
- j. A further extension to Q6 is another possibility to align the timetable. There are downsides to an extension – including an impact on investors of 'rough justice' from a roll over, and the implications for masterplan and capital programming. However, if a revised timetable for H7 cannot be made to work, a further extension to Q6 may be the only viable option. We support the CAA's stated intention to resolve the question of an extension by June 2017.

51. We would ask the CAA do further work with Heathrow, airlines, the CCB, government and others to craft a logical, pragmatic sequence for building the regulatory framework and business plans. We therefore urge the CAA to consider not just the regulatory timetable in isolation but the DCO, airspace and policy timetable when making regulatory decisions. It is important it be consolidated into a single timeline. It is also important that the CAA provides clear feedback on its thinking in a timely way through this sequence.

## Review of elements of the regulatory framework

### 52. RAB based regulation

53. We agree with the CAA's discussion of RAB based regulation. In particular, we share the scepticism over a dual RAB approach. A single RAB is central to long term investor confidence. It has a proven record of attracting investment - not just at Heathrow, but across investment-intensive regulated sectors such as energy and water.
54. Heathrow considers that the sooner the CAA can confirm that RAB based regulation will be the starting point of the expansion regulatory framework the better. It will enable a timely and efficient delivery of the programme, avoiding potentially years of debate on alternatives. It will also be the first step to ensuring that the programme is financeable and affordable.

### 55. Remuneration of investment - Assets In the Course of Construction (AICC)

56. We agree with the benefits of the AICC approach stated by the CAA. We also note that AICC is the approach used by most economic regulators. Thames Tideway Tunnel is a clear example and perhaps more significantly, Ofgem and Ofwat implement AICC principles when setting total expenditure (TOTEX) allowances and prices.
57. Heathrow understands that AICC principles should be considered in the context of affordability and financeability. We are also committed to delivering an expansion programme that generates the lowest possible charges. We nevertheless have a number of observations regarding the following discussion:

*“Our initial view is that HAL should be allowed to recover returns and regulatory depreciation to the extent that this is consistent with broader commitments that airport charges should not increase in real terms – and provided that these commitments provide meaningful protections for airlines over the next 10 years as well as the longer term. If HAL were to seek higher charges to support the financeability of its expenditure programmes then it would need to provide persuasive evidence to us and stakeholders that this would be in the interests of consumers.”:*

- a. We consider that the CAA should be concerned by the provision of meaningful protections to consumers rather than airlines' interests as this is prescribed by its primary duty.
- b. Meaningful protections to consumers in this context should not only consider price but also the ability or otherwise to actually deliver new capacity. They should also consider the impact on consumers prior to opening new capacity and the relative consumer cost at various stages in market development.
- c. It appears to us that in this discussion financeability has been treated by the CAA as a second order consideration relative to affordability. It is important for us that both considerations are of equal importance since absence either of them expansion is not viable.
- d. We do note the potential for smoothing of charge and recovery within the overall context of the AICC principle.

58. Heathrow considers that the sooner the CAA can confirm that AICC will be the remuneration principle for expansion the sooner we will be able to progress other elements of the regulatory framework. This would support timely delivery, financeability and clarity for airlines on a realistically financed charge and thus affordability.

#### **59. Special Purpose Vehicles (SPVs)**

60. We agree with the CAA that alternative SPV funding structures would only complicate, delay and endanger the deliverability of the project. They will also inevitably add to transaction costs ultimately borne by passengers. Most importantly they will reduce flexibility in the ability of the overall airport design and operation to respond to changing airline and passenger needs.

61. There is no evidence that the mechanisms used to award Thames Tideway Tunnel and off-shore and on-shore electricity transmission networks have resulted in lower financing costs after account is taken of the particular terms and guarantees involved. These include guarantees and support offered from the public purse to licensees and the lower cost of new debt. One advantage of Heathrow expansion from a public policy point of view is it does not require public support if regulated effectively. The government has been clear that it will not offer guarantees for funding or airline growth. The CAA should work on this basis too.

62. The CAA states that it might be possible for certain assets to be financed outside the single till RAB if these are reasonably separable from the main investment programme. The CAA uses terminal buildings as an example for this. The CAA has clearly misunderstood how integrated terminal capacity is with the rest of the airport and indeed building programme. We would like to engage with the CAA to ensure that we have a common understanding regarding the physical reality of the development options.

63. On the more general point of financing assets outside of the RAB or single till we struggle to ascertain what is the difference with a SPV like approach and therefore the merits. We urge the CAA to discard the option as a complication going forward.

#### **64. Early Category C costs**

65. We welcome the CAA's recognition that substantial Category C costs will be incurred before the DCO is granted. We also concur with the CAA that the onus is on Heathrow to make a case for the most appropriate way to treat them from a regulatory perspective.

66. We have already outlined to the CAA the urgency to develop a comprehensive regulatory treatment for these costs. We need to resolve them to ensure local communities are treated fairly and to enable us to explain to airlines what development timelines we are on. Resolution can also allow earlier delivery of expansion to the benefit of passengers. Heathrow is seeking meaningful feedback on these costs in the June consultation paper. To that end we welcome the engagement that we have had with the CAA on these costs to date and extend our commitment to continue working collaboratively.

67. We would emphasise that the Category C costs broadly come in three categories. The first of these relates to hardship offers to local residents, a relatively small amount but vital for the airport and aviation industry to meet its social obligations. The larger amounts are either in design or early property purchase. These sums are ultimately justified because they reduce overall costs or timeline or both. There are legitimate choices to be made for these costs, and we would welcome the CAA facilitating airline and airport thinking on the right approach.

## **68. Allocation of volume risk**

69. We note the CAA's discussion regarding the way in which volume risk should be allocated. We understand the principles of price cap regulation and revenue cap regulation. It is important that the CAA is mindful of the radical difference in exposure to risk that each framework generates. This is especially the case when the CAA defines the appropriate reward in that properly risk adjusted returns will be the key enabler for financeability.
70. Our exposure to volume risk will change in the coming years. It is particularly increased throughout the ramp up period as Heathrow will likely not be capacity constrained for a number of years after the opening of the runway.
71. We are keen on engaging with the CAA on the different regulatory approaches to deal with this increase in risk. These range from risk sharing arrangements to the treatment of the extra movements once the DCO is granted. It will not be until after the NPS is passed that we would have a clearer view on the scheme. We therefore would recommend to the CAA that at this stage we explore options as opposed to making policy decisions.
72. We would also note that volume risk sharing offers a real opportunity to align airport and airline incentives to grow volumes faster. This will be in the interests of passengers – reducing the charge and increasing services. Such positive incentives on all sides appear to be a real opportunity in the regulatory framework.

## **73. Estimating the cost of capital - long-term investor confidence and financeability**

74. The RAB represents one side of the regulatory commitment to investors. Investors also look at the return they expect on the RAB. As the underlying risk for Heathrow is bound to increase over the next 10-15 years, investors will seek an appropriate return.
75. We believe that the CAA should consider the following issues when setting a risk adjusted cost of capital:
- a) Volume and thus revenue risk associated with the speed of take-up of new capacity. This is largely under the control of airlines. There is both an increase in absolute risk and of the volatility of volumes to address.
  - b) Volume and thus revenue risk associated with the possibility that the new capacity will not ultimately be fully utilised, for example because of a structural change in the market.
  - c) Risk associated with a delayed earnings recovery on assets and thus a longer payback, as a result of the greater mix of new assets.
  - d) Capital expenditure risk linked to both the quantum of capex and higher risk to capital reimbursement. This will be dependent on the nature of regulatory commitments to the RAB.
  - e) Construction risk and risks of overrun or disallowance through no fault of the airport or its investors. These risks might arise for example due to changes in user requirements, supply chain conditions or unexpected circumstances in building outside the current perimeter and with new techniques or assets.

- f) Higher debt platform costs associated with the larger capex programme, such as new issue premiums and Revolving Credit Facility costs, within constrained debt markets.
- g) Financial market and credit risk, for example the risk of weaker credit metrics, implying a lower notional credit rating.
- h) Political and DCO risk, for example the imposition of onerous or unpredictable and last minute new planning conditions or policy change after planning consent is granted.

76. None of these risks are insurmountable. Nor are investors seeking special treatment or risk-free rewards. However, unlike a private enterprise in an unfettered market, given that the company upside is capped due to the regulatory framework these risks do need to be addressed or compensated for in the regulated return.

77. Additional gearing caps, cash/asset lockups or requirements to maintain cash reserves or an investment grade credit rating have the potential to increase cost for passengers. Heathrow already has strict debt covenants that ensure stable financing. To the extent that new regulatory restrictions could unnecessarily constrain efficient financing of the business they have potential to increase investor uncertainty. That uncertainty will cost passengers as financing costs rise. We would urge caution in this area.

78. The existing simple calculation of the WACC on a pre-tax basis provides clarity and certainty. That would be undermined by more complex regulatory corporation tax allowances that would vary year-by-year and require true-up processes. This uncertainty in the airport charge would be detrimental to investors, airlines and passengers.

#### **79. Surface access contributions**

80. We are concerned that the CAA does not make any reference to the surface access contributions in its paper. These are important for expanding passenger access to the airport and addressing environmental issues. Heathrow, airlines and transport stakeholders need early visibility of the treatment of what are material costs. We would like to highlight to the CAA the need to prioritise this issue going forward. We are keen to engage on it in advance of the June consultation document.

## Appendix 1: Overlay of regulatory and DCO timetable

