

# Consultation on core elements of the regulatory framework to support expansion at Heathrow (CAP 1541)

Heathrow's response

Date: 22/09/2017

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Status: Final

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## 1. Executive summary

1. Heathrow believes that expansion is fundamentally in the interests of consumers, airlines and the UK. We therefore welcome the CAA's acknowledgement that expansion is in consumers' interests as the starting point for the regulatory framework for at least the next 15 years. We believe it is important that all involved keep this long term prize in mind throughout.
2. Heathrow also believes that expansion should not and cannot happen at any cost. It must be affordable and be financeable – both are equally critical tests. Furthermore, new airport capacity needs to be created in a way that meets the needs of the community and the environment. Our collective challenge is to balance these legitimate concerns not pursue one to the exclusion of the other or taking any aspect for granted. We therefore continue to welcome the CAA explicitly acknowledging the importance of all these concepts.
3. A number of factors do make regulating the period of expansion, including H7 and beyond, more complex. The CAA's consultation mentions a number of such factors. They include a necessarily somewhat uncertain policy and planning timetable and as yet unknown potential policy or physical construction challenges. Financing investment of this scale and duration privately is unprecedented and will also be complex. While we firmly believe it is achievable, it should not be taken for granted for either debt nor equity investors. Passenger demand is also not guaranteed.
4. In this context the CAA has a vital role. It must create a framework that provides the conditions for expansion to succeed. The way in which this is done could also decide whether investment and expansion happens or not. We therefore believe the optimal regulatory framework should (a) encourage commercial innovation as an alternative where appropriate (b) build certainty early wherever possible while avoiding being premature on core decisions and (c) introduce regulatory innovation only where truly necessary based on objective evidence.
5. On the first of these we are encouraged by the CAA's preparedness to support commercial alternatives. The CAA discusses the possibility of exploring long-term agreements between Heathrow and the airline community. Heathrow is keen to engage with the airline community to explore the possibility of entering into collective and/or individual agreements. In 2017 we have already seen positive results in terms of affordability and design from closer engagement with airlines. We envisage developing potential agreements will take at least 12 to 18 months, not least since all sides will require greater certainty on the National Policy Statement, costings and detailed design and operating implications as a basis to consider such agreements.
6. On the second, we believe the CAA needs to make more progress to create certainty where the outcome is unlikely to have a long term material impact for consumers or the implications are already clear. While we welcome the progress made in terms of clarifying CPI/RPI questions for example, we are frustrated that opportunities for a simple, clear decision on the timetable have been delayed. The absence of a clear decision by the CAA in June's consultation document regarding the terms and conditions for Q6+2 creates unnecessary complexity and challenges confidence. Furthermore, in order to support progress on expansion, a decision on early Category C costs cannot be further postponed. Heathrow outlines proposals for the terms and conditions for Q6+2 and the treatment of these type of costs in this document.
7. On the third, Heathrow thinks that the CAA needs to build on the strength of the current regulatory framework in order to meet the overarching objectives of affordability and

financeability. Incentives on different building blocks must be assessed individually and, perhaps more importantly, collectively. As a whole they need to be simple, proportionate and consistent, generating a balanced regulatory package. In the context of an enhanced business risk profile, continuity and simplicity that aims to reduce risk is likely to provide a better outcome for consumers than making too many changes at once.

8. The current arrangements to regulate capital investments were jointly designed only 3 to 4 years ago by the airline community, Heathrow and the CAA to reflect Heathrow's operational reality. The framework is providing value for money for all stakeholders. Heathrow therefore has some concerns with the CAA's exploration of ex-ante incentives. Heathrow believes that ex-ante incentives represent a significant departure from current regulatory practice which could introduce new risks, including for financeability, and new costs in H7. We would like to see a clear evidence base for the benefits of this innovation and more acknowledgement of the real world trade-offs involved. We are not yet persuaded that ex-ante incentives are the best way to incentivise efficiency in the aviation sector.
9. Over decades the current framework has successfully driven better service and value for money for consumers to a degree rarely seen elsewhere. Heathrow thus welcomes the CAA's confirmation of maintaining a RAB-based framework and a single till approach. We think there are benefits for consumers, airlines and investors in providing certainty on how risk will be recognised and rewarded over longer than a 5-year regulatory period. Given the long-term nature, scale of investment and risks involved with expansion, the CAA should provide clarity over the basic regulatory framework at a minimum for the next 15 years. This of course is not the same as a 15-year regulatory period.

## 2. Regulatory framework

### Regulatory design

10. We agree with the CAA that RAB-based regulation can best deliver an affordable and financeable outcome. Heathrow welcomes the CAA confirming that RAB-based regulation will continue to be the cornerstone of the regulatory design for H7. Heathrow is supportive of implementing RAB-based regulation in a way that delivers an affordable and financeable expansion programme.
11. Heathrow welcomes the CAA's confirmation of the current policy that enables efficient capital expenditure to be added to the RAB as it is incurred. As regards the single till concept and its application going forward, Heathrow agrees with the CAA that it should be retained for the next price control (H7).
12. The CAA should investigate what further longer term assurance it could provide regarding a RAB-based approach, efficient capital investment being added to the RAB as it is incurred and the single till for future price control decisions.
13. Heathrow notes the discussion regarding appropriate incentives for efficiency and profiling of regulatory depreciation. We have the following comments on each in turn:
14. Appropriate incentives for efficiency:
  - a. The CAA states it is looking for "*Appropriate incentives for efficiency to bring overall costs down*". Heathrow is committed to delivering an expansion programme that is both financeable and affordable. We have consistently stated we will work to achieve

the Secretary of State's goal of expansion with charges remaining close to today's levels. ✕. In Heathrow's opinion efficiency incentives should aim to achieve an efficient, affordable and financeable cost base that delivers value for money and great service for consumers.

- b. The current framework, as designed by the CAA, has provided value for consumers over time. The CAA should recognise this at the outset of any price control review. The existing framework includes very significant efficiency incentives – and risk for airport investors - on every single building block. These long established incentives should not be ignored because of loose rhetoric or simplistic comparisons to other sectors. Heathrow is perfectly comfortable with the principle discussed by the CAA of defining a RAB-based framework that incorporates efficiency arrangements since it is the basis on which investment has always been made. The issue is what are the simplest, most effective incentives and what is the total risk thus implied.

15. Regarding the profiling of depreciation, in principle we agree that it could be flexed. Any flexing should not compromise the overarching objectives of financeability and affordability. The current presumption of the discussion in CAP 1541 is for deferral of regulatory depreciation relative to current practice. Caution is needed to ensure this approach does not compromise financeability in particular. We have the following observations on the implications of a major reprofile:

- a. **Potential increase in revenue recovery risk.** Breaking the link between the useful economic life of the assets and the way the RAB is amortised would have an impact on Heathrow's risk profile as more revenue would need to be recovered where more passenger volume risk exists. All else equal, this will increase costs to passengers.
- b. **Potential increase to financeability risk.** One of the strengths of the expansion business case is that it builds on the cash-flows of the existing business. This provides confidence to creditors and shareholders on the recovery of investment and supports financeability ratios. A significant shift in cash-flow would weaken Heathrow's ability to fund additional investment. This is because it would potentially stretch key ratios in the crucial build period and also create uncertainty on long term recovery for creditors.
- c. **Alternatives to profiling of depreciation.** In addition to exploring different profiles to regulatory depreciation, the CAA could explore alternative mechanisms to enable affordability and financeability objectives. This could include the use of revenue advancement/deferral or P0 adjustments.

16. In conclusion, while Heathrow is open to considering the idea of flexing the regulatory depreciation profile to meet general objectives of affordability and financeability, we consider that any such profile needs to:

- a. Be done in a sensible way since the change in depreciation policy is likely to last for a number of regulatory periods.
- b. Meet short and long run financeability and affordability objectives
- c. Consider the risks of different approaches alongside its potential rewards and mitigations, and;

- d. Start from the useful life of the airport assets as the initial basis for calculating regulatory depreciation.

## Long-term agreements

17. The CAA is open to considering the idea of Heathrow entering into long-term agreements with the airline community on the basis that the agreements would protect consumers' interest. Heathrow is keen to engage with our airline customers to explore the possibility of entering into collective and/or individual agreements. Heathrow would like to reassure the CAA that any potential agreement will be designed to generate a positive outcome for consumers. It would be available to any interested airline. We agree that the CAA will have to reassure itself that this is the case once any agreement is achieved by assessing the financeability and affordability implications of any agreement. While optimistic about the prospects for agreements being reached, we are not certain they will be possible to achieve. We thus also welcome a parallel development of a more traditional regulatory approach.
18. The CAA is seeking feedback regarding how it can facilitate commercial agreements. First of all, it is important to note that the CAA has already set the right tone for Heathrow and the airline community to enter into commercial discussions. Secondly Heathrow considers that the CAA should allow for a considerable amount of time for Heathrow and the airline community to engage in what are clearly complex issues.
19. In that interim period, Heathrow considers that if the CAA wants to incentivise commercial discussions, it should be careful in not being too prescriptive in its policy papers regarding H7. Consider for example, the perhaps extreme, scenario where the CAA defines a unique price path as the only affordable and financeable outcome. If that is the case it would be difficult to find room for commercial discussions to take place. If the CAA was to define a wider range of price paths as affordable and financeable, then there could be significant room for commercial discussions. This logic also applies to key regulatory assumptions, variables or choices.
20. In Heathrow's view, the CAA could also materially facilitate commercial discussions if it is able to provide certainty by resolving interim regulatory issues. By this we mean those that happen in Q6 and that the CAA has not yet resolved. This could also include a number of more technical regulatory issues. The CAA should thus confirm the Q6+2 terms and conditions, set policy regarding early Category C costs and publish the future consultations as defined in the timetable section of the consultation paper.

## 3. Incentives and efficiency assessment

### Incentives

21. Heathrow agrees with the CAA that the incentives defined in the regulatory framework need to be assessed individually but more importantly as a comprehensive and integrated incentive package. That package should be one that:
  - a. Meets the general objectives of financeability and affordability;
  - b. Allows Heathrow to proceed in a timely and efficient way with expansion;
  - c. Does not distort Heathrow's focus on the day to day operation, and;
  - d. Maintains stakeholders' confidence in the regulatory framework.

22. To that end, we consider the principles outlined by the CAA to assess the merits of different incentives mechanisms to be a sensible start. Particular attention will need to be given to the risk and reward trade-off that individual incentives on key variables may pose on Heathrow and how this translates into airport charges.
23. We agree with the price control duration, RAB-based regulation and the CAA's initial view of maintaining the fixed allowance approach for the cost of embedded debt. We also acknowledge the CAA's discussion regarding other ways to provide long term investor certainty and the fact that the CAA will be open to exploring them. We would like to engage with the CAA on this going forward.
24. Heathrow in principle agrees with the CAA regarding operational expenditure, commercial revenues and the discussion on passenger volumes. Incentives as defined by the current Q6 framework are working in the best interest of consumers – delivering better service and falling prices.
25. Heathrow nevertheless would like to raise a principle point that, like any other regulated entity, it should not be expected to bear the risk or reward of any costs that it is not able to influence or control. Likewise, there are potentially costs airlines are better placed to scrutinise and influence. Heathrow would like to reassess the regulatory treatment of a number of costs, for example rates and police costs.
26. Equally, the H7 review provides an opportunity to reassess the range and regulatory arrangements of Other Regulated Charges (ORC), which in the context of expansion related environmental initiatives will be of particular importance for airlines and others, for example noise insulation or colleague car parking.
27. There also needs to be a fundamental assessment of ancillary debt financing costs, such as bond issue new issue premia, the costs of maintaining forward liquidity and various other fees and costs that any efficient borrower incurs on an ongoing basis. The current allowance for recovery of such costs is insufficient today and these costs will inevitably rise in Heathrow's expansion phase.
28. Regarding passenger volumes, we agree with the CAA that risk sharing arrangements are likely to be more relevant for H8. Nevertheless, we consider that there is merit in exploring these arrangements so that these could be easily incorporated in H8. This will also help protect against any issues that arise from potential changes in the timetable for new capacity.
29. The CAA is seeking feedback regarding the best way to assure itself that it has the best forecast of operational expenditure, commercial revenue, traffic volumes and capital investment. These are needed to support its assessment of affordability and financeability and to set price controls in the future. Heathrow considers that the best way to gather this important information will be a mixture of expansion governance fora, the CAA's formal information requests and Heathrow's H7 business plan due to be issued in late 2018. We would advise against a proliferation of additional or bespoke information flows – in large part to avoid confusion, and also to streamline the reporting burden.
30. Heathrow would like to highlight to the CAA how each building block projection is necessarily a forecast. These are currently far from certain and these numbers will necessarily evolve over the coming years. Therefore, affordability and financeability tests will need to be assessed carefully, most usefully using a range of forecasts for each building block.

## Incentivising timely delivery, outcomes and resilience

31. Heathrow's position regarding incentivising outcomes and resilience has not changed from our responses to the CAA's business planning guidance document.
32. Heathrow is currently operating, maintaining and developing the airport in an economical, timely and efficient manner. The CAA does not provide any evidence of a problem that requires further regulatory intervention. Instead the CAA appears to rely on the fact that Network Rail has a similar type of licence condition.
33. The current regulatory framework already sets the right incentives so that Heathrow operates, maintains and develops the airport in an economical, efficient and timely manner. Heathrow considers that it is unnecessary and disproportionate to develop a new licence condition to require Heathrow to perform its activities in the way that it already does.
34. If the CAA was to be concerned that Heathrow is not behaving in the manner prescribed above, Heathrow would argue that targeted interventions would be the best response from a regulatory perspective rather than a "catch all" licence condition. A Licence condition with such a wide scope for interpretation could have counterproductive effects.

## Procurement

35. Heathrow notes the CAA's views and proposed approach regarding procurement. We would like to reiterate our intention to the CAA and the airline community to reach a common position on our future procurement strategy and processes as we did in Q6. Having said that, Heathrow would like to make the following observations regarding this issue:
  - a. Heathrow's procurement processes are competitive, efficient and deliver value for money. There is significant evidence that demonstrates it. This has been recognised by the Independent Fund Surveyor (IFS). It has confirmed that Heathrow's on-costs have reduced from 18% in Q5 to 15.5% in Q6 and that they were significantly more competitive than comparative on-costs in the rail sector of c25%<sup>1</sup>. Heathrow's performance regarding base construction costs, preliminary costs and overheads has also been analysed by the IFS, demonstrating that Heathrow operates an efficient procurement process<sup>2</sup>.
  - b. Heathrow's Q6 procurement strategy was agreed with the airline community. The airline community raises anecdotal concerns regarding a procurement process that was jointly agreed, the implementation of which they also have the opportunity to oversee and challenge in real time. Absent relevant data or information, the CAA should not rely on subjective opinions to make regulatory decisions.
  - c. We publish and comply with our procurement code of practice to provide further assurances to all of our stakeholders as prescribed by Heathrow's Licence.
  - d. We acknowledge that the airline community has a non-evidenced concern that a minority shareholder has been given some type of preferential treatment under Heathrow's procurement processes. This ignores the governance arrangements at Heathrow. Providing a minority shareholder with an economic advantage would result in the remainder of the shareholders and/or our other stakeholders subsidising the

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<sup>1</sup> CPB 20<sup>th</sup> November 2014

<sup>2</sup> CPB 22<sup>nd</sup> June 2017

profits enjoyed by that minority shareholder. A minority shareholder would not have the ability to achieve such an outcome given our governance and oversight arrangements, and nor would our management or shareholders (as a whole) countenance such an outcome. Accordingly, we simply do not understand how the concerns raised within the airline community are credible.

- e. It is noteworthy that very few regulated entities in the UK have any specific licence conditions which are prescriptive about the manner in which the entity undertakes procurement. In this respect, the CAA's regulatory treatment of Heathrow is already significantly more onerous than for other regulated entities.
- f. The CAA has indicated that it may take "further steps" such as modifying Heathrow's licence or focused efficiency reviews. While acknowledging that the CAA has not proposed any specific further steps at this point, any further regulatory intervention needs to be targeted and proportionate. There is a very real risk that more prescriptive regulatory arrangements will be worse for Heathrow's customers:
  - i. increasing the costs and resources of administering tenders, creating processes and procedures which are not proportionate.
  - ii. reducing Heathrow's operational flexibility (e.g. to take advantage of good value supply options when those options are not compatible with the tender process but there are otherwise good business reasons to adopt them);
  - iii. potentially reducing the number of eligible bidders (i.e. because they may not be able to meet any more prescriptive requirements imposed by any modified process), thus leading to higher costs and poorer quality;

36. In conclusion, we will engage with the airline community in order to reach an agreement on procurement as we did in Q6. Nevertheless, we believe that the current regulatory arrangements coupled with the existing licence conditions regarding procurement provide full incentives for Heathrow to procure efficiently, and avoid the counterproductive consequence that further regulatory intervention would generate - making capacity expansion more difficult to deliver efficiently.

### **Early Category C costs**

37. Heathrow agrees with the principles set out by the CAA to support its assessment of the recovery of compensation costs from future airport charges; these are:

- a. *Spending on compensation is likely to be higher than the norm and the statutory minimum in the UK; and*
- b. *A need for enhanced compensation should not be an open-ended commitment, and that we will guard against inefficient expenditure.*

38. Heathrow believes there may be a number of areas where overall efficiency of the investment programme, the timely and early delivery of capacity for consumers or social or legal obligations are likely to require spend by the airport before planning consent. Examples include property purchase in hardship cases, early design work or progressing work for displaced infrastructure to move early in a controlled manner. The precise rationale, scale and certainty of each area of spend differs from case to case.

39. The CAA expects Heathrow to provide a clear indication of how the regulatory mechanisms for compensation costs should work and to set out any modifications that may be required to the current capital expenditure governance process. Given the nature and rationale for this spend, we think these 'early Category C costs' are best dealt with within the existing Q6 process. We propose that from a regulatory perspective they should be treated as follows:
- a. **Governance process for the Q6 period.** Heathrow proposes to follow the governance process as set out in the Heathrow Airport Capital Investment Protocol, agreed by Heathrow and the airline community. We believe that if the governance process throughout the Q6 period proves to be fit for purpose, it should also be maintained throughout H7. In Q6 this will allow full airline scrutiny of any early pre-planning Cat C costs as they progress from development to core capital.
  - b. **The CAA's role.** Heathrow considers that no significant changes to the CAA's role is required compared to business as usual. However, as the CAA has an arbiter role, in the event where Heathrow and the airline community are unable to find a common position regarding a particular investment. The CAA may need to be more active in this role for early Category C costs – scrutinising the specific case for such spend in some depth if there is no agreement. We would need the CAA to make any such decisions on a timely manner given the scale of the early Category C costs and the potential impact on local people or the project's critical path
  - c. **The remuneration and recognition of costs.** These costs will be treated in line with business as usual development and core framework. Investment decisions will transition into core capital investment and will be added to the RAB at the time expenditure is incurred. This allows for flexibility in addressing actual Category C spend requirements as the need for them becomes clear. Heathrow will be remunerated via airport charges as with any other investment.
  - d. **Ensuring efficiency.** Heathrow believes that it should be rewarded based on efficient investment. We therefore consider that arrangements such as the current role of the IFS will need to be part of the framework.
40. In addition to the outlined proposal, Heathrow believes that the CAA should consider a number of principles when assessing the need for Early Category C investment. These are:
- a. The need to developing particular investment in order to treat our residents fairly. It is important that the CAA's thinking is consistent to its general duties.
  - b. The impact of particular investments in the critical path for a timely delivering Expansion and thus the
  - c. The costs savings that a timely delivery of particular investment can generate for the overall cost of the investment programme and thus charges to passengers
  - d. The impact that particular investments may have on the deliverability of Expansion
41. The CAA's expresses concerns regarding Heathrow's investment throughout the remainder of the Q6 and Q6+1 on other Early Category C costs. The CAA states that *"This may create issues where capital expenditure is expressly linked to the development of the third runway rather than having been already envisioned as part of the two runway masterplan at Q6. This is because the governance process for recognising capital expenditure in the Licence*

*explicitly refers to the Q6 investment programme*". Heathrow disagrees with the CAA. The Development and Core framework was indeed designed to cater for exactly these situations where the airport needs to adjust its investment programme in the face of changed circumstances. The framework allows for capital investment not envisioned at the time of the decisions to proceed so that the interests of consumers are furthered. Of course this does not change the need for any investment to be fully justified in terms of efficiency and rationale.

42. The CAA expresses its intention to consult on the treatment of early Category C costs in Q4 this year. Heathrow welcomes this. It is critical for a timely delivery of expansion that the CAA provides certainty as to how this type of costs will be treated for regulatory purposes. We therefore would like to engage with the CAA regarding the substantial information submitted to the CAA and any other questions the CAA may have.

### **Ex-ante incentives**

43. Heathrow's understands that the CAA is investigating the potential use of ex-ante incentives as another tool to best encourage efficient delivery of capital projects. Equally, our understanding is that the CAA is starting from the presumption that the current regulatory arrangements are fit for purpose and it is only exploring alternatives. It is in this context that Heathrow responds to the CAA's discussion on ex-ante incentives.

### **Reasons for the design of the Q6 regulatory arrangements**

44. Heathrow believes it is important that the CAA, the airline community and ourselves acknowledge the strengths of current framework. It was designed with a sound rationale and there is good evidence from the IFS and other sources that it performs well. The collaborative approach taken by all stakeholders throughout Q6 Constructive Engagement (CE), exemplified by the co-creation of the Capital Efficiency Handbook, has delivered important benefits for our passengers. This should not be casually disregarded based simply based on anecdote or a presumption there needs to be regulatory change.
45. The Development and Core Framework was created taking into consideration the limitations that the Q5 framework exposed. In high level terms, the Q5 regulatory framework defined a very prescriptive list of projects that Heathrow had to develop throughout the regulatory period. These projects were conceived and costed early, in advance of their development. This approach led to a capital investment programme that at points did not reflect the operational realities of the airport, the needs of airlines or passengers or efficient use of the supply chain. This in turn triggered significant change control. It was agreed that a more flexible framework was needed. The current framework allows for the management of a living plan within clear processes and procedures, enabling a timely delivery of the business cases in Q6. We should be wary of assuming a more fixed regime is better or more efficient.
46. Under the current framework Heathrow and the airline community have the opportunity to define, deliver and if needed update a joint plan to the benefit of airlines and the airport. It has also meant a move to a more commercial setting in which benefit driven conversations are given the right space, from early CE conversations to monthly Capital Portfolio Board (CPB).
47. The current framework was also designed to protect the interest of consumers in the following ways:

- a. It ensures that consumers only pay for the projects actually developed. This is achieved by adjustments to airport charges as investment transitions from development into core capital.
- b. It incentivises efficient decision making. This is achieved through on-time assessment of projects (amongst other things) done by the IFS.
- c. It provides for efficient delivery of projects. Ex-post reviews of projects, IFS reviews and triggers set the right incentives on Heathrow to efficiently develop and deliver projects. It follows best industry practice. The Development and Core framework is based on the Gateway process, a well-established process to deliver capital investment projects.

### **Performance of the Q6 regulatory arrangements**

48. As with any new process or mechanism, there is a learning process to go through. The Development and Core framework was no exception. Through joint work over a number of years the Development and Core Framework has come a long way. The joint effort of the airport community in putting the framework in practise has managed to achieve:

- a. An annual rate of investment of £680m in a live environment
- b. Over 450 business cases or projects have progressed through Gateway 3. All of which have gained Heathrow and airline agreement.
- c. The IFS has provided ample evidence of the efficient decision making by Heathrow's project managers
- d. Throughout the benchmarking group the IFS has also demonstrated that Heathrow's procurement of projects is competitive relative to relevant comparators<sup>3</sup>
- e. The airline community has repeatedly expressed its satisfaction with how governance processes are working<sup>4</sup>
- f. Governance arrangements are understood and are working efficiently. From the CPB, to the Future Portfolio Group (FPG), including Triggers working group, or IFS working group are examples of governance fora that are enabling the Development and Core framework to operate efficiently

49. There are nevertheless areas where more work needs to be done and where potentially changes to the framework may be required. For example:

- a. There appears to be a misconception that initial cost allowances for projects included in the Q6 decision represent actual project budgets. This has led to a perception that cost increases between G0 and G3 are down to inefficiency rather than defining scope and actual costs.
- b. Potentially there is a lack of airline and IFS engagement at the early stages of the Gateway process. An early engagement of these key stakeholders may improve the

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<sup>3</sup> CPB 20<sup>th</sup> November 2014, CPB 22<sup>nd</sup> June 2017

<sup>4</sup> CPB 22<sup>nd</sup> June 2017, CPB 20<sup>th</sup> July 2017

benefit of projects and streamline the governance process later on. Potentially the airport and the airline community may have put too much emphasis on the transition of projects from G2 to G3 rather than focusing on earlier steps in the project process.

- c. There also appears to be a sense that the Development and Core framework has generated too much bureaucracy. Potentially the airport and the airline community at times engage in unnecessary detail that does not add particular value to consumers and potentially delays project delivery or adds cost.
- d. Not all projects may be best suited to follow the standard Gateway process and the associated development to core process from an aeronautical charges perspective. This is particularly true of minor works or short term commercial opportunities where a streamlined process built around incentives could reduce cost or increase speed to market

### **Early views regarding ex-ante incentives**

- 50. Heathrow expansion does represent some change in the inherent risk of the capital investment plan. It changes its nature, its size and for some project elements the time horizon compared to the typical Q6 Heathrow project.
- 51. On the one hand, this increase in risk in itself will trigger an increase in the compensation required from debt and equity holders to deliver expansion.
- 52. On the other hand, it is at least possible that in this new context, a different approach to incentives for some elements of the investment programme does result in more certainty over costs for consumers. We understand why the CAA wishes to explore these options. However, the case for ex-ante incentives from a cost and efficiency point of view is not clear cut and should not be assumed to be so.
- 53. As a starting point, any move, whether partial or total, to an ex-ante incentives regime would mean a fundamental change to the current framework. It would alter the current balance of incentives, would introduce new risks into the framework against a background of an already enhanced business risk. Equity and debt holders would need to be further compensated for that. By definition this will have an impact on the aeronautical charge. Any expected efficiency gain would need to outweigh this impact. Heathrow also questions whether the expansion regulatory framework represents the right time to move to an ex-ante approach given the other pressures on cost and financeability at the same time.
- 54. Heathrow acknowledges that other regulators, including Ofwat and Ofgem, have introduced ex-ante incentives in their respective frameworks. We make the following observations:
  - a. Water and energy are less dynamic industries than aviation, where investment is more often driven by changing operational requirements. For example, it is not clear that current or future airlines could or should define their requirements for key terminal processes and thus the build programme into the 2030s now. This is reflected in the way in which the CAA, Ofwat and Ofgem have designed their respective regulatory treatments for capital investment.
  - b. Water and energy companies don't have the benefit of the role that the airlines play in our industry. Their framework does not include elements like CE, governance fora like CPB or others that allows them to track investment and latest performance

considerations. Equally water and energy companies do not have the requirement to agree specific projects and values with their customers.

- c. Ofwat and Ofgem, in general terms, regulate their industries by virtue of revenue cap determinations, where regulated companies are given a total revenue allowance based on an estimated required total expenditure (totex) needed to develop their licence activities. This means that, regulated water and energy companies face very little volume risk. As the CAA is aware, Heathrow's regime is at the opposite end of the scale it is a price cap determination, where volume risk is fully allocated and managed by Heathrow.
  - d. Totex allowances, with ex-ante capitalisation rules (i.e. what proportion of expenditure goes into the regulated base or value) allow regulatees to find innovative ways to provide their services and meet their service related regulatory targets without needing to deliver specific investments. In fact, a significant part of the revenue determination for water companies is econometric based, rather than bottom-up as for Heathrow, which means that it is not associated with specific investment initiatives.
  - e. Ofwat and Ofgem (although to a lesser degree) can comfortably set totex allowances because they regulate a large number of comparable companies. It allows them to develop robust econometric models that allow them to set ex-ante totex allowances. The aviation sector is different – there is only one hub airport in the UK and it is the only fully regulated airport. This is a major reason why previous regulatory decisions have not followed either an ex-ante or totex approach.
  - f. In conclusion, Heathrow believes that the CAA cannot look to a specific feature of other regulatory frameworks and consider its implementation for Heathrow without understanding all the other associated regulatory incentives and rules in place in these other frameworks.
55. Heathrow is concerned that a move to ex-ante incentives could take us back to some of the challenges seen in Q5, where (as discussed above) very prescriptive lists of projects could reduce the flexibility of the framework to adjust to unforeseen events or simply to changes in project scope or cost due to information unknowable at the time projects were defined.
56. Ex-ante incentives will lead us to change our cost estimating process, our risk process and our overall project process. Perhaps this can be seen as the very aim of such incentives. On the other hand, this would also lead to a retooling of our delivery teams adding to the costs for business cases and slowing delivery. More fundamentally, experience across the UK and international supply chain suggests that an over-emphasis on ex-ante pricing and incentives very often actually increases total costs and time to deliver, as focus moves to allowing for extra risk and contractual wrangling both before and after projects.
57. Therefore, Heathrow agrees with the CAA that before implementing ex-ante incentives significant work would be needed by the CAA to understand whether ex-ante incentives are in the best interest of consumers. This work should include a detailed understanding of the potential design options, trade-off between increased risk and required reward and its impacting on airport charges, and potential arrangements associated with an ex-ante framework. It should consider carefully, and based on evidence, in what circumstances and for what elements of the build programme such incentives are likely to be appropriate. In our view, this will be far more productive than a debate about the pros and cons of blanket ex-ante incentives for the whole investment programme.

58. Heathrow agrees with the challenges identified by the CAA in paragraph 4.20. In addition to those challenges identified by the CAA, Heathrow believes that additional complexity to an already tailor-made regulatory framework as well as a rigorous analysis of the financeability impacts needs to be considered prior to introducing new regulatory arrangements.
59. On balance Heathrow is not yet convinced of the merits of introducing ex-ante incentives. We believe that the current development and core framework represents a material step forward from Q5 in terms of flexibility, speed and efficiency. We therefore think the CAA, the airline community and Heathrow should build on the strength of the framework that was jointly created for Q6. If there was to be any move away from that approach, we suspect it should be applied only for certain elements of the investment programme and it will need to be done in a way that properly reflects the costs of the ex-ante approach and seeks to mitigate some of its challenges.
60. Heathrow would like to extensively engage with the CAA on these issues throughout the second half of 2017 and 2018.

## 4. Financeability and affordability

### Affordability

61. Heathrow believes the CAA is right to identify affordability and financeability as high level objectives for the regulatory framework. Intuitively, Heathrow needs to be able to fund expansion and it needs to be at a price that increasing numbers of passengers choose to fly from Heathrow. It is therefore right to pursue a regulatory outcome that meets both objectives.
62. Heathrow is still somewhat uncertain about what the CAA means by affordability. We note and welcome that the CAA is developing work to bring clarity to the notion of affordability. Heathrow would like to raise a number of points regarding the notion of affordability:
- a. The CAA's duty is towards consumers, therefore affordability needs to be defined and assessed relative to them.
  - b. Affordability in the context of economic regulation of airports differs from the notion of other regulated industries, where it is closely aligned to Universal Service Provision of goods and/or services.
  - c. We must avoid a narrow perspective or regulatory definition of affordability. There are several factors that require proper consideration. This includes cost and value for current and future passengers. It also needs to consider the value created for users, including airlines across the aviation value chain. Viewing the airport charge in isolation, or price as the only relevant variable for affordability would be a mistake.
  - d. Therefore, the removal of capacity constraints and the associated shadow cost for consumers in terms of airfares should be considered by the CAA when defining affordability. Affordability should consider the proportion of Heathrow's charges that are borne by current or future users.
  - e. The notion of affordability cannot be used to simply back-solve a regulatory price determination. The CAA needs to ensure itself that the regulatory decision is based on a thorough bottom up exercise.

63. Heathrow believes that affordability must ultimately be defined from a consumers' perspective rather than airlines'. This is not contradictory to ensuring that Heathrow' expansion generates an outcome that provides value for money and opportunities for airlines. We have consistently stated that we will work towards achieving the Secretary of State's goal of expansion with charges remaining close to today's prices. In doing so we are working with airlines, government and the CAA to achieve this.

64. We would welcome the opportunity to engage with the CAA on the notion of affordability.

### **Financial robustness and assessment of Financeability**

65. There are a number of factors that contribute to any business' financial resilience. These include:

- a. Stability of the business, its cash flows and the business' strategic direction
- b. Stability, clarity and reasonableness of the regulatory framework
- c. Breadth, depth, quality and scrutiny of equity and debt investors financing a business
- d. Financial resilience conditions built into the company's financing arrangements; and
- e. Management practice to operate the business' financing in a manner that delivers financial resilience greater than its financing arrangements require.

66. Heathrow is currently positioned extremely strongly in most of the above respects. Continuing that situation provides more than sufficient assurance to all stakeholders that it has the financial resilience to meet the undoubted financing challenges associated with expansion.

67. Heathrow's financing arrangements include extensive and in many cases contractually binding controls on many aspects its finance. These include controls on gearing levels, unexpected financing related cash flow changes through hedging, debt maturity concentration, minimum ratings and minimum liquidity. These arrangements will endure for many years due to the outstanding debt. Heathrow does not have discretion over this longevity as lenders' consent would be needed to amend them. On top of that, Heathrow has proactively taken other measures that significantly enhance financial resilience such as diversifying its funding sources, for example in the range of currency and relationship banks, so as ensure a resilient, deep and global funding platform.

68. Heathrow has operated comfortably within these controls for nearly 10 years since its current debt financing arrangements were established. Below, the specific points raised by the CAA are discussed in more detail.

### **Gearing caps, minimum liquidity requirements and minimum credit ratings:**

69. Heathrow is strongly of the view that the introduction of gearing caps and minimum credit ratings to the current regulatory setting are unnecessary steps. Heathrow's financing arrangements already impose these constraints.

70. On gearing caps, Heathrow's financing documents include significant controls on gearing limits in relation to the net debt to RAB metric, a measure widely used in UK regulated utility

company debt financing arrangements. These controls include so-called ‘trigger events’, which would result in suspension of dividends if ever triggered, as well as covenants/events of default. In addition, Heathrow has demonstrated consistently for nearly the last 10 years that it operates the business’ financing in a manner that delivers financial resilience greater than its financing arrangements require in this area, i.e. actual gearing has been maintained comfortably within the constraints of its financing.

71. Heathrow does not believe that gearing caps alone make a significant difference to financial resilience. In fact, there are arguments that in certain circumstances gearing caps could jeopardise financial resilience. For example, if a gearing cap is introduced at a lower level than in Heathrow’s financing documentation, an equity contribution to reduce leverage would be required straightaway, this would reduce the equity buffer in case a market disruption or significant business underperformance took place.
72. The CAA cites the example of NATS (En Route) Plc (‘NATS’) where it has introduced gearing caps. Heathrow’s understanding is that this was in response to actual financial distress that NATS experienced in the past. So it is not clear how those circumstances are relevant to Heathrow. For all the above reasons, the introduction of further gearing caps on Heathrow seems disproportionate to the possible benefit they might provide.
73. Regarding credit ratings, Heathrow considers that similar arguments like those relating to gearing caps indicate that any further regulatory steps would be redundant. Controls in Heathrow’s financing arrangements are already in place. It is similarly highly uncertain that minimum ratings are able to transform financial resilience, again both for reasons of equity finance and also signalling to creditors.
74. It is important to note that Heathrow’s Licence already includes a requirement to pre-notify the CAA if it is considering making changes to its financing documents in respect of credit rating requirements. This notification obligation could then enable the CAA to revise the Licence requirements in this area if it felt that was appropriate at the time. Therefore, the introduction of further controls on Heathrow’s credit ratings seem disproportionate to the possible benefit they might provide.
75. Out of the three measures considered in this section, Heathrow believes that minimum forward liquidity provides the strongest assurance of financial resilience. However, minimum liquidity comes at a significant cost.
76. The CAA has historically not remunerated Heathrow sufficiently for these type of costs. Nevertheless, the CAA is suggesting the introduction of additional obligations and cost in this area and it seems to be focused on the most expensive forms of providing assurance on forward liquidity. That is, considering actual cash reserves, rather than leaving the licensee to manage the form of its forward liquidity in the manner it considers most appropriate.
77. Forward liquidity can be provided essentially in two forms, cash and revolving credit facilities, or in any combination of the two. The cost of forward liquidity is mainly dependent on two factors: the form of the liquidity and the minimum period of forward liquidity required, expressed for example in number of months.
78. In a scenario of small RAB growth like Q6, where forward liquidity needs are driven primarily by debt repayments, Heathrow estimates the additional allowance to recover the cost through the regulated cost of debt under current market conditions would increase from 4bp and 7bp for 12 months and 24 months’ forward liquidity in the form of undrawn facilities. In the case of

cash reserve requirement Heathrow estimates an increase of 5.0 to 6.0 times, 20bp for 12 months and 40bp for 24 months.

79. When looking to H7, where there is an expectation of significant RAB growth, and higher debt and facility volumes would be required, as well as higher costs of providing the same form of liquidity versus Q6, the additional allowance to the cost of debt is estimated at 11bp and 21bp for 12 and 24 months' liquidity in the form of undrawn facilities and 2.5-3.0 times (37bp for 12months and 74bp for 24 months) in the case of a cash reserve requirement.
80. In contrast to the costs highlighted above, in the Q6 settlement, the CAA included an allowance for all ancillary costs of maintaining an appropriate resilient debt financing platform. This is just 15 basis points on the cost of debt. This was intended to remunerate Heathrow for the costs not only of maintaining forward liquidity but also other significant ancillary debt costs such as new issue premia on new bond issues (versus the price of similar existing bonds), bond bookrunner fees, the cost of index-linking part of its debt financing (given the CAA's assumption on this to support financeability), rating agency fees and various other ancillary fees and expenses. Heathrow has argued for many years that this allowance is insufficient, even in the context of Q6. It is clear that this allowance should increase materially in H7 even with a forward liquidity requirement of just 12 months in the form of undrawn facilities.
81. Heathrow's existing Licence requires it to certify annually that it has a reasonable expectation of having sufficient financial resources to continue to operate for at least the following 24 months. Whilst not an absolute liquidity requirement, Heathrow believes that this Licence condition coupled with the minimum 12-month forward liquidity requirement included in Heathrow's financing arrangements (and also required for audit going concern purposes), to already provide a robust suite of forward liquidity protections.
82. For all these reasons, it is not clear that the increase in cost of enhancing forward liquidity commitments, relative to the potential benefits that it may deliver, is in consumers' interest.

### **Third party assurance with respect to financial stability and resilience**

83. Third party assurance is provided by rating agencies which do a qualitative and a quantitative assessment of Heathrow on a constant basis. Heathrow also has extensive experience gathered over nearly 10 years of consistently raising and managing significant amounts of debt and is confident of continuing to do that successfully through expansion with the right regulatory framework in place.
84. Heathrow's senior debt credit rating of A- is only exceeded by 8 corporates in the FTSE100 index of the largest UK listed companies. It is not clear to Heathrow how, relative to the above, any stronger assurance of its financial stability and resilience can be provided by third parties.
85. Each of the three most relevant rating agencies, Fitch, Moody's and Standard & Poor's (S&P), uses their own methodology and ratios. Heathrow considers that the six most relevant ratios to test the robustness of the plan are:

- a. Regulatory Asset Ratio (RAR): Part of the regulatory construct and Heathrow's financing agreements
- b. Interest Cover Ratio (ICR): Part of Heathrow's financing agreements

- c. Post Maintenance Interest Cover Ratio (PMICR) or Adjusted Cash Interest Cover Ratio (ACICR): Fitch and Moody's use different names for the same ratio. Measures the ability to meet interest payments after payments of the capital charges.
  - d. Debt to EBITDA: Core Ratio for S&P and Fitch to measure total level of debt compared with the cash generation of a business
  - e. FFO to Debt: Ratio used by Moody's and S&P that compares cash generation after interest vs. total debt
  - f. FFO interest cover: Included in Moody's methodology to rate airports, compare Funds from operations before interest against interest expenditure.
86. The CAA seeks feedback on its previous approach to assessing financeability. Heathrow considers that a ratio based analysis is a sound approach and it is common regulatory practice. Heathrow suggests that for H7 the CAA develops more sensitivity analysis ensuring that they properly reflect the design of the regulatory framework. We also think that the CAA should explore the option of targeting stronger ratios (potentially associated with stronger credit ratings than in Q6) so that headroom is provided for unforeseen circumstances.

### **Regulatory design**

87. The CAA is keen to understand what else it can do to improve financial robustness. In Heathrow's view topics currently discussed by the CAA appears to take a too narrow perspective focused on different licence conditions or restrictions to Heathrow's ability to manage its finances.
88. Heathrow thinks that the CAA needs to approach financeability from a broader perspective. Financeability and financial robustness will only be achieved if the overall regulatory framework is fit for purpose. It will be if the framework properly recognises and rewards the significant change to Heathrow's existing business model and risk profile in the short and long term.
89. More Licence conditions or restrictions to Heathrow's ability to manage its finances will not be of any value if the CAA does not develop a balanced regulatory framework that is cognisant of the risks within which Heathrow will operate. Therefore, the CAA should approach this critical matter asking itself what risks Heathrow will face over the coming 15 to 20 years. This should then inform the development of H7, H8 and H9 regulatory frameworks.
90. Heathrow's risk profile will change. Heathrow will be exposed to an increase in the level of risks that it already faces but also to new risks. For example, construction and delivery risk, revenue generation driven by an increase in volume risk and an increase in financing risk driven by the scale and nature of the expansion programme. Heathrow will also see increased operational risk and will be exposed to new surface access risks.
91. We consider that protecting financeability and financial resilience will involve constructing a regulatory framework that properly recognises these risks but also one that builds on the strengths of the current framework. This would maintain debt and shareholder investor confidence in the CAA.
92. Heathrow considers that the CAA should consider options to ensure that enhanced risk is properly rewarded over the life of the project i.e. at least the next 15-20 years. These options

should include alternative mechanisms to fixing a premium to the cost of capital throughout the development, delivery and operation of expansion. The CAA should develop its thinking on this matter before it publishes a potential range for H7 WACC in Q4 2017.

93. Finally, Heathrow would also like to raise its concerns regarding implementing radical changes to the regulatory framework, in particular regarding how revenue is recovered. Ex-ante incentives provide an example that will represent a significant departure from the current framework and that would increase Heathrow's risk profile further, leading to an increase in the compensation required by debt and equity holders and potentially compromising financeability. The CAA should carefully consider if the trade-offs that ex-ante provides are in the best interest of consumers and the link to financing.

### **Continuing to engage with the CAA**

94. Heathrow has been engaging with the CAA through much of 2017 to provide it with assurance on its stability and resilience to support the challenge of financing the expected expansion investment programme. It is keen to continue that dialogue in the coming months, most immediately in the lead up to the CAA's proposed further consultation on expansion financeability in Q4 2017.

### **Cost of debt indexation**

95. Alternative approaches to projecting a fixed cost of debt allowance are not new in either UK regulatory decision-making or even the CAA's decision making. Cost of debt indexation was considered in the context of the Q6 settlement when the CAA ultimately determined it was in consumers' interests to retain the pre-existing fixed allowance for the cost of debt. The CAA's is once more keen to evaluate alternative approaches in order to understand what option would provide the best outcome for consumers.
96. Heathrow has previously expressed reservations about introducing an indexation approach to the cost of debt. This has partly reflected concerns with the view implied by the CAA that a cost of debt indexation approach will meaningfully reduce risks of variance between forecast and actual debt costs in expansion versus a fixed cost of debt allowance.
97. Heathrow does not accept this view. Heathrow considers that there is still significant risk that its cost of debt during the expansion process may significantly vary from any pre-determined cost of debt allowance (fixed or indexed).
98. This could occur due to a number of reasons including the substantial change in the supply demand balance for Heathrow debt in financial markets (including the potential disproportionate impact of financial market disruption on Heathrow's cost of debt), or Expansion project related factors such as regulatory and political risk.
99. There is a clear risk that an index will not properly represent unique nature of Heathrow's debt throughout expansion. It will therefore not represent Heathrow's efficient cost of debt.
100. Despite these concerns, Heathrow is however open to discuss with the CAA how to further develop options for the indexation of the cost of debt. We do think as part of this separate mechanisms should also be considered to deal with index mismatch risk described above. This would be consistent with the principle raised by the CAA of implementing risk sharing arrangements in different parts of the regulatory framework.

101. We outline below more detailed points regarding the potential shift to a cost of debt indexation approach.

### **Application of cost of debt indexation to new and/or embedded debt**

102. If indexation is to be implemented, Heathrow believes it should only be used for the allowance for the cost of new debt. This view reflects three key points if this was not done. Firstly, long term financeability would be jeopardised as there would be no periodic reset of the cost of embedded debt. Secondly, potential outperformance even versus indices would no longer be passed on to passengers. Thirdly, it would break the rating framework that mandates to hold a significant portion of the total debt on a fixed cost basis. For these three reasons Heathrow considers it would be inconsistent to set a variable rate indexation for the embedded debt.

### **Implementation/further consultation**

103. Although a change in methodology could potentially reduce forecasting error risk, Heathrow has significant concerns regarding implementation of indexation. At a minimum, it will generate a more complex process for the determination of aeronautical charges. As other economic regulators have done in other sectors, Heathrow strongly recommends that a further full consultation is undertaken by the CAA to define how a potential change of policy would be implemented.

104. Heathrow believes that this consultation should consider or include the following high-level elements:

- a. Regulatory principles that would potentially guide the development and implementation process of the indexation approach
- b. The index (or indices) to be utilised and the approach to determining their forecast levels for new debt to be issued in the following regulatory period;
- c. The use of risk sharing mechanisms alongside indexation as advocated above;
- d. The treatment of inflation in determining the allowance; the benchmark indices are nominal references and therefore do not capture properly the movements in real rates.
- e. True-up mechanisms and financeability, possible evolution of the RAB and prefunding of new investment. This should also include the impact of an expansion scenario on financing costs. The significant increase in the volume of debt to be issued by Heathrow might imply:
  - i. an insufficient offer in the financial markets
  - ii. a worse credit risk perception (even keeping the same credit rating)
  - iii. a significant increase in ancillary cost (see next point)

105. Heathrow considers that it would be ideal if this consultation could be part of or be run in parallel with the CAA's proposed Q4 2017 consultation on cost of capital and financeability referred to in the CAA's paper.

### **Ancillary debt financing costs**

106. UK regulators have traditionally focused their determination of appropriate costs of debt for regulated companies effectively on the coupon cost of debt capital market transactions. This approach has strong merits, given bond issues tend to form the core of regulated businesses' debt financing. However, there are significant incremental costs of maintaining a debt financing platform that regulators have systematically failed to reflect fully in determining cost allowances.
107. For example, Heathrow has a 15bp allowance added to its Q6 cost of debt to fund all these costs whilst even today it estimates these costs are 2-3 times bigger. It is very likely that these costs will be even greater during expansion even with an efficient debt raising programme. The most likely areas where cost increases will occur are in the relative scale and cost of revolving credit facilities and new issue premia required on new bond issues.
108. It is critical that these costs are considered carefully alongside the core cost of debt allowance and the Q4 2017 financeability consultation may be an appropriate point at which to consider this in more detail.

### **Tax**

109. In the Consultation the issue is raised of whether to use an actual tax paid approach, or continue with a simple assumption of standard corporation tax. Other regulators have used an actual tax paid approach so we understand the CAA's interest in exploring this issue. We are however concerned that this might not be the best approach in the context of expansion. In particular:
- a. The main reason other regulators have taken an actual tax approach is that it removes an incentive for companies to increase gearing. The corollary of this however is that it also creates a strong incentive not to reduce gearing within a given price control because actual tax payments would increase but not be reflected in revenues. In the context of the financial demands of expansion, there are advantages in allowing Heathrow to flexibly reduce gearing. A pre-tax approach is much better aligned with such a flexible response.
  - b. In addition, an actual tax approach would require the CAA to take a view on Heathrow's approach to financing expansion and the resulting gearing path. (This would not be an issue in a business as usual approach because a lower financing requirement means gearing changes would likely be small). This is potentially problematic, and raises issues about the appropriate boundary between regulators and companies.
110. Together, these concerns suggest that even if an actual tax approach is preferred, it would be better to delay implementation until after expansion in order to retain appropriate flexibility while it is occurring.
111. A key taxation change since previous reviews is the disallowance of industrial building allowances (IBAs). Heathrow is uniquely disadvantaged in this respect compared to other regulated sectors as a significant proportion of its investment is considered as industrial buildings. This results in the tax being paid being higher than would result from a simple assumption of corporation tax. An adjustment to reflect the current tax treatment of this expenditure needs to be made irrespective of the tax approach.

## Comments to the CAA's Q6 cost of debt performance analysis

112. The cost of new debt has been below that assumed by the CAA in the Q6 determination. The CAA estimates that this has resulted in a current benefit to Heathrow of £100m per annum. This calculation was based on a benchmark nominal cost of debt of 5.0%, adjusted by inflation of 3.0% and compared to the cost of debt allowance in the determination of 3.2%.
113. Heathrow considers that this estimate is incorrect as it does not focus only on the cost of new debt, and conflates the effects of debt costs being different to that assumed with inflation being different to that assumed.
114. For Q6, the assumed nominal cost of new debt was 5.4%. The actual cost of new sterling debt raised during the period is 3.08% based on public debt (£495m) or 3.05% including private placements (total £935m). The lower value results in a relative outperformance of 2.35% on new debt costs. Applied to an assumption of 30% new debt, 60% gearing and a 2018 RAB of £13.6bn (2011/12 prices), this results in an outperformance on the cost of new debt in 2018 of £58m. This is considerably less than the estimate in the consultation.<sup>5</sup>

## RPI/CPI

115. Heathrow welcomes the CAA's initial policy that RPI will continue to be used to inflate the RAB and determine the real allowed rate of return for H7. We agree with this approach which is consistent with the views we put forward in our April 2016 response to the CAA's consultation document 'Strategic themes for the review of Heathrow Airport Limited's charges ("H7")'. The lack of Government commitment to developing a CPI index-linked gilt market is a material impediment to managing potential future CPI exposure prudently.
116. Continuity in this area should also improve financeability as credit markets will be reassured that Heathrow will not carry significant risk of variations in the evolution of RPI and CPI. Over a full regulatory period, this could result in hundreds of millions of pounds in uncontrolled variance between the RAB (CPI-linked) and Heathrow's existing RPI-linked bonds and swaps.
117. The CAA should go further by providing explicit longer-term guidance on evolution from RPI to CPI based indexation of the RAB. This will help as Heathrow will need to put in place substantial amounts of RPI-linked instruments during H7 given the large capital programme envisaged in this period. These instruments tend to be relatively long-dated (swaps 10-15 years and bonds 20-40 years). Therefore, guidance that CPI indexation would only be introduced gradually beyond H7, e.g. for new investment, would further underpin markets' confidence in the CAA's sensitivity to financeability issues and Heathrow's ability to manage balance sheet risks with confidence.
118. In terms of whether the price control itself should be expressed with reference to CPI or RPI, on balance Heathrow considers that continuing with an RPI approach would render a more consistent outcome; we would make the following observations:
- a. *Ceteris paribus* a CPI based tariff profile will have a higher 'X' value associated with a given price profile which is perhaps counterproductive in an environment where parties are striving to achieve airport charges as close as possible to today's level through expansion.

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<sup>5</sup> To obtain an out-performance of £100m, the cost of new debt over the whole of the period would have to have been only 1.3% nominal, i.e. an outperformance of over 4% compared to the determination.

- b. Secondly, Heathrow would still be exposed to RPI/CPI basis risk if a CPI-based approach was adopted. An ex-post true-up mechanism should be used at the end of H7 to adjust for what is ultimately a risk outside Heathrow's control. This in itself would mean creating another complex regulatory formula and likely costs for consumers.

## 5. Surface access

### The CAA's surface access policy

119. The CAA correctly states that Heathrow is currently developing proposals for surface access projects. We are also engaging with key stakeholders on these proposals and will continue to do so over the coming months and years.
120. The CAA's surface access policy will play an instrumental role in the development, delivery and funding of the surface access projects. As with all the CAA's policy making, surface access policy should be consistent, predictable and provide clear guidance to stakeholders that enables decision-making that generates the best possible outcome for consumers.
121. Heathrow believes that the CAA's surface access policy remains fundamentally fit for purpose. It is true that significant developments have taken place since the CAA enacted its policy in 2005 yet the current policy still enables the CAA to deliver its duties. This is true not only to further the interest of consumers but also for important secondary duties like ensuring that the Licencee can finance its activities or the need to secure that the Licencee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects.
122. Heathrow thinks that the CAA's surface access policy is robust in that it is formed of a number of well-defined criteria with clear guidance on each for the Licencee. It provides a sensible common ground that enables key stakeholders to start commercial discussions.
123. Although Heathrow considers that the CAA's policy is fit for purpose, we want to highlight that significant work still needs to be undertaken from a policy perspective. We, as an industry, need to learn from our experience in the last decade or so on surface access. For example, the Crossrail contribution in Q6 is the most recent example of surface access contribution assessed under the policy that the CAA is consulting upon with relevant lessons.
124. Heathrow thinks that significant work and thinking needs to be done in finding a common approach or methodology to assessing the benefits and costs of surface access projects to airport passengers. This is the area that was most contentious regarding the Crossrail contribution. Different stakeholders used different methodologies to assess the benefits, achieving diametrically opposite answers. The CAA subsequently had to make a policy decision with the available information.
125. Given the relative scale of the surface access projects that will be delivered (and therefore decided upon) we must learn from the past, and ensure that from early in the process we are using very similar methodologies if not the same to assess the benefits of surface access projects. Heathrow, the CAA, the ORR, DfT, TfL and all relevant stakeholders must prioritise this issue in the coming months.
126. To that end, we are pleased to understand that the CAA has already started work with the DfT regarding WEBTAG methodology. Heathrow requests that the CAA and DfT to share the results with us and the airline community as soon as practicably possible. As an interested

party we consider that it is important that our input and expertise is taken into account before any work is deemed final.

## Recent developments

127. Regarding the outcome of the recent High Court judgment in R (Heathrow Airport Limited) v ORR. We note the CAA's position that the case dealt mainly with an event of the past and that the CAA will consider the Track Access Charge (TAC) contribution to the single till in the context of the H7 decision. Heathrow would like to highlight to the CAA that it has consistently followed the CAA's surface access policy throughout the process for setting the TACs for the use of Heathrow's Spur. This should be a key consideration for the CAA reviewing the contribution to TACs contribution into the single till in H7.
128. We would like to engage with the CAA and the ORR going forward to discuss important matters such as the integration of the TACs into the single till and the role that both regulators are due to play in future surface access developments and/or contributions.

## 6. Timetable and extension of the price control

### Further extension to Q6

129. The CAA needs to build confidence in the regulatory process to enable the successful delivery of Expansion. A clear direction on the implementation of Q6+2 is required in Q4 2017 at the very latest to avoid on-going regulatory uncertainty. This is in the interest of consumers, airlines and of Heathrow. Any further delay will be unacceptable.
130. Heathrow believes that there will never be absolute certainty regarding the expansion timetable. It is simply not feasible to have a perfect regulatory timetable that allows for all unforeseen events, aligns to all key dates and enables the creation and gathering of perfect information for regulatory decision-making. It is therefore not in the best interest of passengers to link the decision on the implementation of Q6+2 to any future decision or final resolution of further extensions beyond December 2020 (Q6+3). By delaying its decision making the CAA creates extra risks and complexity for Q6 rather solving the uncertainty over H7.
131. Heathrow agrees with the CAA that the implementation of Q6+2 should be "effective and clear", and "proportionate". Heathrow also accepts that different arrangements could apply during any further extension period (Q6+3) if a further extension beyond Q6+2 be required. However, we do not at present see benefit in having further extensions to Q6, beyond Q6+2.
132. Heathrow would at this stage accept a simple rollover of the price cap in Q6+2. This is mainly because of simplicity. It would provide certainty to all stakeholders and avoid the distraction of a mini price control. This must be seen in context. A simple rollover means a further fall in airport charges for consumers. At the same time, Heathrow is providing record levels of passenger satisfaction - amongst the very highest in Europe. There are very real risks for the 2020 and uncertainty around actual outcome versus the Q6 settlement but the risks, as far as can be forecast, crudely balanced. Such an outcome would be practically beneficial to consumers. Such an outcome is both "effective and clear", and "proportionate".
133. The price cap for Q6 has been calculated on the basis of year on year efficiency savings. The further reduction in airport charges of RPI-1.5, in both Q6+1 and Q6+2, therefore implies that Heathrow makes further efficiencies beyond the level assumed by the CAA in the Q6 settlement. Furthermore, Heathrow will take on significant specific additional risks in Q6+2,

including the full year impact of Brexit, and the first full year impact on rail revenues following the introduction of Crossrail services.

### **Timetable**

134. The CAA outlines a timetable for developing the H7 framework in figure 2. The timetable assumes a further year extension to the Q6 price control (Q6+2) Subject to a few changes, Heathrow considers that the timetable is coherent and should enable sensible decision making. Heathrow suggest the following changes:

- a. Q4 2017. Heathrow considers that alongside the CAA's initial thinking on the cost of capital consultation, the CAA should run a technical consultation regarding whether and how to implement cost of debt indexation in H7.
- b. Q4 2017. The CAA should consult on its decision to the terms and conditions that would apply to Q6+2.
- c. Q4 2017. The CAA should consult on its decision regarding the treatment of early Category C costs. Absent a decision in Q4, as suggested by Heathrow, the CAA should illustrate in the timetable when it is going to make a final decision regarding early Category C costs.