Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable

CAP 1819

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About this document

This consultation document focuses on the costs of expansion incurred by Heathrow Airport Limited (“HAL”) in advance of receiving a development consent order (“DCO”) under the Planning Act 2008 for the expansion of Heathrow airport. It deals with the new information that has emerged on these costs and notes that there could be significant implications for the wider programme timetable, depending on the levels of this spending and how we propose to treat the expenditure in the regulatory framework.

It also deals with issues relating to the regulatory timetable and updates the guidance we provided previously to HAL on the scope and content of its price control business plans.

Stakeholder views invited

We welcome views on all of the issues raised in this document including the issues set out in the Executive Summary and those highlighted in chapters 1 to 3.

Please e-mail responses to economicregulation@caa.co.uk by no later than 22 August 2019. We cannot commit to considering representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact robert.toal@caa.co.uk.

Executive Summary

Introduction

1. Capacity expansion at Heathrow airport is a very large and complex programme and under HAL's existing plans very significant costs will need to be incurred for planning and other pre-DCO[1] costs to support a target date for the new runway opening of 2026.

2. Under our existing policy, planning costs are termed "Category B costs" and are those costs which are directly associated with, and incurred solely for the purpose of, seeking planning permission for the delivery of new runway capacity at Heathrow airport. The other pre-DCO costs termed "early Category C costs" are in addition to Category B costs and are a subset of HAL's overall Category C costs[2]. HAL's most recent estimates of early Category C costs include the costs of relocating certain large commercial/other facilities, community costs (including compensation costs relating to other commercial activities, agricultural activities and residential property) and other enabling costs to prepare for construction.

3. HAL's forecasts of early Category C costs have increased significantly and are now very material. In order to retain a target of 2026 for the opening of the new runway, HAL has said it needs to bring forward the timing of certain spending. HAL now expects to spend a total of £2.9 billion (in 2014 prices), consisting of over £500 million of Category B costs and £2.4 billion (in 2014 prices) of early Category C costs, before it obtains a DCO. In the light of these increases, we have asked HAL to consider different options for this spending and the

[1] HAL will apply for planning permission to permit capacity expansion in the form of a "development consent order" ("DCO") under the Planning Act 2008 ("PA08"). HAL is targeting late 2021 for obtaining a DCO. The DCO must meet the requirements of the Airports National Policy Statement ("NPS") designated by the Government under PA08.

[2] We are consulting on the regulatory treatment of Category C costs through our wider regulatory framework consultations including the consultation we published in March 2019 CAP 1782: Economic regulation of capacity expansion at Heathrow: Policy update and consultation ("the March 2019 Consultation").

implications of this spending for the overall programme timetable and the interests of consumers.

4. This document discusses the regulatory treatment of Category B and early Category C costs in the light of these increases and the further options that HAL is considering for this spending and the overall programme timetable. Bearing in mind the uncertainty about the overall programme timetable, this document also discusses the regulatory timetable and updates our guidance to HAL on its initial price control business plan (due in December 2019).

5. Our previous policy documents on these matters include:

- consultations in July[3] and November 2016[4] on the regulatory treatment of expansion costs;
- the February 2017 policy statement[5] and December 2017 policy update on costs;[6]
- guidance to HAL in April 2017 on its price control business plan;[7]
- April 2018 guidance document[8] and policy update on costs[9]; and
- a consultation in October 2018 that dealt with the regulatory timetable.[10]

[3] See CAP 1435: The Recovery of Costs associated with obtaining planning permission for a new northwest runway at Heathrow airport: initial proposals ("the July 2016 Consultation").

[4] See CAP 1469: The Recovery of Costs associated with obtaining planning permission for a new northwest runway at Heathrow airport: final proposals ("the November 2016 Consultation").

[5] See CAP 1513: Policy Statement on the Recovery of Category B costs ("the Planning Cost Recovery Policy Statement").

[6] See: CAP 1610: Economic regulation of capacity expansion at Heathrow: policy update and consultation ("the December 2017 Consultation".

[7] See: CAP 1540: Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control ("the April 2017 Consultation")

[8] See: CAP 1651: Guidance on preparation of the annual budget and statement for those costs associated with obtaining planning permission for a new northwest runway ("the Budget Guidance").

[9] See: CAP 1658: Economic regulation of capacity expansion at Heathrow: policy update and consultation ("the April 2018 Consultation").

[10] See CAP 1722: Economic Regulation of Capacity Expansion at Heathrow: policy update and consultation ("the October 2018 Consultation")

6. The level of Category B and early Category C costs are important to consumers because:

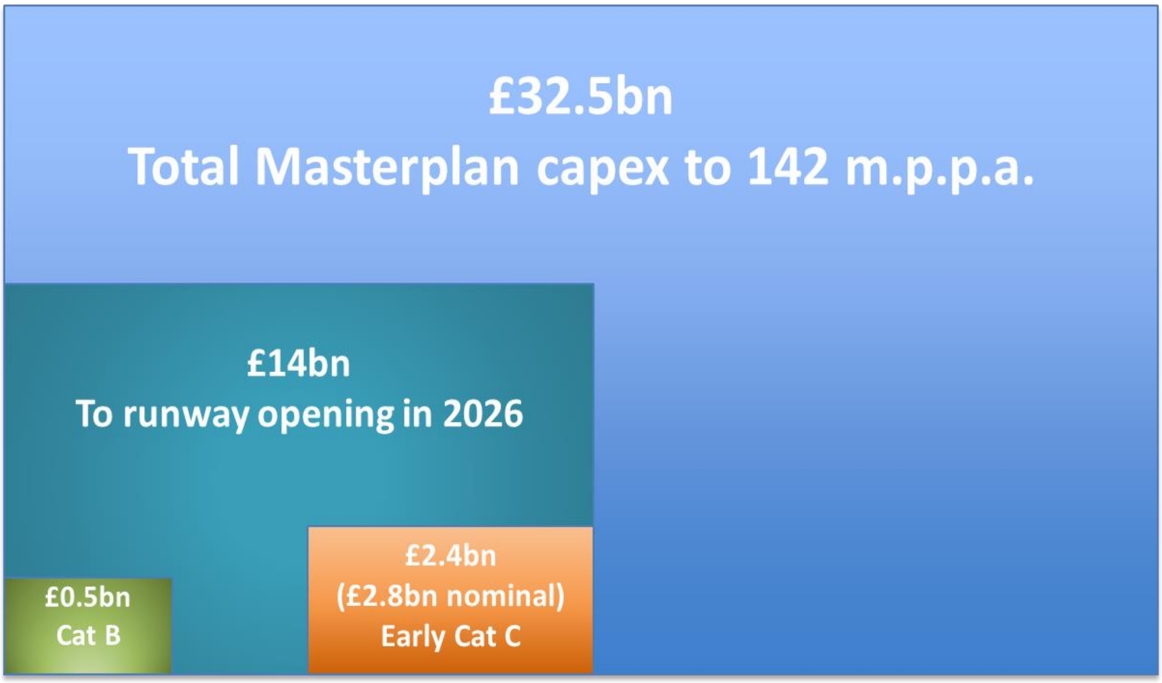
- overall cost efficiency supports both the affordability and financeability of the capacity expansion programme;
- of the potential impact on the overall timetable and timely delivery of capacity expansion, with early Category C spending promoting timely delivery of new capacity at Heathrow airport that would benefit consumers by promoting choice, greater competition between airlines and increasing resilience;
- there is a risk that, if early expenditure is passed on to consumers through airport charges, consumers are at risk of those costs becoming sunk[11] if HAL's DCO application were not to be successful (or if HAL decided to withdraw from the DCO process); and
- there may be a difficult trade-off between (i) the timely delivery of capacity expansion and the benefits to consumers that this would bring, and (ii) the potential for sunk costs if HAL were not successful with its DCO application. In practice, this means that a higher level of early spending may lead to earlier opening of the new runway, but at the risk of higher sunk costs if HAL is not granted a DCO. The risks associated with these sunk costs could be reduced by lower levels of early spending, but this would delay the target date for runway opening.

7. Nonetheless, HAL's total forecast costs to deliver the new runway and associated capacity by 2026 remain broadly in line with 2017 expectations (although there are certain changes in the scope of the infrastructure it intends to deliver for 2026). HAL's current estimates suggest that its total capital costs to facilitate the opening of a new runway in 2026 will be in the region of £14 billion (in 2014 prices). Further, HAL's current estimates for total expansion capital costs are around £32.5 billion (in 2014 prices) in the period to 2050 (to provide

[11] "Sunk" costs can be considered as costs that have been properly incurred in relation to the runway expansion programme, but which would become wasted or cannot be recouped by the sale of the assets those costs were used to acquire in the event that the DCO is not granted due to the output of these costs no longer being required.

the capacity to accommodate 142 million passengers per annum). HAL's estimates of costs are illustrated in the figure below.

Figure 1: Category B and early Category C costs in the context of expansion costs (2014 prices)



Source: HAL, Cost and Benefit Working Group, March 2019

8. As well as HAL's work to develop its capacity expansion programme it is important to note that other important changes will be required to allow airlines and passengers to take advantage of new capacity at Heathrow airport. In particular, airspace modernisation will be required across the southeast of England to allow for aircraft to make best use of airspace and reduce the impact of increases in air traffic on the environment.

Main issues raised in this consultation

9. As noted above HAL's total forecast costs to deliver the new runway and associated capacity by 2026 remain broadly in line with 2017 expectations (although there are certain changes in the scope of the infrastructure it intends to deliver for 2026). Nonetheless, the estimates of HAL's pre-DCO spending, which are important components of its wider £14 billion programme, have

increased significantly. It is these early costs that are the focus of this consultation.

10. In relation to Category B planning costs, chapter 1 notes the sharp increases in these costs and that when we established the original approach to regulating these costs in 2017 we said we would review our approach to these matters if HAL's forecasts of these costs exceeded £265 million (in 2014 prices). HAL's latest forecasts suggest these costs could be over £500 million. In the light of this escalation in costs, we consult on strengthening the governance and regulatory incentives that apply to these costs including that:

- reporting arrangements should be enhanced so HAL reports every three months on these costs;
- we intend to review the total level of these costs to establish a recovery cap based on our assessment of efficient costs, with any increase in forecast costs beyond this level subject to approval by a governance process involving airlines, or else referred to the CAA for decision;
- we intend to increase the scrutiny of these costs through the work of the Independent Planning Cost Reviewer (IPCR), CAA assessment of these costs and through the work to establish the recovery cap discussed above; and
- the regulatory incentives should be tightened by the use of the recovery cap and we consult on whether a change in the financing costs that HAL should be allowed to recover on the costs would be appropriate.

11. Chapter 2 discusses early Category C costs and explains that, following the sharp increase in HAL's estimates of these costs, we have asked HAL to look at, and report on, a range of options for early Category C spending and the implications of each option for the wider programme timetable and for consumers. These include options that would involve a significantly lower level of early spending. We have asked HAL to complete its initial work on these scenarios by the end of July 2019. It will be particularly important that HAL takes a leading role in engaging with airlines on these matters and actively seeks agreement with airlines on an option that both HAL and airlines can support and is also in the best interests of consumers.

12. There is a need for timely decisions on these matters since there are plausible scenarios in which HAL would need to accelerate early Category C spending in early 2020. So, in parallel to this work on options, we are considering how best to treat these costs in the regulatory framework and are consulting on:

- our view that once a broad programme of early Category C spending that is consistent with the interest of consumers is identified, efficient costs that are incurred consistent with this programme should be added to HAL's RAB;
- a proposal to regulate early Category C costs in a similar way to Category B costs (with the exception of the 85/105 risk sharing mechanism that we intend should only apply to Category B costs), including in relation to allowances for financing costs; and
- the possibility of developing a modification to HAL's licence that would put in place stronger and more formal governance arrangements for the agreed programme of early Category C costs and decisions about whether they should be added to HAL's RAB. This approach could allow each of HAL and airlines the opportunity of an appeal to the Competition and Markets Authority ("CMA") (consistent with the provisions of CAA12) if they thought the CAA's approach in bringing forward the licence modification was wrong.

13. In the light of the potential impact of the decision on early Category C spending on the overall programme timetable, chapter 3 discusses the regulatory timetable and updates our guidance to HAL on its price control business plan due in December 2019. We consult on:

- the proposal to retain December 2019 as the target date for HAL's initial business plan (IBP);
- to the extent it is practicable for the CAA to retain a target of 2021 for its main price control proposals, with greater use of uncertainty mechanisms to deal with those elements of the programme which will inevitably be less certain given a programme of the scale and complexity of capacity expansion at Heathrow;
- retaining the flexibility for the next main price control to include provisions for an interim price control review and to be open minded about the duration of

the price control given the uncertainty with respect to the wider programme timetable; and

- ensuring that the Enhanced Engagement processes that have been put in place between the airport and airlines are sufficiently robust and wide ranging that they also deliver the objectives of the processes we have previously described as Constructive Engagement.

Our duties

14. In developing this consultation, we have had full regard to our statutory duties under the Civil Aviation Act 2012 ("CAA12"), which are set out more fully in Appendix A.

Structure of this document

15. The structure of this consultation document is as follows:

- chapter 1 deals with our policy proposals in respect of Category B costs;
- chapter 2 deals with our emerging thinking and next steps in respect of early Category C costs; and
- chapter 3 covers issues relating to the regulatory timetable and preparation of HAL's price control business plans.

Next steps

16. We invite comments from stakeholders on the issues raised in chapters 1 to 3 of this consultation document by 22 August 2019. We cannot commit to taking account of representations made after this date.

17. Having considered stakeholders views, and emerging evidence, we intend to:

- set out our revised policy for the regulatory treatment of Category B costs in October 2019, as part of our next update on the broader regulatory framework for HAL and capacity expansion;
- report on the outcome of airport and airline discussions on the options for early Category C spending and the timetable for expansion, together with

the CAA's views on these matters (including next steps) in September or October 2019; and

- finalise the principles for the regulatory treatment and governance of early Category C costs in September or October 2019. If we decide it is appropriate to modify HAL's licence with respect to these matters, then we will consult on a draft licence condition at that time.

CHAPTER 1

Policy proposals for Category B costs

Introduction

1.1 Capacity expansion at Heathrow airport involves a very large and complex capital programme. The planning process requires HAL to apply for a DCO and comply with the obligations created by the PA08 and the NPS. In addition to these requirements, the timely and efficient delivery of such a large capital programme requires the assessment of a full range of options for scheme development and consultation with stakeholders (including airlines) on the preferred approach. Taken together, these factors mean that HAL will need to incur substantial planning costs to successfully deliver capacity expansion.

1.2 These planning costs were not allowed for when the last main price control (Q6) was set in 2014. Our present policy in respect of the regulatory treatment of these costs (and how costs consistent with our policy should be recovered by HAL through airport charges) is summarised in the Planning Cost Recovery Policy Statement. We described these costs as “Category B” costs and defined these costs as:

- in general, incurred by HAL after the Government policy announcement on its preferred location for new capacity (25 October 2016); and
- associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow.[12]

1.3 When we published the Planning Cost Recovery Policy Statement, HAL expected that the Category B costs that it would incur might be up to £265 million (2014 prices). Since then, there has been a very significant escalation in HAL’s estimates of the overall level of Category B costs that it will incur. HAL’s most

[12] See paragraph 3.10 of the Planning Cost Recovery Statement.

recent Category B cost estimate (in December 2018) suggests that it will, in total, spend over £500 million on these costs.

1.4 The Planning Cost Policy Recovery Statement made clear that our policy on Category B costs may be reviewed if efficiently incurred Category B costs have exceeded, or appear likely to exceed, £265 million.[13] We said that the CAA's decision on whether to conduct any review of this policy, and the scope of any review, would have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of spending.

1.5 This chapter invites comments on our review of our existing policy and is structured as follows:

- a summary of our current policy on the regulatory treatment of Category B costs;
- HAL's latest projections of its Category B spending; and
- our policy proposals for the future regulatory treatment of Category B costs.

Current policy for the regulatory treatment of Category B costs

1.6 The Planning Cost Recovery Policy Statement defined Category B costs in the way set out in paragraph 1.2 above. The Budget Guidance[14] provided an example list of categories of costs that would be likely to fall within Category B, drawing on our earlier consultations on these costs.[15] In January 2019 we consulted on the recovery by HAL of Category B costs incurred in 2016 and 2017 and a number of issues that have arisen in relation to the categorisation of costs. These matters are dealt with in Appendix B.

[13] See paragraph 1.17 of the Planning Costs Recovery Statement. The £265 million is expressed in 2014 prices. This equates to £298 million in nominal prices. Throughout this consultation, all references to £265 million in respect of our existing Category B cost policy relate to 2014 prices.

[14] See paragraph 3.4 and Table 2 of the Budget Guidance for a full list.

[15] However, the CAA made clear that this list is not exhaustive and should be used as guidance. Furthermore, the CAA will make the final decision on whether any costs should not be treated as Category B costs.

1.7 Our current Category B policy, set out in the Planning Cost Recovery Policy Statement, has four key elements:

- scope of policy and the materiality thresholds that will trigger a review of the policy;
- the recovery mechanisms including the treatment of costs that will ultimately be added to HAL's regulatory asset base (RAB);
- incentive arrangements including the treatment of risks around whether HAL will be granted a DCO; and
- the governance processes, including the role of the Independent Planning Costs Reviewer (IPCR).

These are summarised in Figure 2.

Figure 2: Current Category B costs policy

Existing Category B Costs Policy *Source: Planning Cost Recovery Policy Statement*

Our published Category B costs policy has 4 main elements

1. Scope of policy

Range of costs

Efficiently incurred Category B costs are covered by the existing policy with a review point at £265 million

Above £265 million (2014 prices)

The CAA may conduct a review of our policy for the recovery of costs, depending on:

- the expected materiality of any Category B costs over £265 million (2014 prices); and
- any emerging evidence on the efficiency of these costs.

2. Recovery mechanism

Treatment of Costs

First £10 million per year:
Recovered through higher airport charges through the per passenger correction factor in the Price Control Condition in the licence.

Above £10 million per year:
Capitalised and rolled into HAL's existing RAB. These must be transparently identified and separately reported in the regulatory accounts. HAL should be able to earn the WACC on any Category B costs that are added to the RAB from the date that they are incurred.

The level of the WACC will be the same as that level determined for the price control settlement in force from time to time (currently 5.35%). The WACC will also be applied to the Category B costs in the RAB irrespective of whether the DCO is successful or not (para 2.24 of CAP1513).

Recovery Period

Category B planning costs should be recovered after the outcome of the DCO is known, with the profile of regulatory depreciation taking account of our broader approach to affordability and financeability.

3. Incentive arrangements

Risk sharing

Category B costs above £10 million per year subject to a risk sharing mechanism. The risk sharing factors will be 105/85 based on the success or failure of the DCO. If HAL is successful with its DCO application it would recover 105% of its efficient costs. If unsuccessful it will recover only 85% of its efficient costs.

Unilateral Withdrawal

If HAL withdraws from the planning process the CAA can use its discretion to reduce recovery below the 85% threshold only in certain limited circumstances where there was compelling evidence that HAL had unilaterally withdrawn from the planning process.

We would not expect to reduce recovery below 85% where HAL could demonstrate that it used all reasonable endeavours to continue with the capacity expansion programme.

4. Governance process

Reporting and IPCR

Costs are reported annually and subject to review and scrutiny by the CAA appointed IPCR which will scrutinise and advise the CAA on the inclusion of Category B costs in the RAB.

Note: the CAA will make the final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.

Governance protocol

The Planning Cost Recovery Policy Statement specified that HAL should develop a governance protocol. HAL developed and agreed this protocol with the airline community and finalised it in September 2018 in line with the procedures set out in the Planning Cost Recovery Policy Statement.

1.8 The Planning Cost Recovery Statement also explained that HAL should make available the materials and reports produced for the planning process to the airline community and other stakeholders as soon as practicable and consult the airline community on the rules and principles for the release of confidential information. In the context of the aspirations of the Arora Group and Heathrow West to submit its own DCO application, we have subsequently clarified that HAL should not be required to release information on aspects of its designs or plans that would distort competition or rivalry with Heathrow West (such as the detail of terminal design) but should provide information that is essential for Arora to be able to proceed with its DCO application or where providing information would avoid the substantial duplication of costs that might be recovered from consumers.

Category B cost escalation

1.9 Since we published the Planning Cost Recovery Policy Statement, there has been a very significant escalation in the overall level of Category B costs that HAL expects to incur. HAL's most recent Category B cost estimate, made in December 2018, includes a total spend of over £500 million, significantly more than its original £265 million estimate.

1.10 As noted above, the CAA's decision on whether to conduct any review of our existing policy, and the scope of any review, will have regard to the expected materiality of any Category B costs in excess of £265 million and any emerging evidence on the efficiency of spending.[16]

[16] We define efficiency on page 11, paragraph 3.9 of the Budget Guidance as follows:

"Efficiency is not necessarily about achieving the lowest cost; rather it is about delivering the right outcomes and making informed and robust decisions on scope, cost, time and risk. In this context, costs are considered to be efficiently incurred when:

i. The programme which they are attributable to has been set up to succeed in the early planning stages;

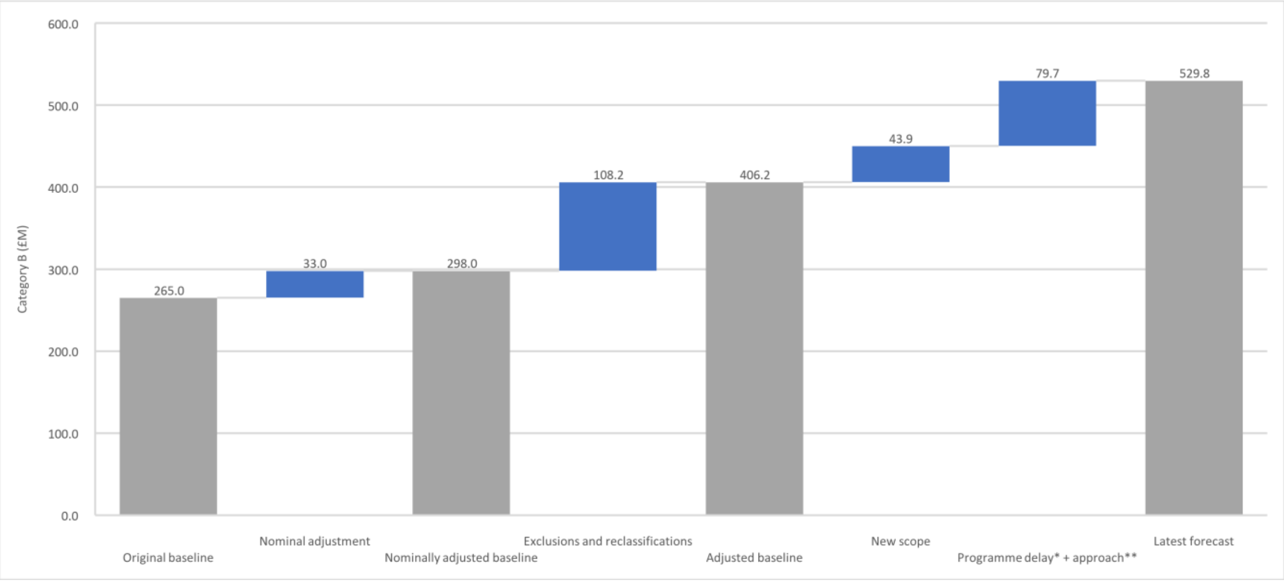
ii. Performance and progress are meaningfully measured to enable management intervention; and

iii. An environment is created which proactively identifies opportunities to improve."

1.11 We understand the main driver of the cost increase to be related to HAL not having developed a sufficiently mature understanding of the scope of work necessary to support the relatively complex planning process when it made its original Category B cost estimate. As shown in Figure 3, based on HAL's presentation to the airport/airline Cost and Benefit Working Group in December 2018, HAL has explained the changes in its estimates of costs in the following terms:

- the cost of new scope not established at the time of the original estimate, for example additional consenting activity, including an additional consultation, increased geographical spread requiring more ground investigation works and improved understanding of stakeholder requirements;
- costs classified as early Category C at the time of the original estimate which have since been reclassified as Category B, such as ground investigations, land referencing and certain staff costs; and
- cost items relating to the original scope but excluded from the original estimate, such as additional operating costs, airspace design costs and the costs of dealing with consultation responses.

Figure 3: Category B costs movement from original estimate



Source: HAL, Based on Cost and Benefit Working Group presentation, December 2018

* These delays relate to the 2017 General Election and Aviation National Policy Statement
** This change in approach refers to top-down verses bottom-up

1.12 The IPCR has reviewed HAL's Category B costs for 2016 and 2017 (as discussed further in Appendix B) with a view to ensuring that costs have been correctly classified as Category B costs and not double counted in terms of costs already allowed for in HAL's main price control. The IPCR has also considered whether there was a clear and consistent baseline, whether established and appropriate governance processes were in place, whether progress and performance was clearly and consistently reported and whether information provided was relevant, complete and timely.

1.13 In each of these areas, the IPCR review highlighted concerns. Stakeholders have also said that this work was not sufficiently wide ranging and there could have been greater focus on whether costs were necessary and represented value for money. Nonetheless, it is also important to bear in mind that HAL was at the start of the planning process in 2016 and 2017 and needed to create momentum to help secure timely delivery and develop an engagement process with airlines that would allow for the exploration of a full range of options.

1.14 At the end of May 2019, HAL shared with us a report prepared for it by consultants, Steer. HAL had asked Steer to consider whether the December 2018 (nominal) £530 million Category B cost estimate is "reasonable" and "justified" and consistent with that which might be expected for a project of this scale and complexity.

1.15 Steer's approach was to use a combination of:

- "top down" benchmarking, drawing on a range of other large UK infrastructure projects which have either been through, or are going through, the DCO process; and
- a "bottom up" assessment of whether the types and levels of costs included in the estimate seem appropriate.

1.16 While we understand that HAL has shared the Steer report with airline stakeholders, it should publish this report so that all stakeholders can comment on the robustness of the evidence on efficiency.

1.17 In summary, there is only limited evidence on the efficiency of HAL's Category B costs and we have observed the near doubling of HAL's estimates of these costs.

These factors strongly suggest that it is appropriate for us to carry out a review of our existing policy in respect Category B costs.

Future treatment of Category B costs

1.18 Overall, we consider that our main policy aim should remain one of ensuring that HAL is able to recover only those Category B costs which:

- fall within the definition of Category B costs which we have developed (including seeking to ensure that there is no double counting of other activities that HAL would be undertaking absent expansion);
- have been efficiently incurred; and
- are consistent with the regulatory incentive arrangements for these costs.

1.19 The cost escalation which we have observed suggests that greater reliance on regulatory incentives for cost efficiency as part of our future Category B policy would be desirable. However, for planning costs there are substantial difficulties in developing effective incentives, including how to:

- benchmark planning costs (due to the limited number of genuinely comparable projects);
- identify and measure the efficiency of spending by reference to deliverables arising from that spending (even though much Category B spending will contribute indirectly to the likelihood of a successful DCO application); and
- avoid creating unintended and adverse consequences: for example, a gain sharing mechanism to encourage efficiency could unintentionally reward HAL for simply reallocating costs.

1.20 Bearing the above in mind, we propose to develop a revised Category B cost policy that focuses on strengthening the existing governance arrangements and, where it is proportionate and reasonable to do so, strengthening the existing regulatory incentives. Our proposals in relation to these matters are described below and summarised in Figure 4.

Strengthening existing governance arrangements

1.21 Stronger and more robust governance of Category B costs is a high priority if these costs are to be correctly allocated and efficiently incurred. HAL should be able to:

- show that it has a good understanding of these costs by clearly and transparently identifying costs, cost drivers and deliverables;
- anticipate and budget for these costs transparently and robustly;
- identify and quantify any risks to meeting its budget and deploy appropriate risk management strategies to minimise any unnecessary cost increases;
- provide evidence that it is incurring costs efficiently; and
- engage regularly with stakeholders on all of the above.

1.22 HAL's approach to governance in 2016 and 2017 did not meet the above objectives and requirements although, as we have noted above, HAL was starting a difficult programme and it is expected that governance arrangements will evolve and improve over time. More recently, HAL has started to improve its approach to governance and has provided greater transparency of its cost estimates. Nonetheless, it needs to make substantial further progress on these matters if it is to win the confidence of stakeholders.

1.23 Our proposed approach to the future governance of Category B costs has three main elements:

i) <u>strengthening reporting requirements:</u> HAL will be required to commit to a governance process that delivers the objectives set out in paragraph 1.21 above. At this stage our intention is that this will also include sharing with us and the airlines, at quarterly intervals [17], an updated forecast for Category B costs including (a) actual spending to date; and (b) the amount it expects to spend on a month by month basis until the DCO process is complete. We will discuss

[17] We understand that quarterly reporting was established by Ofwat in relation to 'development costs' (which are broadly analogous to Category B costs) incurred by Thames Water on the Thames Tideway Tunnel.

further the detail of these arrangements with HAL and airlines to ensure that the final arrangements are proportionate and robust.

We expect HAL to accompany its forecasts with a detailed commentary which describes what costs are included on a month by month basis, what are the expected deliverables and outputs associated with this spending, and how the cost categories are consistent with our definition of Category B costs and to identify what risks exist to meeting this budget and how HAL intends to mitigate these risks.

ii) establishing recovery cap: the CAA will establish a new recovery cap by assessing HAL's overall revised budget (currently about £500 million) for reasonableness (including building on the findings of HAL's Steer report and other evidence including the findings of the IFS and IPCR reviews). At regular intervals and at the same time as it updates its Category B budget, HAL should explicitly consider and report on whether it is likely to breach this recovery cap. If it considers that a breach is likely, it will need to seek stakeholder approval for spending in excess of the cap through its existing approach to engaging stakeholders as specified in its governance protocol with disputes being determined by the CAA. Unless airlines agree to the spending proposed by HAL, or, in the event of a dispute, the CAA considers that such spending is appropriate, no costs above the new recovery cap will be recoverable.

iii) increasing cost scrutiny: we aim to improve our scrutiny of Category B costs, although we recognise that in a new and relatively novel programme such as capacity expansion this assessment remains relatively difficult. We will do this through (a) our approach to setting the recovery cap discussed above, (b) and through the work of the IPCR in continuing to scrutinise Category B costs and making recommendations to CAA as to whether they both fall within the definition of Category B costs and are reasonably efficient. We will consider further whether these scrutiny arrangements could reasonably be strengthened and/or whether there is further work we could reasonably complete on the efficiency of Category B costs.

Strengthening existing regulatory incentives

1.24 Regulatory incentives have the potential to play an important role in ensuring that HAL only seeks to incur costs on an efficient basis. Targeted and effective incentives should seek to reward HAL for efficiency and penalise it for inefficiency, while avoiding incentives for perverse or inefficient behaviour.

1.25 In the light of the recent escalation of HAL's costs estimates and the limited evidence as to the efficiency of these costs, it is appropriate to review the incentive arrangements for these costs to make sure that consumers interests are properly protected and that HAL can continue to recover its efficiently incurred costs.

1.26 Since our policy was established in February 2017, further information has emerged both on the overall level of Category B costs and on HAL's cost of capital. We consider the implications of this additional information below for the incentive arrangements that should apply to HAL's Category B planning costs.

i) <u>Recovery mechanism:</u>

a. The existing regulatory arrangements roll forward those Category B costs that are to be capitalised and added to HAL's RAB at the cost of capital associated with the price arrangements that are currently in force. This means that for costs incurred in 2016 to 2018 costs will have been allowed a return at the Q6 price control real cost of capital of 5.35%. As noted above, since the publication of the February 2017 policy statement that set out this approach further information is available both on the level of Category B costs and HAL's cost of capital. The CAA is also developing further analysis to inform the estimate of the cost of capital for the period of capacity expansion.

b. Given that the increase in HAL's estimates of Category B costs has triggered our review of the regulatory treatment of these costs, it is appropriate to take account of this new information on the cost of capital. Nonetheless, it is also important to maintain the stability of the regulatory framework and not to act retrospectively, as this might increase uncertainty and raise HAL's cost of finance. This suggests allowing a 5.35% real return on Category B costs for the period 2016 to 2019 (for costs up to a maximum of £265m), but reconsidering the cost of capital for spending above this level and for the period 2020 to 2021 (i.e. the point in time when we anticipate that the position becomes clear on planning consent). Once added to the RAB, these costs will be treated consistently with the other items in HAL's RAB and in due course remunerated at the same cost of capital as used to set HAL's next main price control.

c. There are arguments in favour of retaining a real cost of capital of 5.35% for the period 2020 and 2021. It would promote regulatory stability and reflect a relatively high level of return that might compensate for risks associated with capacity expansion. Another approach would be to apply the cost of capital we develop for the next main H7 price control review. The arguments for this approach would be strongest if the risks associated with the Category B expenditure were similar to those for costs that will be incurred after the grant of the DCO. This approach could also avoid setting multiple different costs of capital. However, using a cost of capital that has not yet been calculated, and would not be confirmed until 2021, would reduce transparency and could increase uncertainty as well as arguably having an element of retrospectivity. It is also important to note that if the DCO was not granted, the CAA may not set a cost of capital that corresponded to the period covering expansion.

d. On the other hand, we are not setting full efficiency incentives that would involve a target level and automatic cost sharing incentives around this target for Category B planning.[18] This means that, in practice, the risks for the period 2020 to 2021 may be more like those of HAL's "business as usual activities" rather than the period of capacity expansion. While there are additional risks linked to the possibility that HAL not be granted DCO consent, these are dealt with below under the discussion of the incentive gain share mechanism.

[18] The difficulties of this approach are noted above at paragraph 1.19.

Bearing this in mind, another option for allowing for financing costs over 2020 and 2021 would be to use a cost of capital that is consistent with our estimates of the financing costs for HAL's business as usual activities. For instance, a mid-point from the range of 3.2% to 4.2%[19] based on PwC's February 2019 cost of capital report[20] (which we have uplifted to account for 17% rate of corporation tax and using embedded debt costs of 1.8% as proposed in PwC's December 2017 report[21]) would be 3.7%. Using 1.2% for embedded debt costs would give a real cost of capital of 3.4%. This reflects the more recent estimate which we have available and is broadly consistent with our approach to estimating the WACC for NERL and included in our February 2019 Draft Reference Period 3 ("RP3") performance plan proposals for the regulation of NATS (En Route) plc;[22]. We welcome views on the approach to the estimate of the cost of capital.

e. We will finalise our estimate of the cost of capital to use for the roll forward of HAL's Category B costs for the period up to the government's decision on its DCO application in September or October 2019, following consideration of responses to this consultation.

f. If HAL were to propose spending beyond the new recovery cap (as discussed in the governance section above) and airlines were to agree, or in the event of a dispute the CAA were to consider that such spending is appropriate, this could be financed at our estimate of HAL's current cost of debt. In its December 2017 report, PwC estimated HAL's current real cost of debt in the range of 1.7% to 1.8%

[19] This does not include the impact of expansion, which we are considering for the cost of capital in H7. If this broad proposal is accepted, then we would seek to specify an exact figure within this range.

[20] See PwC report which report presents an updated WACC estimate for HAL in the 'as-is' case for the H7 price control, Estimating the Cost of Capital for H7 - response to stakeholder views

[21] We recognise PwC estimated a lower RPI-deflated embedded cost of debt of 1.2% in its February 2019 report. HAL has responded that it considers PwC has understated its embedded cost of debt. The CAA will be considering PwC's approach and HAL's response during 2019, and at this stage we have taken the conservative approach of using the higher 1.8% cost of embedded debt from PwC's December 2017 report.

[22] See Paragraphs 71.6 to 7.21 of Draft Reference Period 3 performance plan proposals, 'Draft RP3 proposals'

(including both new and embedded debt costs) in line with the pre-tax WACC estimate above. This further tightening of returns should provide an additional incentive and signal to HAL on the importance of controlling costs, while continuing to allow for the financing and recovery of efficient costs.

ii) Incentive risk share mechanism:

a. The incentive risk share mechanism was designed to provide HAL with an incentive to develop a high-quality planning application. Given the escalation in HAL's estimate of Category B costs, it is appropriate to consider whether these arrangements remain appropriate. Generally, it does not seem appropriate to provide HAL with any additional reward for its costs increasing above £265 million.

b. If HAL's application for a DCO is successful, we propose to allow recovery of 100% (as opposed to 105%) of its costs above £265 million and up to the new recovery cap, to the extent that they are consistent with our Category B cost definition and have been efficiently incurred.

c. If HAL's application for a DCO fails, it will be allowed to recover 85% of its Category B costs up to the revised recovery cap, unless it can demonstrate that it used its reasonable or best endeavours to successfully pursue its planning application, when the reduction in its cost recovery would be limited to the first £265 million, consistent with our present policy. We would welcome views on whether it would be best to adopt a reasonable or best endeavours test of HAL's conduct if such circumstances were to arise.

d. If there is clear and compelling evidence that HAL has unilaterally withdrawn from the planning process, consistent with our 2017 policy, we reserve the right to decide that HAL will be able to recover less than 85% of Category B costs.[23]

[23] We would not expect to reduce recovery below 85% where HAL could demonstrate that it used all reasonable endeavours to continue with the capacity expansion programme.

1.27 Our policy on the release of information developed as part of the planning process remains as set out in paragraph 1.8 above.

Figure 4: Proposed Category B costs policy

Proposed Category B Costs Policy

For costs over £265m, highlighting variations from our current policy

1. Scope of policy

Range of costs

Efficiently incurred Category B costs are covered by the existing policy with a review point at £265 million. The proposed policy will apply to costs above £265m.

Above recovery cap

~~The CAA may conduct a review of our policy for the recovery of costs, depending on:~~

- ~~the expected materiality of any Category B costs over £265 million (2014 prices); and~~
- ~~any emerging evidence on the efficiency of these costs.~~

Unless airlines agree to the spending proposed by HAL or, in the event of a dispute, the CAA considers that such spending is appropriate, no costs above the new recovery cap will be allowable.

2. Recovery mechanism

Treatment of Costs

Capitalised and rolled into HAL's existing RAB. These must be transparently identified and separately reported in the regulatory accounts.

HAL should be able to earn the WACC on any Category B costs that are added to the RAB from the date that they are incurred.

The level of the WACC for costs incurred in 2020 and 2021 is subject to further consultation.~~same as that level determined for the price control settlement in force from time to time~~. The WACC will also be applied to the Category B costs in the RAB irrespective of whether the DCO [application] is successful or not (see para 2.24 of CAP1513).

Costs over the new recovery cap which are agreed will be recovered at a lower cost of finance, but at least at the cost of debt finance.

Recovery Period

Category B planning costs should be recovered after the outcome of the DCO is known, with the profile of regulatory depreciation taking account of our broader approach to affordability and financeability.

3. Incentive arrangements

Risk sharing

Category B costs above £265 million per year subject to a risk sharing mechanism. The risk sharing factors will be 100/85 based on the success or failure of HAL's DCO application. If HAL is successful with its application it will recover 100% of its efficient costs over £265m. If unsuccessful it will recover only 85% of its efficient costs, with an extra allowance for costs based on a reasonable/best endeavours test, subject to further consultation.

Unilateral Withdrawal

If HAL withdraws from the planning process the CAA can use its discretion to reduce recovery below the 85% threshold only in certain limited circumstances where there was compelling evidence that HAL had unilaterally withdrawn from the planning process.

We would not expect to reduce recovery below 85% where HAL could demonstrate that it used all reasonable endeavours to continue with the capacity expansion programme.

4. Governance process

Reporting and IPCR

Costs are reported ~~annually~~ quarterly, and a commentary provided on these, and subject to review and scrutiny by the CAA appointed IPCR which will scrutinise and advise the CAA on the inclusion of Category B costs in the RAB. The CAA is considering if the scrutiny arrangements could be strengthened for the 2018 review and beyond and we are putting in place a new recovery cap.

Note: the CAA will make the final decision on the level of planning costs to be added to the RAB, taking into account all the available information, including the advice of the IPCR.

Governance protocol

The Planning Cost Recovery Policy Statement specified that HAL should develop a governance protocol. HAL developed and agreed this protocol with the airline community and finalised it in September 2018 in line with the procedures set out in the Planning Cost Recovery Policy Statement.

Views invited

1.28 Views are invited from stakeholders on any aspect of the issues raised in this chapter and in particular on:

- scope of policy: whether the focus of our policy proposals should be strengthening the governance arrangements for these costs, establishing a new recovery cap and reconsidering the allowances for financing costs for the period 2020 to 2021;
- governance and cost scrutiny: whether our approach to strengthening governance arrangements (including the setting of a new recovery cap) is appropriate and proportionate or whether there are further or different steps we could reasonably take, and how any such further or different steps could work and the advantages and disadvantages of these steps;
- recovery mechanisms: whether we should retain the existing approach to allowing for financing costs and the use of a real cost of capital of 5.35% or whether we should use an updated estimate of the cost of capital for 2020 and 2021. If we use an updated estimate of the cost of capital what should this estimate be. Initial calculations set out in this chapter indicate a possible range for HAL's business as usual real cost of capital of 3.4% to 3.7%. Is this range appropriate or should we adopt alternative calculations or estimates;
- further, if HAL's costs exceed the recovery cap discussed above should the allowance for financing costs for this additional spending be adjusted downwards, perhaps to reflect the estimate of HAL's real cost of debt, which we have estimated at 1.7% to 1.8%; and
- incentive arrangements: whether we should cap the 105% incentive on HAL for a successful DCO application at £265 million of spending and whether we should adopt a reasonable or best endeavours test to higher levels of spending if we need to apply the 85% sharing rate.

Next steps

1.29 We will carefully consider responses to this consultation and intend to publish final proposals on new governance and regulatory arrangements in October 2019. We will also publish our initial assessment of HAL's forecasts of Category B costs, which could form the basis of the recovery cap, if following consultation, we decide to pursue this option.

CHAPTER 2

Early Category C costs

Introduction

2.1 Early Category C costs are those costs that HAL will incur prior to the grant of a DCO permitting capacity expansion (currently targeted for late 2021). These costs will be incurred in addition to the Category B planning costs discussed in chapter 1. HAL's most recent estimates of these costs include the costs of relocating certain large commercial and other facilities, community costs (compensation costs for other commercial activities, agricultural activities and residential property) and other enabling costs for construction. An important requirement for costs to be considered as early Category C expenditure is that the purpose of this expenditure must be to promote the efficient and timely delivery of the overall programme for capacity expansion at Heathrow airport.

2.2 We discussed the possible regulatory treatment of these costs, in terms of determining whether these costs should be added to HAL's RAB, in the April 2018 Consultation. At that time, HAL's latest estimate was that it would spend approximately £650 million (in 2014 prices) on early Category C costs. We stressed the importance of HAL providing further detailed and robust information on each of: (i) its forecasts; (ii) the need for this expenditure; and (iii) evidence and assurance on the efficiency of its proposed spending.

2.3 HAL provided further high-level information in the autumn of 2018 as part of its business plan information for the iH7 price control period (2020-21). While HAL's forecasts of these costs had, by then, increased significantly, suggesting total spending might reach £1.6 billion, it provided only limited information on the reasons for this increase. HAL has now provided more detailed information on its forecasts for these costs and its latest estimate for early Category C costs has increased further to £2.4 billion (in 2014 prices).

2.4 These costs, being very significantly higher than previously forecast, raise difficult issues around whether there is a compelling case for such large amounts of expenditure given that a relatively high proportion of these costs would be sunk and provide consumers with no benefit if HAL were not to obtain a DCO. In addition to working with stakeholders to understand the broad programme of early Category C costs that will be in the best interest of consumers, it is also important for us to consider how any costs that are incurred:

(i) consistently with such a programme; and

(ii) in an economical and efficient manner by HAL,

should be treated under HAL's regulatory framework and price control arrangements.

2.5 This chapter discusses these issues in more detail, including:

- HAL's latest projections of early Category C costs;
- how we should assess whether there is a compelling case for a relatively high level of such costs before HAL obtains a DCO to support capacity expansion;
- once we have an agreed programme of early Category C costs, how such costs incurred consistently with this programme should be regulated including:

  (i) how the risks of HAL not getting a DCO should be managed and allocated;

  (ii) whether costs should be added to HAL's RAB and, if so, what assumptions we should make on financing costs;

  (iii) what arrangements we should put in place to incentivise efficiency; and

  (iv) whether we should seek to bring forward a licence modification to provide stronger and more formal governance arrangements for these costs.

- next steps for establishing a clear position on these important matters, including encouraging discussion and engagement (and, ideally, agreement) between HAL and airline stakeholders on options for early Category C spending and the programme timetable.

HAL's latest projections of Category C costs

2.6 In 2017, HAL produced an estimate of its capital expenditure for expansion of approximately £14 billion (in 2014 prices) over the period to 2026. During 2018 this estimate of the cost of expansion came under pressure and HAL refocused its efforts to establish a master plan design that would be consistent with its original budget and its objectives of delivering capacity expansion in a way that is both affordable and financeable. This led it to review the programme schedule and revise the phasing of its proposals for capital expenditure.

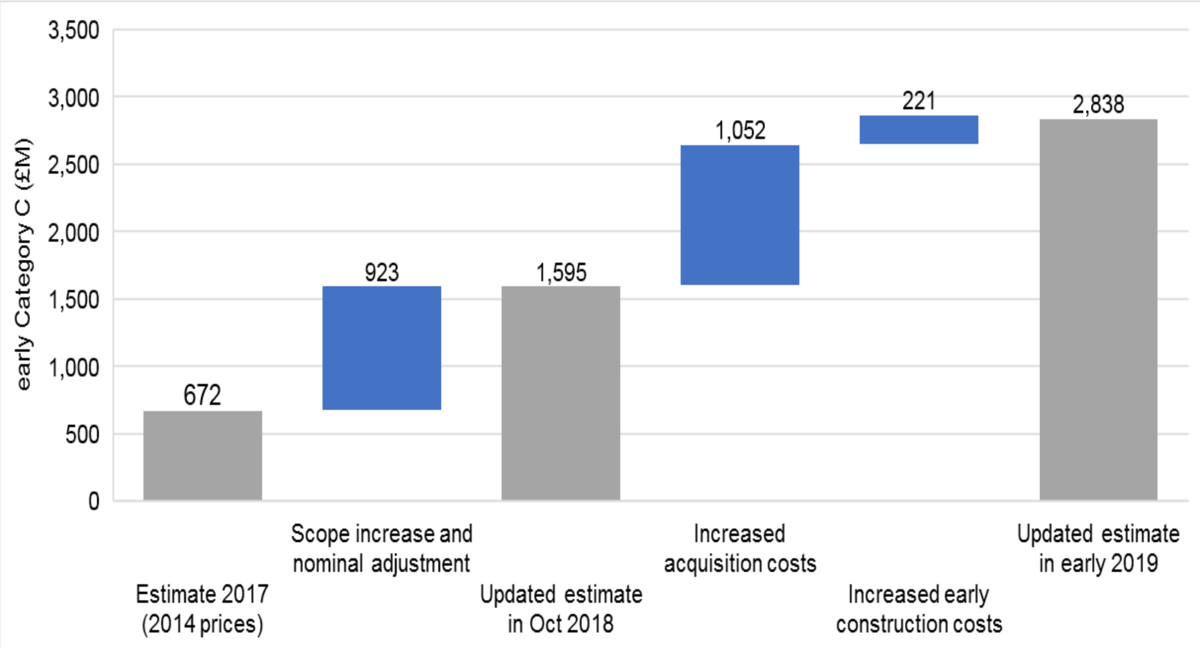
2.7 By re-phasing its proposals for capital expenditure and making changes to the scope of the infrastructure to be delivered by 2026, HAL has been able to develop a master plan broadly consistent with its 2017 budget of £14 billion (in 2014 prices) of expenditure. The IFS has also provided a greater level of assurance both for HAL's estimates of its total capital expenditure and the contingency in its budget.[24] HAL's latest estimates of £14 billion (in 2014 prices) for capital expenditure for expansion to 2026 includes all its Category B costs and Category C costs, including early Category C costs.

2.8 Nonetheless, early Category C spending now forms a greater proportion of HAL's plans, with its estimate of these costs having increased to £2.4 billion (in 2014 prices). HAL has said that these increases are necessary to retain its target opening date for the new runway of 2026, because it would need to ensure a prompt start to construction activities on the grant of a DCO. This approach would require it to have substantially completed both the relocation of certain large commercial/other facilities and its property

[24] The IFS is continuing its work to assure certain further aspects of HAL's plans and will produce further assessments in due course.

acquisition programme in the Compulsory Purchase Zone (CPZ) to the north of the existing airport campus by that time. It has also made substantial allowances for the design, detailed planning and procurement of the new infrastructure to promote timely and efficient spending in later years and has made substantial allowances for the risk of cost inflation consistent with guidance from the IFS.

Figure 5: Category C costs movement from original estimate (in nominal prices)



Source: HAL, Based on Cost and Benefit Working Group presentations

Assessing whether spending is in the interests of consumers

2.9 We consider that it is highly likely that HAL will need to incur some early Category C costs to allow for the expansion to proceed in a timely and efficient way. In particular, it may be appropriate to commence work on the re-provision of certain large facilities where it is uneconomic or impractical to extinguish the facility or where re-provisioning is required by the NPS. In addition, a certain level of spending on design and detailed planning of infrastructure, going beyond that required for the DCO application is highly likely to be necessary for the efficient delivery of capital spending in later years.

2.10 However, HAL's recent projections of £2.4 billion (in 2014 prices) for these costs raise important questions about the most appropriate level for this spending. This higher level of proposed spending reflects the relocation of large commercial/other facilities, community costs and other enabling costs to permit an early start to the very extensive programme of earth works and other construction after the grant of a DCO in late 2021.

2.11 There would be significant advantages for consumers in a programme for capacity expansion at Heathrow airport that delivers new capacity as soon as is practicable. We have consistently said that new capacity is required to prevent future consumers experiencing higher airfares, reduced choice and lower service quality. HAL has provided evidence prepared by Frontier Economics ("Frontier")[25] that suggests that air fares are already affected by the shortage of capacity at Heathrow airport.

2.12 We also observe that some landing slots at Heathrow trade for very significant sums in the secondary market, indicating that capacity constraints may be increasing costs and pushing up prices for consumers. Some of this evidence is contested by airlines, which have highlighted the impact of competition in constraining airfares to consumers.[26] While some of the estimates contained in the Frontier analysis may overestimate the impact of capacity constraints on air fares, we currently consider that, on balance, the evidence suggests that the provision of substantial new capacity at Heathrow would allow for greater competition between airlines and would put downward pressure on air fares.

2.13 Nonetheless, there would also be disadvantages for consumers in the event that HAL does not receive a DCO for capacity expansion but airport

[25] Heathrow have provided two reports by Frontier; "Economic Regulations of Terminal Expansion: A report prepared for Heathrow" dated December 2018 and "Estimating the Congestion Premium at Heathrow: A report prepared for Heathrow" dated May 2019.

[26] IAG submitted a report by RBB Economics: "The effect of congestion at Heathrow Airport: Comments on Frontier and FTI reports" dated February 2019.

charges are increased to fund expenditure that had already taken place on the basis that planning consent would be granted. While HAL may be able to recoup some of this expenditure (for example by selling interests in land it had purchased), a large proportion of these costs could be sunk. If this were to be the case, and HAL were to recoup those costs through its charges, we would expect the higher airport charges this would cause to feed through to higher prices for consumers, even if some of the cost increases were absorbed by airlines.

2.14 We could, in principle, devise regulatory arrangements that allocated the risks of a failure to get a DCO to HAL but, in practice, this would require HAL's investors to be compensated for the risks HAL would face. This risk might be hard to quantify and, therefore, price accurately. In any event, this approach would lead to higher airport charges and would also require the same basic economic assessment of whether the expenditure was worthwhile so that both we and other stakeholders could understand whether it would be in the interests of consumers to proceed with the investment and fund appropriate risk management arrangements. Therefore, simply allocating risks to HAL does not offer a solution to determining whether expenditure on early Category C costs is in the interests of consumers.

2.15 Quantifying the advantages and disadvantages to consumers of different options is not straightforward. To date, the estimates of congestion costs at Heathrow that we have seen are contentious, based either on econometric modelling or analysis of the limited amount of information available on the secondary trading of landing and take-off slots. Quantifying the risks of HAL not being successful with its application for a DCO is also very difficult. While there was strong political backing for the NPS in 2018, this does not mean that a DCO application by HAL will automatically be approved by the Secretary of State or designated government minister in late 2021. There are also other risks, including the possibility of a legal challenge to any decision to grant a DCO. As a result, it is not practical to discount a scenario in which HAL's DCO application fails and consumers face exposure to significant sunk costs.

2.16 We could attempt a quantitative assessment of the costs and benefits of HAL's current programme. Given the uncertainties involved, however, such an approach may not yield clear conclusions. In these circumstances, there are additional advantages in considering a full range of options for both early Category C spending and the target date for opening the new runway, to see if it is practicable to identify options that would continue to provide for reasonably timely delivery (but later than 2026) while involving significantly lower levels of early Category C spending.[27] We have asked HAL to investigate these issues and it has indicated an intention to provide further assessment of options by the end of July 2019. The options being assessed by HAL include:

- reducing spending on early Category C costs consistent with delaying the planned runway opening date by one year;
- identifying the minimum level of early Category C spending necessary to reasonably support its DCO application; and
- the cessation of all work on expansion in September or October 2019 until political and regulatory certainty is provided.

2.17 While these options should provide a useful range of scenarios, we expect HAL to be pragmatic in its assessment and present additional options if its analysis reveals changes to costs and the timetable that might better reflect the interests of consumers. We have asked HAL to complete its initial work on these scenarios by the end of July 2019. It will be particularly important that HAL takes a leading role in engaging with airlines on these matters and actively seeks agreement with airlines on an option that both HAL and airlines can support and is also in the best interests of consumers.

The regulation of early Category C costs

2.18 There is a pressing need to decide on both the preferred option for early Category C spending and the appropriate regulatory treatment of these

[27] The Airports Commission Final Report considered that significant consumer detriment in the absence of expansion was most likely by 2029/30

costs given the possibility that this spending could be significantly above the levels anticipated in the April 2018 Consultation. Decisions are needed as soon as practicable to allow for the orderly planning of expenditure in 2020 and 2021. In these circumstances, it is appropriate for us to consider in parallel:

- what broad programme of early Category C expenditure would be in the interests of consumers; and
- how this spending should be treated by, and incentivised under, the regulatory framework.

2.19 There are a number of important issues that we will need to decide in finalising our approach to the regulation of early Category C costs. These include:

a) what risks should be allocated to HAL and how HAL should be compensated for the risks that it bears;

b) how the governance and regulatory arrangements for early Category C costs should work, including:

   - how the regulatory allowances for early Category C costs should be determined;
   - the approach that should be adopted for deciding on what costs should be added to HAL's RAB;
   - what allowance should be made for financing costs; and
   - when these costs should be recovered through airport charges.

c) how we can best incentivise cost efficiency;

d) whether we should seek to bring forward a licence modification to provide stronger and more formal governance arrangements for these costs; and

e) what the implications of the approach to early Category C spending might be for other aspects of the wider programme timetable, as well as our approach and timetable for developing the regulatory framework and HAL's next main price control review.

2.20 The first four of these issues (a to d) are discussed further below. The final issue, the implications of our approach to early Category C spending for the wider programme and the timetable for developing the regulatory framework for HAL, is discussed further in chapter 3.

The allocation of risks

2.21 The December 2017 and April 2018 Consultations set out an approach to the governance of the costs incurred by HAL in relation to those large commercial and other facilities that will need to be relocated relatively early in the process to allow for the timely delivery of the wider capacity expansion programme. This approach involves the assessment of the case for early expenditure and scrutiny of cost efficiency. Subject to both these tests and the spending being in the interests of consumers, we said that it would be added to HAL's RAB and recovered through airport charges in the future.

2.22 We made it clear that early Category C costs should only be incurred if there were expected benefits to consumers in accelerating the programme or reducing overall costs. We said that this assessment should take account of the uncertainties associated with the programme for capacity expansion, rather than these uncertainties being a constraint on efficient expenditure. Expenditure that satisfied our tests of appropriateness and efficiency would be added to the RAB and recovered from airport charges even if HAL's DCO application were to fail.

2.23 We also noted that our Category B policy provided additional regulatory incentives for HAL to develop and submit a high quality DCO application. We continue to support these incentives for Category B costs but we did not make similar proposals for early Category C costs as we decided that the existing arrangements for Category B costs (i.e. the 85/105 risk sharing arrangement described in chapter 2) provided sufficient incentives on HAL with respect to its DCO application.

2.24 Bearing in mind the prospect of much higher early Category C costs, it is appropriate for us to consider whether the approach to risk allocation that involves airlines and consumers bearing the risks of early Category C spending if HAL were not to be successful with its DCO application remains appropriate. As we have explained above, the difficulty of allocating these risks to HAL is that this would require HAL's investors to be compensated for the risks it would face, and so would, in any case, lead to higher airport charges. Such an approach would require not only the same basic economic assessment of whether the expenditure was worthwhile, but also the quantification of appropriate risk allowances. Given that a significant driver of the risk of HAL not obtaining a DCO could include changes in government, allocating these risks to HAL would not necessarily mean that the risks were (or could be) better managed.

2.25 As HAL does not have control over important elements of these risks, and it would be difficult to quantify appropriate compensation for managing them, it seems appropriate to continue to assume that efficient levels of early Category C spending will be recovered through HAL's RAB and there will be no additional risk sharing mechanism (i.e. the 85/105 risk sharing arrangement will apply only to Category B costs). Nonetheless, this also emphasises the importance of looking carefully at a full range of options for early Category C spending and the timetable, to ensure that the risk for airlines and consumers of bearing sunk costs is reasonable and proportionate.

Governance arrangements and regulatory allowances for early Category C costs

2.26 The December 2017 and April 2018 Consultations envisaged the following governance processes for establishing regulatory allowances for those elements of early Category C costs relating to the costs of relocating large commercial and other projects and certain other commercial and residential compensation costs:[28]

[28] See paragraph 5.15 of the December 2017 Consultation.

- HAL should seek agreement from the airlines on the overall need for, and broad timing of, this expenditure and why it supports a programme schedule that is in the interests of consumers. This should be done through the existing capital expenditure governance protocol. HAL would also explain its approach to providing assurances on cost efficiency;
- a CAA appointed expert would assess the negotiation process and outcome and report to the CAA on the appropriateness of the settlement (with a summary report presented to the relevant airline engagement group);
- we would then determine whether there is any evidence either that spending has not been categorised properly (to guard against the double counting of costs), is inefficient, or not in the interests of consumers, which would justify excluding the recovery of expenditure through the RAB. In doing so, we would consider carefully the evidence that HAL provides on efficiency and that it is pursuing capacity expansion in a way consistent with the interests of consumers, and any representations from airlines and other interested stakeholders; and
- upon making and publishing our determination under the process discussed immediately above, cost recovery would need to be consistent with the overall objectives of affordability and financeability, with any approved expenditure being remunerated at HAL’s cost of capital until it is recovered.

2.27 While a similar approach to governance might be appropriate for higher levels of expenditure, it will be appropriate to consider:

- whether these arrangements should be modified and/or improved; and
- whether the approach to the regulation of Category B costs set out in chapter 1 provides useful precedent for the regulation of early Category C costs.

2.28 Consistent with the approach to Category B planning costs, it will be important to ensure that appropriate budgets, reporting arrangements and cost recovery caps are in place for early Category C costs. It will also be appropriate to adopt similar arrangements for the return on costs from the date that they are incurred until the decision on HAL's DCO application. There are other detailed aspects of the regulatory treatment of early Category C costs that we will need to confirm. These include the timing of cost recovery, whether these costs should be treated in a similar way to core and development costs within the Q6 price control or whether bespoke arrangements should be developed. We will consider responses to this consultation in coming to a final view on all these matters and publish our decisions in September or October 2019.

2.29 As with our approach to Category B costs, this approach should remove any perception that, by allowing for a higher cost of capital, we were providing an incentive for over investment or allowing excess returns. It would still, however, allow for capital expenditure to be efficiently financed and protect the interests of consumers by ensuring that HAL is able to recover its efficiently incurred early Category C costs and associated efficient finance costs.

Incentive mechanism for cost efficiency

2.30 Consistent with our approach to Category B costs, it is appropriate to consider whether there are additional steps we can take to strengthen the incentives on HAL for efficient delivery. It is likely that there will be difficulties in establishing appropriate and reliable benchmarks against which to assess this spending. Given that we have asked HAL to consider different options for this spending, there is also, at present, no established or agreed budget in place. As noted above, it will, therefore, be appropriate for us to address these issues and strengthen governance arrangements.

2.31 Particular considerations apply to spending on other enabling costs that include design, detailed planning and procurement costs. Elements of these costs will be closely related to Category B planning costs, and there could be significant advantages to adopting a similar regulatory treatment for these costs to avoid difficulties and perverse incentives associated with the allocation of costs to different regulatory categories. There could also be interactions with our approach to setting broader incentives for capital efficiency. Our present view is that it is most important and urgent to address the interactions between Category B and early Category C costs. This strengthens the case for similar governance and regulatory arrangements applying to Category B and early Category C costs.

Recognising Category C costs through the licence

2.32 Given the materiality of the sums at stake, and the importance of these matters to stakeholders, there may be advantages for consumers in bringing forward a modification to HAL's licence that could, for example:

- reflect the broad programme of spending that should emerge from further consultation with stakeholders on early Category C costs and timetable; and
- formalise either the principles supporting, or the detail of, the revised governance arrangements that we expect to put in place following consideration of responses to this consultation.

2.33 Such an approach could provide a firmer basis both for decisions on the broad programme of expenditure and for the stronger and more formal governance arrangements for the programme of early Category C costs than we have consulted on up to now. It could also allow each of HAL and airlines the opportunity of an appeal to the CMA (consistent with the provisions of CAA12) if they thought the CAA's approach in bringing forward the licence modification was wrong.

2.34 The CAA12 provides for a process for making licence modifications. In practice this usually involves one or two rounds of consultation on the policy supporting the modification and then a statutory consultation on the final drafting of the condition. After a statutory consultation, the CAA must give due consideration to stakeholders' responses. If appropriate (i.e. the modification is consistent with our duties under CAA12) we can then proceed to direct a modification of HAL's licence.

2.35 How much consultation is required will be influenced by how complex and/or novel the policy is, in order to allow stakeholders time to consider the detailed development of policy and how it was evolving in the light of the evidence available. If a licence modification was required to deal with urgent matters, the underlying policy were simpler, had already been subject to consultation and discussion or reflected an emerging consensus, there may be scope for a single round of consultation ahead of the statutory consultation on the final drafting of the condition.

2.36 This is important in the context of early Category C costs: if we were to decide that a licence condition could be in the interests of consumers, then there may be advantages in bringing forward such a condition sooner rather than later, not least because there may be credible scenarios in which there would be relatively large amounts of early Category C spending in 2020.

2.37 In these circumstances, it is important to consider whether a relatively simple licence modification might be a reasonable and appropriate way forward. Such a licence modification could encompass:

- a very high level description of the programme of early Category C spending that we would have confirmed is appropriate following further discussion and consultation with stakeholders, potentially by reference to documentation that described the programme in more detail;
- acknowledgement that, in referring to such documentation that described the programme in more detail, the purpose would not be to set the detail of the programme “in stone” (which would be unrealistic) but to provide for a baseline from which changes and variations could be considered, subject to appropriate governance arrangements; and
- confirmation of the principles for the governance arrangements that would allow for appropriate consideration and decisions on whether and how to change the detail of the proposed programme. These principles could draw on the arrangements that we have already consulted on for early Category C spending and the additional

governance arrangements set out in this consultation. These could include that:

(i) HAL should set out a reasoned case for, and seek agreement from airlines on, changes to the baseline programme;

(ii) there should be independent assessment of programme costs and efficiency; and

(iii) the CAA would determine the level of costs to be added to HAL's RAB, taking account of information from HAL's engagement with airlines, the delivery of programme objectives and information on efficiency.

2.38 Even with such a relatively simple licence condition, there would be significant policy, process and evidential requirements that would need to be developed to support this approach. These could include, in particular, the need for HAL to discuss and seek to agree with stakeholders and the CAA its broad approach to early Category C spending and the overall programme timetable. As noted above, HAL has committed to bringing forward a range of options for early Category C spending by the end of July and a reasonable expectation might be that there should be two or three months of assessment and discussion of these options before a decision on the best way forward. However, it should be noted that this decision will largely depend on the quality of the evidence that HAL presents to us in July and the success of its engagement with stakeholders on these matters.

2.39 Depending on the evidence supplied by HAL, we would look to set out a way forward on the overall programme for early Category C spending that we are minded to adopt in September or October 2019. However, we note that the development of measures to implement any such approach, including any licence modifications to support this would require further consultation.

2.40 If we do proceed with a licence modification, the CAA12 gives each of HAL and airlines the right to appeal against any decision by the CAA to modify

HAL's licence to the CMA. In such circumstances, there would likely be a further delay of around six months before an appeal was finally determined by the CMA. This, again, emphasizes the importance of HAL considering a range of options for early Category C spending (as it is not clear that the existing timetable will allow for certainty on the regulatory treatment of spending in early 2020) and discussing options with stakeholders to try and reach a mutually agreed way forward that will protect the interests of consumers.

2.41 An appeal to the CMA could lead to the implementation of any licence condition being suspended. If this were to be the case, the licence condition would not have effect, and the CAA would not be able to make any decisions under it. This could clearly lead to the implementation of our preferred approach being delayed.

2.42 Under such circumstances, it will be important to give consideration to what would happen to any early Category C expenditure incurred while any appeal was being heard by the CMA. This might include considering whether, in the circumstances that arise, it would be appropriate for the CAA to provide regulatory guidance or comfort during that period. Given the importance of not undermining the rights of parties to appeal to the CMA the scope of such guidance would be necessarily limited, but it might for instance clarify if there were elements of spending where there appeared to be a particularly strong and compelling case that such spending would be in the interests of consumers.

2.43 It will also be appropriate to consider further how the timetable for deciding on the programme of early Category C spending relates to HAL's M5a programme gateway (at which point airlines will have a formal opportunity to express their commercial views on whether sufficient comfort is available on overall scheme affordability). This is scheduled for early 2020 and should provide airlines with the opportunity to offer their commercial views on whether the overall scheme is affordable and fit for purpose. Airline stakeholders may take the view that the timetable for a licence modification should be coordinated with this programme gateway.

Views invited

2.44 Views are invited from stakeholders on any of the issues raised in this chapter and, in particular, on:

- **our view that once a broad programme of early Category C spending that is consistent with the interest of consumers is identified then costs incurred both consistent with this programme and efficiently should be added to HAL's RAB**;
- our proposal to regulate early Category C costs in a similar way to Category B costs (with the exception of the 85/105 risk sharing mechanism that we intend should only apply to Category B costs) including in relation to allowances for financing costs;
- the possibility of developing a modification to HAL's licence that would put in place appropriate governance arrangements for the agreed programme of early Category C costs and allow for HAL and airlines to appeal to the CMA if they considered that our approach was wrong;
- our view that given HAL is undertaking further work on options for the programme of early Category C spending and timetable and that HAL will then need to consult stakeholders, should a licence condition become necessary to support this spending, it is unlikely to be practicable to put such a condition in place before the end of 2019; and
- whether in the circumstance of an appeal to the CMA there might be scope for regulatory guidance to limit any disruption to the programme where there would be clear detriment to the interests of consumers.

Next steps

2.45 Having considered stakeholders views, and any additional emerging evidence, we intend to finalise the principles for the regulatory treatment and governance of early Category C costs in September or October 2019. If we decide it is appropriate to modify HAL's licence with respect to these matters then we will set out a draft licence condition for further consultation.

2.46 As we have noted above we have asked HAL to look at and report on a range of options for early Category C spending (including options that would involve a significantly lower level of early spending), and the implications of each option for the wider programme timetable and for consumers. We have asked HAL to complete its initial work on these scenarios by the end of July 2019.

2.47 It will be particularly important that HAL takes a leading role in engaging with airlines on these matters and actively seeks agreement with airlines on an option that both HAL and airlines can support and is also in the best interests of consumers. We also expect airlines to engage with HAL on these matters and consider carefully the advantages of reaching agreement with HAL on the best way forward.

2.48 We intend to report on the outcome of airport and airline discussions on the options for early Category C spending and timetable, and the CAA’s views on these matters in September or October 2019.

CHAPTER 3

Timetable and business plan guidance

Introduction

3.1 This chapter deals with issues relating to the regulatory processes for the next main price control review including:

- the regulatory timetable and possible approaches to dealing with the uncertainties associated with the wider expansion programme timetable;
- HAL's initial and final price control business plans, including the issues raised by stakeholders in response to the October 2018 Consultation on these matters;
- our updated guidance to HAL on the scope and content of its price control business plans; and
- our approach to Enhanced Engagement and Constructive Engagement.

3.2 The regulatory timetable may be affected by changes to the wider programme timetable discussed in chapter 2 on early Category C costs and as discussed further below.

3.3 We last discussed business plan guidance in the April 2017 Consultation and so it is timely for us to update on these matters as part of this consultation. This chapter also explains more about how we intend to ensure that the process for Enhanced Engagement between HAL and airlines also delivers the benefits to consumers of Constructive Engagement.

3.4 Finally, we identify key issues for consultation with respect to the above matters and discuss next steps.

Regulatory timetable

Timing of Q6 and H7 price control reviews

3.5 As we have said consistently during our work on developing the regulatory framework for capacity expansion at Heathrow, we consider there should be broad alignment between the timetable for our work to develop the regulatory framework and the wider programme for capacity expansion. To reflect our commitment to this, we extended the price control by one year in 2016 and consulted in February this year on proposals for a further transitional arrangement (based on emerging commercial arrangements between airport and airlines) to cover 2020 and 2021. The intention was that in setting HAL's next main price control we would be able to take into account all the information in HAL's DCO application and its more detailed plans for capacity expansion. We said we would make proposals in 2021 for a five year price control to cover 2022 to 2026.

3.6 The wider timetable for capacity expansion is clearly under a degree of pressure (which is not in itself surprising given the scale and complexity of the programme). We have asked HAL to look at different options for the level of early Category C costs. While its current target date for runway opening remains 2026 these options could involve delays to the overall programme for capacity expansion and the target date for runway opening of a year or more. The Independent Funds Surveyor (IFS) has also identified other risks that might crystallise and lead to further delays of 12-24 months to the date for runway opening (including in relation to the planning process, enabling works and earthworks). HAL's work on options will also take into account the findings of the IFS and so involves certain scenarios with the date for runway opening delayed until 2029 or 2030, with other scenarios focusing on earlier dates for runway opening from 2026 to 2028. It should be noted that these scenarios involve dates for runway opening by 2030, the year in which the NPS sets out the need for an additional runway at Heathrow airport.

3.7 There is considerable further work required on these issues. We expect that the capital programme to achieve runway opening may also stretch out beyond the next main five-year price control period (currently planned to be 2022 to 2026 inclusive). We also expect that some of the cost estimates HAL will be able to provide in 2021, when we are due to finalise our price control proposals, may be less mature than they otherwise would have been in the absence of such timetable pressure.

3.8 In these circumstances, it is important to consider whether the regulatory timetable remains appropriate. Our present view is that there would be a number of advantages in retaining our current timetable for HAL to provide an initial business plan ("IBP") at the end of 2019 and the CAA making price control proposals in 2021, rather than delaying the regulatory timetable or introducing a further transitional period. These advantages include:

- ensuring that consumers benefit from the efficiencies and other gains HAL has made since its main price control was set in 2014;
- providing airlines, consumers, investors and other stakeholders with a degree of certainty on affordability and financeability; and
- avoiding some of the uncertainty and difficulty of a further transitional period (which we have previously said would involve the resetting of additional regulatory assumptions compared to the changes made in support of the transitional arrangements for 2020 and 2021).

3.9 Given the potential timing uncertainties, making price control proposals in 2021 would require us to deal with a greater level of uncertainty about the capital programme than might otherwise be the case (as there would remain scope for a greater range of cost estimates to further mature). Nonetheless, we would have access to the information supporting HAL's DCO application and there is the opportunity to manage the challenges of uncertainty with respect to costs estimates by using established regulatory tools and techniques. These include:

- arrangements for an interim price review to assess elements of the programme that are less certain when the main price control is set;
- the core and development capital expenditure framework, similar to the arrangements that were put in place for the Q6 price control;
- using logging up/down arrangements; and/or
- trigger mechanisms that make adjustments to reflect changing circumstances.

3.10 These mechanisms could help deal with some of the ongoing cost uncertainties and could be developed and implemented in a way that is consistent with greater capital efficiency incentives and the approach to financeability we set out in the March 2019 Consultation on the regulatory framework for HAL. We could also consider a different duration for the next main price control, including extending the control period (for example to six, seven or eight years) to capture the complete phase of the capital programme that would support runway opening.

3.11 It is important to note that there are likely both advantages and disadvantages when it comes to considering different lengths for the next main price control. A longer price control may mean there is more certainty over the CAA's approach to regulation, however other risks may arise, depending on which regulatory assumptions are fixed, as there is greater scope for under or over performance by HAL. By contrast, a shorter price control offers less opportunity for prices to be smoothed over the period, and less time for HAL's management to react to price control incentives and deliver longer-term efficiencies.

3.12 These are significant issues and further work is required on the timetable and the mechanisms that might help deal with uncertainty. In these circumstances there remains the need to retain a degree of flexibility in the regulatory proposals and our approach to all of the above matters (including whether another transitional period might be required) may evolve as further information becomes available later in 2019 and in 2020.

We will also need to take account of the timing of HAL's price control business plan submissions as discussed below.

Initial and final price control business plans

3.13 In the October 2018 Consultation, we said that HAL should provide its price control business plan by the end of December 2019. We also suggested that one high quality business plan with information updated on a flexible basis could provide a proportionate and focused approach to regulation. We said that HAL would also need to be prepared to provide targeted updates to this baseline plan on a timely basis to facilitate the CAA setting HAL's price control in 2021 and taking into account the legal process for modifying HAL's licence.

3.14 In response to the October 2018 Consultation, HAL and airlines outlined a preference for us to return to the structure of the earlier proposed timelines, under which HAL would be asked to produce both an Initial Business Plan ("IBP"), followed by a Final Business Plan ("FBP"). HAL noted that such an approach would better enable it to incorporate consumer, airline and other stakeholder views on its IBP. Airlines considered that an updated business plan would ensure that the CAA's decisions are based on the latest information and that HAL should justify its plan in the round due to the scale and complexity of capacity expansion.

3.15 We also understand that HAL's statutory consultation on airport expansion does not close until September 2019 and that it will need time to process responses and decide how best to modify its plans in the light of these responses. It is unlikely that HAL will have time to reflect such changes in a December 2019 business plan.

3.16 In the light of these representations and issues, we confirm that we will continue with the previous approach of requiring HAL to submit an IBP and FBP. There may be a case for HAL submitting its FBP alongside its DCO application in 2020, but this requires further consideration and we would welcome the views of respondents on these matters. It will also be necessary to consider the implications of the FBP for the wider regulatory timetable and stakeholders should recognise that allowing for both an IBP and FBP will increase the pressure on the regulatory timetable, which may lead to either delay to our final price control proposals until late 2021, with the process for the licence modification spilling into 2022, or an additional transitional year. We will look to clarify the timing of the FBP in our regulatory framework consultation later in 2019.

Business Plan Guidance

3.17 We published the "Business Plan Guidance" in the April 2017 Consultation to assist HAL in the preparation of its H7 business plan and, among other things:

- noted that business plans should be high-quality, clear, robust, and well-justified by supporting evidence;[29]
- confirmed that HAL's Board should certify that its final business plan reflects efficient costs and financing, is affordable, deliverable (including in respect of financeability), and reflects consumer views and preferences to the fullest extent practicable;
- confirmed the principles that should underpin the outcome-based framework that we expect HAL to develop as part of its business plan;
- provided guidance to the Consumer Challenge Board ("CCB") on how it can best frame its advice to the CAA and the areas where it should focus its attention as it begins to engage with HAL and the airlines; and
- set out expectations for Constructive Engagement, including that it should build on the airport/airline engagement taking place on overall scheme design for capacity expansion and that it should encompass both HAL's existing activities and capacity expansion.

[29] Additionally the document set out more detailed criteria under the headings Outcomes and consumer engagement, Resilience, Costs, Incentives and risks, Financeability / affordability and Scope.

3.18 We explained that the CAA would assess the FBP as a key part of setting the H7 price control. This would involve consideration of both how well HAL had met our criteria and feedback from the airline community, the CCB, and other interested stakeholders. We emphasised that we would be unlikely to consider a plan high quality if the airlines, CCB and other stakeholders did not broadly support the plan.

3.19 Over two years have elapsed since we issued the Business Plan Guidance and there have been a number of significant programme and policy developments in the meantime, including the designation of the NPS, the interim price review, and the emergence of HAL's master plan.

3.20 As a result, we have updated the business plan criteria table, which captures the CAA's expectations for HAL's business plans and the new criteria table is set out at Appendix D. In summary the changes made to the table are:

- transparency: this new section emphasises the importance of business plans being open and public documents. Stakeholders can reasonably expect an open and transparent process for the setting of price controls on businesses with substantial market power and should be able to assess and comment in a meaningful way on the key evidence and assurance that support decisions on airport charges. Accordingly, we will tend to give greater weight to information and evidence that HAL provides as part of a published business plan, rather than information that is provided on a confidential basis;
- outcomes and consumer engagement: we have added further detail, reflecting our publications since 2017 and we have confirmed the importance of HAL working closely with airlines and the CCB in developing its business plans;
- resilience: we have highlighted that the pressure on the H7 timetable means that it is even more important that HAL is focussed on resilience in the transition to increased runway capacity and that

better operational resilience is built into the design of an expanded Heathrow airport;

- costs and other revenue building blocks: this section has been expanded so it is clear HAL should provide (i) a reasonably wide range of approaches and scenarios in respect of those operating costs, non-aero revenues, capital costs (asset renewal, replacement and enhancement) and passenger traffic forecasts consistent with its business as usual activities. Where appropriate these forecasts should separately identify the incremental impact of capacity expansion (e.g. the impact of more flights if HAL is successful in using the planning process to lift the cap of the number of air traffic movements) and should include challenging efficiency assumptions; and (ii) costs specific to runway expansion which are consistent with the masterplan (or reconciled to it) and demonstrate the impact on cost of both delays to the runway expansion timetable, events which could lead to cost overruns as well as scenarios that illuminate the level of costs if HAL delivers efficiently and if there were to be lower spending on contingencies;
- incentives in the business plans: we have specified that we expect HAL should take account of the CAA's emerging views on capex incentives and that we expect HAL to provide evidence in support of its proposed incentives;
- financeability and WACC: we have separated these sections given the significantly more detailed policy that we have developed in these areas;
- financeability and affordability: this is a new section and we have made additions to require HAL to use the "price control model" that we are developing to illustrate the affordability and financeability of its business plans. We also expect HAL both to have regard to CAA's policy on financeability[30] and to justify any departures from it;

[30] As set out in CAP1658 and CAP1782

- cost of capital: this section has been expanded to add more detail to reflect that the CAA has undertaken significant work to define the WACC as part of its work on RP3. We expect HAL to have considered this evidence and precedent in making its own proposals. We have also updated this section to reflect our policy on HAL's tax structure and cost of debt indexation;
- alternative delivery models: we have added this new section to reflect our expectations that HAL engages in good faith with third parties coming forward wishing to develop commercial arrangements; and
- scope: we have updated the relevant timelines for the H7 period and added detail on our policy that the final business plan must provide evidence of how HAL's Board has been engaged and agreed that it has submitted the best possible final business plan, and that it reflects the consumer interest.

Constructive engagement

3.21 The interests of consumers are best served when the airport and airlines are working constructively together against a backdrop of CAA regulation which is focused on supporting good consumer outcomes. Our Business Plan Guidance said that constructive engagement should:

- take place between HAL's submission to the CAA of the initial and final business plans;
- bring the operational knowledge and experience of the airline community to bear on the IBP and help the parties identify the best FBP for consumers and airlines;
- be focussed on HAL's business plan, and the investment and services to be delivered by HAL in the next regulatory period; and
- encompass both HAL's existing activities and capacity expansion.

3.22 The approach to constructive engagement for H7 should evolve in the light of the recent developments for capacity expansion at Heathrow airport. Notably, since 2016, HAL and airlines have substantially stepped up their engagement as part of the Enhanced Engagement process for capacity expansion.[31] Through this process, HAL and the airlines have agreed governance and information sharing arrangements to facilitate extensive engagement on capacity expansion.

3.23 Constructive Engagement on the H7 business plan should be carried out alongside the Enhanced Engagement arrangements currently taking place. These two processes should be properly coordinated and, if appropriate, integrated, but it is for HAL and airlines to agree the detail of any changes in the arrangements for engagement. In this light, our expectations for Constructive Engagement are set out below.

Scope:

- the scope of engagement should be agreed and documented by HAL and airlines, and should be focussed on the regulatory building blocks;[32]
- Constructive Engagement should be explicitly focussed on discussing and developing HAL's business plans to reflect and deliver on the interests of consumers; and
- at the same time, Constructive Engagement should be joined up with engagement on expansion for the M5 process which will focus on the affordability, operability and deliverability of HAL's expansion scheme, (and as HAL and airlines have already begun to discuss).

Timing:

- HAL and airlines should engage closely both before and after the publication of the IBP, and set a timeline for Constructive

[31] Under this process, we report to the Department for Transport our assessment of how well HAL is engaging with and responding to the airline community on its plans for capacity expansion at Heathrow airport, and whether this engagement is appropriately reflecting consumers' interests. See https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/180403%20Final%20Enhanced%20Engagement%20ToR.PDF

[32] In light of the new Enhanced Engagement arrangements that have emerged, we consider that HAL and airlines agreeing the scope is preferable to this being prescribed by the regulator in the form of a mandate.

Engagement that should feed into the wider M5 engagement plan currently being developed;

Governance:

- HAL and airlines should review and update the current Enhanced Engagement and Governance Protocol to ensure it is fit for purpose for Constructive Engagement, in addition to the ongoing engagement for capacity expansion.

Information provision:

- engagement should be supported by the timely provision of high quality, detailed and consistent information on the H7 business plan and expansion, consistent with information protocols agreed in the Enhanced Engagement and Governance Protocol and with that provided in respect of Q6**.**

3.20 We understand work has already begun to develop an Enhanced Engagement plan for the M5 process which will focus on airlines' requirements and priorities for an affordable, operable and deliverable expansion scheme. This engagement plan, and the associated governance arrangements, should be sufficiently robust and wide ranging, so that they can also deliver on the expectations for Constructive Engagement noted above.

Views invited

3.24 Views are invited from stakeholders on any of the issues raised in this chapter and, in particular, on:

- the proposal to retain December 2019 as the target date for HAL's IBP;
- to what extent it is practicable for the CAA to retain a target of 2021 for its main price control proposals, with greater use of uncertainty mechanisms to deal with elements of programme which may be less certain;

- retaining the flexibility for the next main price control to include provisions for an interim price control review and to be open minded about the duration of the price control given the uncertainty with respect to the wider programme timetable; and
- ensuring that the Enhanced Engagement processes that have been put in place between the airport and airlines are sufficiently robust and wide ranging that they also deliver the objectives of the processes we have previously described as Constructive Engagement.

Next steps

3.25 As noted we will continue to work on developing the regulatory timetable and aim to clarify our timetable for 2020 and 2021 (including the timing for the FBP) in our regulatory framework consultation in October 2019.

3.26 We will also continue to closely monitor the engagement between airlines and HAL, and we remain open to further discussions with all stakeholders. We will also consider further how we can best target our support and involvement with the HAL-airline engagement process.

APPENDIX A

Our duties

1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services ("AOS"), including capacity expansion, are set out in the CAA12.

2. CAA12 gives the CAA a general ("primary") duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.

3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of "consumers".

4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.

5. In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:

   - the need to secure that each licensee is able to finance its licensed activities;
   - the need to secure that all reasonable demands for AOS are met;
   - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
   - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
   - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
   - the Better Regulation principles.

6. In relation to the capacity expansion at Heathrow, these duties relate to the CAA's functions concerning the activities of HAL as the operator at Heathrow.

7. CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.

8. We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

APPENDIX B

Category B costs incurred to date

Introduction

1. This appendix considers the recoverability of the Category B costs which HAL has already incurred in 2016 and 2017. It follows on from the January 2019 Consultation on the IPCR reports for this period and draws on the responses which we received.[33]

2. This appendix sets out:

- our views on Category B costs incurred before 25 October 2016;
- our decisions on the recovery of Category B costs incurred in 2016 (after 25 October 2016) and 2017 in accordance with our existing published Category B cost policy; and
- an update on our approach to considering the recovery of those Category B costs incurred in 2018.

Category B costs incurred before 25 October 2016

HAL's request for the inclusion of costs incurred before 25 October 2016 within Category B

3. We set out our policy on Category B costs in the Planning Cost Recovery Policy Statement. This policy acknowledged that HAL had incurred costs between the Airports Commission's Final Report in July 2015 and the Government's policy decision in October 2016. However, it also stated that we consider costs incurred before the Government's policy decision as being analogous to "bid costs"

[33] In January 2019, we published the reports of the IPCR on HAL's Category B costs incurred in 2016 (post-25 October) and 2017 (the "First" and "Second" "IPCR Reports"). Alongside these publications, we published a short consultation setting out our initial views on those costs which we were minded to disallow ("the January 2019 Consultation").

incurred by HAL to win the opportunity to build a new runway.[34] We set out that we did not, therefore, consider that these costs fall within the definition of Category B costs. Instead, these costs fell within the definition of Category A costs. These costs are not generally recoverable.

4. That said, we made clear that some Category A costs may be re-categorised as Category B costs if HAL can provide a strong and clear case that the information submitted as part of the DCO planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016. We stressed that we would expect this to be a demanding test as we expect that the scheme design will have evolved over time.

5. HAL has recently confirmed that it considers that £3.9 million of the costs it incurred before 25 October 2016 meet the definition of Category B costs and has asked the CAA to consider these as being appropriate for inclusion in the RAB, using the “in general” exception within the definition of Category B costs. HAL does not consider these to be Category A costs.

CAA views

6. It has become apparent that stakeholders consider that there is some ambiguity between the definitions of Category A and Category B costs, arising from the wording in the definition of Category B costs that “in general” are incurred after 25 October 2016.

7. The Planning Cost Recovery Policy Statement made clear that the “cut off” between Category B costs and Category A costs is the date of the government announcement. The words ‘in general’ were included to reflect the possibility that Category A costs could be re-categorised as Category B costs in the circumstances contemplated in paragraph 3.19 of that statement.

8. In considering the £3.9 million of costs incurred by HAL prior to 25 October 2016 which it considers should be included in the RAB, we will look to determine whether those costs meet the justifications for re-categorisation set out in the Planning Cost Recovery Policy Statement. Specifically, HAL must provide a

[34] See paragraphs 3.18 to 3.21 of the Planning Cost Recovery Policy Statement

strong and clear case that the information submitted as part of the DCO planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016.

9. The evidence provided by HAL in respect of the £3.9 million of costs incurred before 25 October 2016 does not seek to provide evidence that costs meet this test for re-categorisation. Further, given that HAL has not submitted its DCO application, it is not clear that at this stage HAL will be able to provide information consistent with our tests for re-categorisation from Category A costs to Category B costs.

10. HAL would need to provide evidence that these costs meet the test for re-categorisation from Category A costs to Category B costs set out in the Planning Cost Recovery Policy Statement for us to further consider these costs for inclusion in the RAB. We would not expect HAL to be in a position to provide such evidence until after the submission of its DCO application as it will not become clear until that time whether the information submitted as part of the DCO planning process is materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016.

11. We will consider any evidence submitted by HAL for the re-categorisation of costs from Category A to Category B, should it choose to submit this, including after the submission of its DCO application.

Category B costs incurred after 25 October 2016 and during 2017

12. In the January 2019 Consultation, we set out our initial views on Category B costs incurred in 2016 (after 25 October) and 2017. We stated that we were minded to:

- allow a total of £77.3 million; and
- not allow a total of £4.8 million.

13. We asked for comments from stakeholders on both the published reports and our consultation.

Stakeholder views

14. We received four responses to our consultation.

15. The primary concerns of airlines and their representatives were that:

- HAL had not taken the initial review seriously, resulting in the need for the supplementary report;
- the IPCR reviews did not provide assurance over the efficiency of expenditure, specifically whether spend was necessary or represented value for money; and
- HAL had failed to provide evidence that its costs were efficient.

16. Reflecting the concerns set out above, airlines suggested that further work is undertaken around the efficiency of the costs incurred. They also suggested increasing the frequency of Category B reviews and introducing enhanced efficiency tests into the Category B policy.

17. By contrast, HAL set out its rationale for why specific costs, which the CAA was minded to not allow, should be allowed to be recovered.

CAA Views

18. While we acknowledge the concerns expressed by airlines that the reviews did not specifically consider whether costs were necessary, or represented value for money, we are satisfied that the reviews undertaken considered the efficiency of expenditure in line with the requirements set out in the Budget Guidance.

19. Further, while we also acknowledge that there were shortcomings in HAL meeting these tests of efficiency, we are mindful of the fact that the costs incurred in late 2016 and 2017 were at a very early stage of the runway expansion lifecycle at a point when HAL was being actively encouraged to begin its work to prevent later delay.

20. Our view is that it would not be reasonable to expect the governance processes in place at that time to have been as well developed as we would expect for reviews by the IPCR of costs incurred in later years. As a result, we do not plan to undertake further efficiency reviews of the costs incurred in 2016 and 2017.

21. However, we have considered airlines' responses in relation to efficiency in developing wider policy on Category B costs as discussed in chapter 1.

Recoverability of Category B costs for 2016 (after 26 October 2016) and 2017

22. The January 2019 Consultation set out the costs which we were initially minded not to allow. Stakeholders' views and our decisions on each of these are set out below.

Low value invoices

23. We were minded to not allow £1.4 million of low value invoices for which no evidence had been provided. HAL responded that the CAA's policy does not require HAL to provide supporting information on invoices of less than £100,000: rather, the Planning Cost Recovery Policy Statement states that HAL must record expenditure on planning costs on a monthly basis (with any items over £100,000 itemised individually) together with a reconciliation against budget.

24. While acknowledging this, we also note that, in respect of evidence provided to the IPCR, the Planning Cost Recovery Policy Statement states that HAL must provide an annual statement of planning costs that it has incurred within four months of the end of each Regulatory Year "in sufficient detail to allow effective scrutiny by the IPCR and/or the CAA."[35] This is important to ensure that the IPCR's review is both unhindered and independent. Further clarification of the information requirement was subsequently provided in the Budget Guidance. This set out the requirement to provide supporting cost data to the annual statement, although it did not specify the format or detail that this data should take.

25. Given the conclusion set out in the First IPCR Report that there was a significant variance between the annual statement and the evidence to support that statement, it was not unreasonable for the IPCR to request detail supporting the low value invoices as part of its review. Further, we see no reason why it would

[35] See paragraph 5.13 of the Planning Cost Recovery Policy Statement

have been unduly difficult or time consuming for HAL, if appropriate governance had been in place, to provide at least a list of these invoices from its accounting systems to enable testing by the IPCR.

26. Nonetheless, if:

- HAL is able to provide detailed supporting evidence for the low value invoices, as requested by the IPCR during its review, within two weeks of the date of this consultation and we consider that such evidence is sufficient to confirm that the recovery of those costs are appropriate; and
- the detailed supporting evidence can be subsequently verified by the IPCR

we will allow the £1.4 million of low value invoices. Otherwise these costs will not be allowed.

Accruals

27. We were minded to not allow £1.4 million of accruals for which no evidence was provided. We noted that the accruals balance comprised of multiple accruals - each of which was below £100,000. HAL responded that CAA policy does not require HAL to provide supporting information on accruals below £100,000. Further, HAL has clarified that these were accruals in place at the end of each period end and did not reflect the accruals as at the time of the reviews.

28. As above, CAA policy requires HAL to provide evidence to support the annual statement "in sufficient detail to allow effective scrutiny by the IPCR and/or the CAA".[36] We acknowledge that the Budget Guidance indicates that the statement is only required to highlight "[a]ny accruals at year-end included with supporting calculations for any accruals greater than £100,000",[37] but note that this does not refer to the detailed information to support the statement. While we would not expect detailed calculations for the accruals in place for the review, it is not unreasonable to require HAL to provide sufficient detail within the evidence it provides to support the statement to enable testing by the IPCR.

[36] See paragraph 5.13 of the Planning Cost Recovery Policy Statement

[37] See paragraph 5.7 of the Budget Guidance

29. However, we note that conversations between us and the IPCR suggest that HAL was able to provide reasonable explanations of what the accruals related to. Further, we note that the accounting treatment of accruals means that, while these accruals would have been accounted for at the end of the 2017 accounting period with HAL's best estimate as to the expected value of these invoices, they would have been "trued up" in the 2018 accounting period when actual invoices were received, and the invoice values could be confirmed. As such, the actual invoices would be recorded within the 2018 accounting period.

30. Given this, it seems reasonable to allow the accruals in the first instance, but ask for the IPCR to include a review of the "true up" of these balances as part of its review of HAL's costs for 2018. This review should specifically ensure that the accruals balances are reversed in the period following them being accrued, with the relevant invoices being included in the testing of invoices relating to 2018 costs. This will also ensure that there has been no double counting of these costs.

2017 staff costs relating to 2016

31. We were minded to not allow £1.2 million of staff costs which it was not clear related to solely seeking planning consent. The IPCR highlighted that the evidence to support these costs indicated that they were incurred prior to the Government announcement in October 2016 and that "further information is required to confirm whether these costs are solely associated with seeking planning permission".[38] HAL's response asserted, without evidence in support, that "these costs are part of the remuneration of colleagues employed on the Heathrow Expansion". As no further evidence was provided to support this claim this does not constitute the confirmation requested by the IPCR.

32. As a result, and in the absence of any other evidence to support the recovery of these costs, our position remains that it is not appropriate to allow these costs. However, we also note that, to the extent that these costs relate to a period prior to 25 October 2016, HAL may choose to include them in the appropriate

[38] See the Second IPCR report, page 11

statement for that period for re-categorisation from Category A to Category B costs. Should this be the case, these costs will be considered as part of the review of that statement.

2018 costs

33. We were minded to not allow £0.5 million of costs which were included on the 2017 statement but did not appear to have been incurred in 2017 "given the invoices were dated 2018."[39] In its response, HAL stated that these costs should be reviewed as part of the IPCR review of 2018 Category B costs.

34. Given these costs appear to relate to 2018, we agree that they should be reviewed as part of the IPCR's work in respect of for 2018, should HAL choose to include these in its 2018 statement. As such, these costs will not be allowed within the recovery of Category B costs for 2017.

Costs incurred before 25 October 2016

35. We were minded to not allow £0.3 million of costs which were included on the 2016 statement of costs for the period after 25 October 2016, but which appeared to have been incurred prior to the Government announcement. In its response to our consultation, HAL stated that these costs should be reviewed as part of the CAA's review of costs incurred before 25 October 2016.

36. Given these costs appear to relate to the period before the government announcement, we agree that they should be reviewed as part of any review of Category B costs incurred prior to 25 October 2016, should HAL choose to include these on the appropriate statement for re-categorisation from Category A to Category B costs. As such, these costs will not be allowed with the recovery of 2016 Category B costs. As set out above, recovery will be allowed only if HAL can provide a strong and clear case that the information submitted as part of the DCO planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016. We

[39] See the Second IPCR report, page 10

stress again that we expect this to be a demanding test as we expect that the scheme design will have evolved over time.

Summary of our decisions on the recoverability of Category B costs for 2016 and 2017

37. The table below summarises our decisions set out above on the Category B costs for 2016 (post-26 October) and 2017 set out above:

Cost Description	**Cost Value (£ million)**	**Allowed/ Not Allowed**	**2016 (post 26 October) (£ million)**	**2017 (£ million)**
Evidence backed costs	77.311	Allowed	3.623	73.688
Low value invoices	1.423	Allowed (1)	0.335	1.088
Accruals	1.445	Allowed (2)	0.125	1.320
2017 staff costs relating to 2016	1.169	Not Allowed	-	1.169
2018 costs	0.515	Not Allowed	-	0.515
Pre-25 October 2016 costs	0.319	Not Allowed	0.319	-
Total costs on Statement submission	82.182		4.402	77.780
Total Allowed	**80.179**		**4.083**	**76.096**
Total Not Allowed	**2.003**		**0.319**	**1.684**

Notes:

1) The low value invoices will be allowed only if HAL is able to provide a breakdown, in sufficient detail to allow scrutiny by the IPCR of these costs within two weeks of the date of the publication of this consultation and if the IPCR is able to verify that these costs are appropriate.

2) Allowed, but the “true up” of these costs will be reviewed as part of the 2018 IPCR review.

2018 Category B costs

38. In early May 2019, HAL submitted its annual statement of Category B costs incurred during 2018, along with supporting information.

39. We have appointed PwC as the Independent Planning Cost Reviewer (IPCR) for the review of HAL's 2018 Category B costs. PwC has now commenced its review.

40. Following the reviews that took place last year, where a supplementary review was needed due to incomplete information being provided in the first review, we met with both PwC and members of the HAL team in advance of HAL submitting its annual statement and supporting information, to set expectations and to facilitate a more efficient process.

41. This included introducing a 'discovery phase' for the first two weeks of the review, providing an opportunity for a high level review of the Statement, supporting schedules and other information provided by HAL to ensure that this provided sufficient grounding for the continuation of the more detailed review.

42. This discovery phase has now completed. Following this, the CAA and PwC have met and agreed that the information provided is of a suitable quality to enable the review to progress to the more detailed phase.

43. We anticipate publishing the report in respect of the 2018 review in late Summer 2019.

APPENDIX C

Definition of costs incurred in the expansion of capacity at Heathrow airport

1. This appendix sets out an overview of the types of costs, and their inter-relationship, incurred in the course of expanding capacity at Heathrow airport, as set out across out previous consultations and policy statements.

2. Costs fall under one of four definitions: Category A; Category B, Category C and early Category C. These are set out in the table below.

Types of Costs to support capacity expansion at Heathrow

The types of costs to be incurred to support capacity expansion at Heathrow are set out in CAP 1469, CAP 1513 and CAP 1658

Category A costs	Category B costs	Category C costs	Early Category C costs
Costs which are incurred by HAL during the Airports Commission process, or before Heathrow was named as the preferred location for new runway capacity on 25 October 2016. *[CAP 1513, paragraph 3.20]* On an exceptional basis, some Category A costs may be recategorised as Category B costs if HAL can provide a strong and clear case that the information submitted as part of the DCO planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016. *[CAP 1513, paragraph 3.21]*	Costs which are: • in general[1], incurred by HAL after the Government policy announcement on its preferred location for new capacity (25 October 2016); and • associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow. *[CAP 1513, paragraph 3.10]*	Costs incurred by HAL in connection with implementation and construction of new capacity, up to entry-into-operation. The majority of these costs will typically be incurred after planning permission is granted. *[CAP 1651, appendix A]*	Those costs that HAL will incur prior to the grant of a DCO permitting capacity expansion. These costs will be incurred in addition to the Category B planning costs. They include the costs of relocating certain large commercial and other facilities, community costs (compensation costs for other commercial activities, agricultural activities and residential property) and other enabling costs for construction. *[Chapter 2, paragraph 2.1]]*.

[1] As discussed in Appendix B, the 'in general' exception reflects the ability of costs to be re-categorised from Category A to Category B only in the circumstances contemplated in paragraph 3.19 of the Planning Costs Recovery Statement.

APPENDIX D
Business plan guidance

High-quality business plans

1. In providing price control business plan guidance our intention is to increase transparency with respect to our expectations of HAL and help it to produce more targeted and focused business planning information and a higher quality IBP and FBP. This should assist us in developing HAL's next main price control and help to improve the scope and depth of the discussions which take place in Constructive Engagement between HAL and the airlines, and thus further improve the FBP which should form a key input to the final H7 price control settlement.

2. **HAL's business plans should be high-quality, clear, robust, and well-justified by supporting evidence and assurance.** We set out more detailed criteria for a high-quality business plan in Table 1 below.

3. We also expect that as part of the process for HAL submitting its FBP to the CAA, HAL's Board will certify that the business plan is:

   - based on efficient costs and financing;
   - affordable;
   - deliverable (including in respect of financeability); and

- reflects consumer views and preferences to the fullest extent practicable.

4. HAL's Board should submit a statement alongside the FBP that explains its views of the plan, and how its members have assured themselves of its quality.

5. The CAA will assess the IBP and FBP as a key part of setting the H7 price control. This will involve consideration of both how well HAL has met the criteria summarised in Table 1 and feedback from the airline community, the CCB, and other interested stakeholders. It is important to underline that a strong indication of a high-quality business plan will be broad support from key stakeholders (including the airlines and CCB) and/or a clear recognition by stakeholders that the business plan is based on high quality evidence, analysis and assessment.

Table 1: Business Plan criteria

Outcomes and consumer engagement	• For the successful implementation of outcome-based regulation (OBR) it is necessary for HAL to build on the success of the existing Service Quality Rebate and Bonus (SQRB) scheme, including by retaining many of the current metrics, where appropriate. This means that the scope of OBR should capture elements where HAL provides service directly to passengers (e.g. security), as well as elements of airport operation services focussed on enabling airlines to provide service to passengers (e.g. stands and jetties). • HAL's plans should take account of and demonstrate a deep understanding of consumer preferences based on a wide range of engagement and research. Its approach should be reviewed and tested by the CCB. We expect HAL will have taken careful account of the challenge and other feedback it receives from the CCB. Where its approach does not fully align with the views of the CCB, HAL should explain and justify its reasoning for doing so. • HAL should propose outcomes which reflect the most important aspects of airport services to consumers. Each outcome should have one or more performance measures associated with it, and the overall package of measures should cover all aspects of airport operations that are either directly or indirectly important to consumers. All the

	outcome performance measures should include reasonably challenging target levels of service performance, which reflect consumer views. The majority of targets should have associated financial incentives on HAL, though reputational incentives may also be appropriate. • There should be strong evidence that (i) consumers have been fully engaged in developing the outcomes that HAL proposes to deliver and (ii) the overall outcome-based regulation framework has been tested with consumers. HAL should be clear about how engagement has shaped and influenced the proposed outcomes, measures, targets and incentives. We expect HAL to have followed a clear and transparent process to be used to convert consumer research into business plan outcomes. • Throughout its plans, we expect HAL to demonstrate that it has made robust assumptions, that possible options have been carefully considered (including the trade-off between affordability and service), and how in the FBP strategic choices have been made. We expect HAL to be explicit that the options proposed are best placed to achieve maximum value for consumers. • In addition to robust engagement with consumers, HAL should engage extensively with airlines throughout the process, including in the development of the IBP. Airlines have a vital role to play in helping to deliver service quality and, thus, HAL should: (i) develop a coordinated approach to service provision with airlines; and (ii) collaborate closely with them in finalising the outcome-based framework.
Resilience	• The CAA has been consistent in its views that capacity expansion will improve the range of options for resilience at Heathrow airport for the benefit of consumers. HAL's business plans should include a clear focus on the resilience of the airport. Its plans need to provide evidence on the following topics: ○ how it will ensure a sufficient level of resilience is maintained throughout the transition to an expanded Heathrow airport so that consumers are not impacted by disruption that might arise from construction and/or from any early increase in capacity.

	○ that sufficient resilience is being built into the design of new infrastructure so that it is fit for purpose and operable for airlines and other stakeholders. We expect HAL to provide evidence on how it has considered and evaluated linkages and trade-offs between resilience, operability, affordability and deliverability, and to justify how the end result reflects consumer interests. ○ how resilience will be built into its asset management and maintenance plans. ○ how the airport will remain operationally resilient over the H7 period and how any additional capacity will be appropriately released and used to maintain sufficient resilience in the longer term. • HAL must also ensure its approach to resilience is joined up across the business (expansion and business as usual) and thus reflected not only in the business plan, but also in its operational resilience plan (consistent with its licence obligations). In particular: ○ we expect HAL to ensure its operational resilience plan is appropriately focused and includes clear contingency measures to enable a joined up, airport-wide response to disruption that might arise during the transition period. ○ HAL must also provide evidence that it has developed and tested robust resilience contingency arrangements in collaboration with other stakeholders, to mitigate the operational impacts and disruption resulting from any additional capacity or early growth that is introduced before the third runway is built. • HAL must consider any updated resilience guidance we issue under the licence and ensure it is taken into account when updating its operational resilience plan.
Costs and other revenue building blocks	• HAL should provide a wide range of approaches and scenarios in respect of those operating costs, non-aero revenues, capital costs (asset renewal, replacement and enhancement) and passenger traffic forecasts consistent with its business as usual (BAU) activities. • Where appropriate these forecasts should separately identify the incremental impact of capacity expansion (e.g. the impact of more flights if HAL is successful in using the planning process to lift the cap of the number of air traffic movements) and should include challenging efficiency assumptions.

	• HAL should also provide detailed capital cost forecasts for capacity expansion, which are consistent with the masterplan (or reconciled to it) and demonstrate risk and challenges which might impact the delivery of the capacity expansion on time and budget, and how the plans have appropriate levels of contingency within them; these should also include scenarios that illuminate the level of costs if HAL delivers efficiently and/or with lower spending on contingency. The phasing of expansion capex should be consistent with its approach to passenger traffic forecasts, affordability and financeability.
	• HAL should provide all costs and revenue in both nominal terms and in 2018 prices making clear the assumptions it is making on inflation.
	• HAL should expressly set out how it has sought to ensure there is no double counting of costs between BAU and expansion costs, particularly in respect of areas where costs which were previously included within BAU have been reallocated to runway expansion costs – including both capital and operating costs (in respect of operating costs, for example, but not limited to, colleague costs and some accommodation costs).
	• With respect to BAU:
	  ○ evidence should be provided showing a wide range of possible cost options, including both operating and capital solutions and the links with outcomes. The IBP should clearly illustrate how the best options have been selected and how maximum value for money will be achieved;
	  ○ a description should be included of how costs have been allocated between BAU and expansion costs and where costs have been moved from BAU to expansion and vice versa;
	  ○ the granularity of cost data provided should be consistent with that provided to CAA as part of the regulatory accounts;
	  ○ forecast of costs should be fully explained, which should include an evaluation of past performance together with challenging assumptions about the scope for increased efficiency in the future. This should include identifying those costs which HAL does not consider to be within its control (for instance because they are determined by a

	wider market). Where practicable costs should be market-tested or benchmarked, and baseline assumptions clearly explained.
	• With respect to capacity expansion costs:
	  ○ forecast costs should reflect (and be reconciled to) the latest masterplan costs;
	  ○ there should be a clear line of sight between cost forecasts provided over time and the most recent cost forecasts and all costs should be presented in a format consistent with that provided in respect of the regulatory accounts to aid comparability;
	  ○ forecast costs should also reflect the latest CAA costs policy and should be broken down by cost type, i.e. Category B, early Category C and Category C;
	  ○ each cost type should be further broken down to reflect the level of detail provided in the relevant cost type dashboard, as presented to the Cost and Benefit Working Group (CBWG) on a quarterly basis;
	  ○ where Category B planning costs and early Category C costs are concerned HAL should show the expected timing and level of additions to the RAB (using the current CAA policy, including the appropriate rate of return to be applied from the cost being incurred);
	Scenario analysis should be provided to demonstrate the impact on each cost type of both delays to the runway expansion timetable (including, but not limited to, a delay to the DCO decision and construction delays) and events which could lead to overrunning costs (including, but not limited to, construction price inflation being higher than expected).

Incentives and risks	• HAL should identify key risks associated with delivering its plans. We expect HAL to identify the risks that it is able to control. For risks within HAL's control, HAL should be incentivised to manage these to the best of its ability, without unduly impacting the business. Risk management and mitigation strategies should be clear and proportionate.
	• At a minimum, we expect this list of incentives to include the proposed regulatory treatment of:
	  ○ outcomes;
	  ○ operational expenditure;

	○ capital expenditure; ○ commercial revenues; and ○ traffic volumes. • With the exception of outcomes and capital expenditure (which have special arrangements, as described below), we expect the same arrangements as in Q6 to apply. If HAL wishes to depart from these, it should set out the case for and evidence supporting. • HAL should be clear on the allocation of residual risks and on how the proposed allocation is consistent with protecting the interests of consumers. • For outcome incentives, HAL should prepare an outcome-based approach to service quality regulation as described above (higher in table). • For capex efficiency incentives, HAL should put forward its proposals for meaningful financial incentives for capital efficiency, clearly explaining any differences with the CAA's latest views. We regard incentives for capital efficiency as an essential part of a credible business plan. • The IBP and FBP should include a quantitative assessment of the potential individual and collective impact of the proposed incentive mechanisms. This assessment should identify the impact in terms of both charge per passenger and return on regulatory equity. The assessment should, where possible, be linked to the downside scenarios examined for financeability analysis. • HAL should make clear in its business plan: ○ how it has consulted with stakeholders on these issues; ○ what comments stakeholders have made in relation to incentives and risk allocation; and ○ how those comments have been taken into consideration in developing the incentives and risk allocations set out in the business plan.

Financeability and affordability	• HAL should provide robust evidence that its FBP is financeable and affordable. • The CAA recognises the importance of HAL maintaining an ability to raise debt with a reasonable investment grade rating to support financeability. Recognising the need to ensure that the business plan remains affordable, HAL should outline what structural and regulatory options/changes would best maintain the rating while being consistent with the interests of stakeholders. • The analysis of affordability and financeability should include a baseline assessment using the CAA's price control model ("PCM") and should be accompanied by a data book detailing the rationale for all assumptions.[40] • The analysis of affordability and financeability should test a range of downside scenarios examining separately the impact of controllable and non-controllable factors on the key affordability and financeability measures. • To the extent that HAL wishes to use other models (besides the PCM) to assess affordability and financeability, these models (and their results) should be provided as part of the business plan submission along with commentary and analysis reconciling the results to those of the PCM. • HAL's baseline affordability and financeability assessment should be undertaken with regard to the CAA's statements on financeability policy and we would expect HAL to examine the same key metrics and use the same broad approach to determine the downside scenarios that it tests. In addition, HAL is free to provide further assessment of affordability and financeability using a different approach though any departures from the CAA's policy statements on financeability should be identified and justified.

[40] The price control model is currently in development and the CAA is engaging with HAL and other stakeholders on the scope and design of the PCM to ensure that the final model meets all stakeholders' needs. The PCM is due to be tested with stakeholders over the summer and to be released as a final version in September 2019.

	• In the event that HAL considers that adjustments of any sort are needed to support the affordability or financeability of its business plan, these adjustments should be clearly identified and justified with analysis of their impact in terms of financeability and affordability. • Where practical, HAL should seek third party assurance of its assessment of affordability and financeability.

Cost of capital	• HAL's proposal on the WACC should be consistent with efficient financing and its assumptions on risks and incentives.
	• HAL should assume a cost of capital for H7 no more than the efficient level necessary to compensate HAL for the business and regulatory risks it faces.
	• In estimating the efficient cost of capital for its business plan, HAL should align this with:
	  ○ recent UK regulatory precedent published since the Q6 decision;
	  ○ market evidence on cost of capital parameters; and
	  ○ the business and capacity expansion risks it faces.
	• In relation to recent UK regulatory precedent, we would expect HAL to provide a cost of capital that is estimated using market wide components (such as total market return and risk-free rate) that are consistent with recent publications from the CAA, including for RP3 and report by PwC on H7. HAL should also refer to recent papers from other UK regulators. In particular, changes in these market-wide parameters since Q6 have materially reduced the required cost of capital, all other things being equal.
	• In any cases where HAL proposes market wide components that depart from recent UK regulatory precedent, we would expect high quality evidence to support HAL's assumptions and we would expect it to undertake additional financeability testing under alternative assumptions that are consistent with recent regulatory precedent.
	• HAL should also reflect recent regulatory precedent and market evidence in its estimates for the cost of debt and other components of the cost of equity.

	• We would expect HAL to propose a tax allowance within or outside the WACC that provides a fair remuneration for the tax it expects to incur during the H7 price control period. The CAA will provide further details on its tax policy during 2019. • HAL should assume indexation for the cost of new debt and clearly identify its assumption for the opening cost of new debt, a forecast cost of debt and explain the impact of its assumptions and approach to debt indexation. • HAL should set out its assumptions used to estimate the cost of capital, including the rate of RPI inflation to set the cost of capital in RPI-deflated terms, consistent with proposed indexation of the regulatory asset base.
Scope	• HAL's business plans must be integrated and fully encompass proposals for both existing operations and the new runway capacity expansion. • The focus should be on the period from the end of the existing price control arrangements (December 2021) to the expected opening of the new runway with higher level projections to demonstrate longer-term financeability and affordability beyond that point. • HAL should provide a level of detail on projects which reflects the time periods for delivery: projects that are further in the future will typically have less detail. • HAL's final business plan must be certified by HAL's Board that it reflects consumer views and preferences to the fullest extent practicable, is based on efficient costs and financing, and is affordable, deliverable and financeable. This certification should include a statement from the Board explaining its views on the plan, and how it has assured itself of the plan's quality and that it furthers the interests of users.
Alternative delivery modelts	• In its business plans, HAL should account for how it has engaged in a proactive, timely and constructive way with interested and credible parties on alternative delivery and commercial arrangements. • Where HAL has not taken forward genuine alternative proposals, we will expect that it is able to demonstrate that its preferred approach better serves the interests of consumers and provides better value for money than the alternative.

Transparency	• HAL's should be as transparent as possible in the information it provides in its business plans. We consider that for a plan to be considered high quality, all stakeholders must have been able to meaningfully assess and comment on the plans. • In assessing HAL's business plans, we will tend to give greater weight to the information evidence that HAL provides as part of a published business plan, rather than information that is provided on a confidential basis.