Consumers and Markets Group

Economic regulation of Heathrow: policy update and consultation

CAP 1940

Published by the Civil Aviation Authority, 2020

Civil Aviation Authority,
Aviation House,
Beehive Ring Road
Crawley
West Sussex
RH6 0YR.

First published June 2020

Enquiries regarding the content of this publication should be addressed to: jon.clyne@caa.co.uk

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

About this document

This consultation follows on from our April 2020 Update on our programme for the development of the economic regulation of Heathrow Airport Limited ("HAL"). It deals with the following main issues:

- the responses we received to the April 2020 Update and our approach to protecting the interests of consumers;
- requirements for HAL's revised business plan ("RBP"), which it is due to publish in the autumn of 2020;
- improving the efficiency incentives and capital expenditure governance arrangements for the H7 price control period; and
- further thoughts on our approach to assessing HAL's financeability and setting the cost of capital for the H7 price control period.

HAL has paused its work on capacity expansion at Heathrow airport. We also address the regulatory treatment of expenditure incurred to date on expansion.

Views invited

We welcome views on all the issues raised in this document and, in particular, the issues set out in the executive summary and those highlighted in chapters 1 to 4.

Please e-mail responses to economicregulation@caa.co.uk by no later than 18 August 2020. We cannot commit to take into account 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 Jon Clyne (jon.clyne@caa.co.uk).

Executive summary and introduction

Introduction

1. In the April 2020 Update[1] on the economic regulation of HAL, we explained that recent developments were having a fundamental impact on Heathrow airport and the aviation sector more widely. The position now remains broadly similar to that in April: in its response to the April 2020 Update, HAL noted that passenger numbers at Heathrow have fallen by around 97%.

2. Prior to the full impact on traffic of the covid-19 pandemic being felt, the Court of Appeal had delivered its judgment that the NPS had not been lawfully produced.[2] This judgment removed the underpinning under the Planning Act 2008 which HAL was using to support an application for planning consent for expansion. This judgment is, however, subject to an appeal by HAL to the Supreme Court and any review of the policy set out in the NPS that may be carried out by the Government.[3]

3. These developments have caused us to refocus our work on the economic regulation of HAL. In particular, the April 2020 Update outlined our proposal to continue work on HAL's next price control (“H7”), but with a focus on a "two runway" airport, with the intention of having a new price control in place from 1 January 2022 on the expiry of the existing regulatory arrangements.

4. We noted in the April 2020 Update that the challenges created by the impact of the covid-19 pandemic will present significant difficulties, and it would not be realistic to think of the work we should do to set new regulatory arrangements as a "business as usual" process. Instead, we outlined how we are seeking to respond to these challenges, including through:

[1] References to previous CAA consultations, and definitions of terms used in this consultation are set out in the glossary at Appendix B.

[2] See: *R (Friends of the Earth)* v *Secretary of State for Transport and Others* [2020] EWCA Civ 214

[3] We note that HAL has obtained leave to appeal from the Supreme Court. See: https://www.supremecourt.uk/news/permission-to-appeal-decisions-07-may-2020.html

- changes to the regulatory programme and timetable;
- the use of scenarios to help explore how the present uncertainty might start to crystallise in the likely future path of air traffic volumes, and airport costs and revenues; and
- a more flexible and interactive process and timetable, but with a continuing emphasis on the importance of the CE process between HAL and its airline customers.

Main issues raised in this consultation

5. This consultation deals with the following main issues:
   - the responses we received to the April 2020 Update and our approach to protecting the interests of consumers;
   - requirements for HAL's revised business plan ("RBP"), which it is due to publish in the autumn of 2020;
   - improved efficiency incentives and capital expenditure governance arrangements for the next price control period; and
   - further thoughts on our approach to assessing HAL's financeability and setting the cost of capital for the H7 price control review.
6. Bearing in mind the pause in the expansion programme, we also address a number of issues that were raised in our previous policy consultations but where policy had not yet been finalised, including:
   - the regulatory treatment of the early costs of expansion (i.e. the costs that HAL has already incurred in respect of expansion);
   - licence conditions relating to financial resilience and ring fencing; and
   - the regulatory treatment of the alternative arrangements for expansion proposed by Heathrow West.

Responses to the April 2020 Update and our high level approach to protecting the interests of consumers

7. Respondents to the April 2020 Update broadly supported:

our assessment of the impact of the covid-19 pandemic on HAL and the aviation industry; and

our suggestion that we should refocus our work on a two runway price control.

8. Airlines stressed the importance of affordable airport charges and that HAL should be held accountable for developing both a high quality engagement process and a high quality revised RBP. HAL emphasised the importance of simplifying and streamlining the regulatory framework, but also of providing comfort as soon as practicable on both early costs and the incentives for longer-term investment.

9. We deal with these responses in more detail in chapter 1 and explain further how we will take forward our work on the H7 price review in the difficult circumstances that the sector is currently experiencing. In particular, we will:

- remain focused on delivering the best outcomes for consumers;
- expect HAL to work to refine (and, if necessary, extend) the information it already has available to it from its extensive work on consumer engagement to inform its RBP. It should consider whether there may be particular benefits to consumers from providing enhanced or different levels of service or resilience, such as new services and processes that may be appropriate given the impact of the covid-19 pandemic;
- continue to encourage HAL and airlines to work together, including on the development of scenarios to inform its RBP, to help ensure that the regulatory arrangements we develop are robust and protect consumers in a relatively wide range of circumstances;
- consider whether any continuing uncertainty about traffic levels and passenger numbers should be dealt with through other uncertainty mechanisms, such as price control “reopeners” or traffic risk sharing arrangements; and
- seek to develop price control arrangements that provide for the efficient financing of HAL and affordable airport charges for airlines and consumers. Reconciling these objectives may be challenging if the recovery in

passenger numbers happens relatively slowly. In these circumstances, we would seek to use maximum flexibility to develop price control arrangements that deliver these twin aims.

Business plan guidance

10. HAL will need to rework its Initial Business Plan ("IBP") substantially focusing on how best to serve consumers, given the pressures lower passenger volumes are likely to create for financeability and affordability. The CAA will play an active role in CE as part of an iterative process to help develop, and encourage the timely delivery of, a robust RBP by HAL that reflects the importance of delivering the right outcomes to further the interests of consumers. As noted above, HAL will need to work with airlines on the development of scenarios and consider whether to carry out further targeted consumer engagement to support its approach. We provide more detail of our guidance for HAL on its RBP in Chapter 2 and Appendix E.

Efficiency incentives

11. A key objective of our policy for the H7 price control is to create appropriate incentives for HAL to make capital investments efficiently. This remains a priority even with our focus on a two runway airport as the present difficult circumstances of the sector mean that getting value for money from capital expenditure will be even more important. Chapter 3 explains our approach to these matters. We will build on the approach taken in the Q6 price control, while making improvements where appropriate. We intend to work closely with stakeholders in developing these incentive arrangements.

Financeability and the cost of capital

12. We noted in the April 2020 Update that dealing with any short term liquidity issues created by the impact of the covid-19 pandemic is primarily a matter for HAL, its shareholders and other providers of finance. Looking forward to H7, chapter 4 explains that the challenges for HAL's financeability have changed significantly. As a result, we are no longer focusing on the financing of the very significant amounts of capex required for expansion. Instead, we need to

develop price control proposals consistent with an efficiently financed licensee continuing to access debt markets on cost effective terms, so that HAL's:

RAB can be efficiently financed; and

airport charges are no higher than is necessary.

13. As for the cost of capital, much has changed since we last addressed this in the January 2020 Consultation. We have commissioned work from Flint Global ("Flint") to help update our thinking on the cost of capital to take account of both our new focus on a two runway airport, and the "Provisional Findings" of the CMA on NERL's price controls. However, a considerable amount of further analysis and monitoring of market developments will be needed to understand the full impact of the covid-19 pandemic on debt and equity markets. We will continue with our work on these matters over the coming months.

Early costs

14. We deal with a number of legacy issues in the appendices to this document. Given that early costs have been of considerable interest to stakeholders, we summarise key elements of our policy here, as well as setting out further detail of our policy in Appendix C. In the light of HAL's decision to pause its work on expansion, we plan to simplify our policy on early costs as a number of aspects of our previous policy proposals no longer appear appropriate. These include recovery caps, enhanced reporting requirements and a new licence condition on governance arrangements.

15. Risk sharing arrangements also no longer seem appropriate, as these had been designed to encourage HAL to make a high quality planning application. Therefore, we propose that the regulatory treatment of the early expansion costs that HAL has incurred up to the end of February 2020 (which are in the region of £500 million) is consistent with the established regulatory principle that costs should be added to HAL's RAB unless there is evidence of inefficiency or misallocation. We intend to complete our work on reviewing the efficiency and allocation of these costs over the coming months. We also intend to make an allowance for financing costs up to the end of 2021. It is important to note, however, that the recovery of regulatory depreciation and allowed returns on

these early costs will not start until 2022 and will be subject to affordability and financeability tests.

16. If the expansion programme recommences at some point in the future, we would expect HAL to consult on detailed, evidence based, robust and properly costed budgets for both early costs and the wider programme.

Other matters

17. We also note that HAL made the following comment in response to the April 2020 Update:

> "*Through the Q6 process, the CAA clearly set out that the price control could be reopened in the event of 'extreme circumstances'. We are developing our thinking on how a reopener might best work to deliver consumer benefits.'"*

18. If we receive detailed representations from HAL on these matters, we will consider them in the light of our statutory duties and consult stakeholders on the most appropriate way forward.

Next steps

19. We will be hosting an online seminar to present the key issues arising from this consultation and discuss with stakeholders the best approach to engagement at 11am on 1 July 2020. If you would like to attend, please contact economicregulation@caa.co.uk.

20. Comments are invited on the issues raised in this consultation by 18 August 2020.

21. We will also issue working papers to support our development of policy as appropriate, including papers later in the summer on capex efficiency incentives and our initial assessment of the efficiency of HAL's capital expenditure during the Q6 price control (as extended).

22. The initial phase of CE between HAL and airlines commenced in early June 2020 and will run until the end of that month. Following this, HAL intends to issue updated information on the regulatory building blocks for a two runway airport.

The second phase of CE will consider these issues further during August and September 2020, ahead of HAL issuing its RBP in the Autumn of 2020.

23. The CAA will issue a further paper setting out the way forward for the H7 review early in 2021.

Views invited

24. Views are invited on any of the issues raised in this document and, in particular, on:

- the key elements of our approach to developing the H7 programme, as set out in the summary of chapter 1, including our proposed approach to furthering consumers' interests;
- how we can best continue to engage with HAL and other stakeholders to ensure that HAL has the best opportunity to develop a meaningful and high quality RBP;
- the criteria and broad approach to capex incentives identified in chapter 3;
- how best to improve capex governance arrangements;
- the approach adopted by Flint and summarised in chapter 4 for estimating cost of capital for H7 prior to the impact of the covid-19 pandemic being felt; and
- how we should best take account of the impact of the covid-19 pandemic on HAL's cost of capital.

Our duties

25. 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

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

- chapter 1 discusses the responses we received to the April 2020 Update;
- chapter 2 considers our requirements for HAL’s RBP;

- chapter 3 addresses capex efficiency incentives and governance arrangements;
- chapter 4 considers our approach to assessing affordability and financeability and setting the cost of capital for H7; and
- the appendices primarily cover issues that were raised in our previous policy consultations but where policy had not yet been finalised, including the treatment of early costs.

Chapter 1

Developing the H7 Programme and responses to the April 2020 Update

Introduction

1.1 The April 2020 Update explained how we intend to react to HAL's decision to pause its capacity expansion programme and the unprecedented impact on Heathrow airport, and the aviation sector more widely, arising from the covid-19 pandemic.

1.2 This chapter deals with the responses to the April 2020 Update on our overall approach to the H7 price control review. In the light of these responses, we set out an updated way forward.

1.3 In particular, this chapter:

- briefly summarises the broad approach outlined in the April 2020 Update;
- discusses the responses we received to that consultation;
- sets out our views on the matters raised by respondents; and
- explains how we expect to take forward the H7 price control review in the interests of consumers, taking account of latest developments and the responses to the April 2020 Update.

The April 2020 Update

1.4 We noted that, given HAL's decision to pause its capacity expansion programme and the impact of the covid-19 pandemic, it would be appropriate to focus on a price control for a two runway airport. If circumstances change in such a way that HAL resumes work on expansion, we retain the option to deal with it by adjusting or resetting HAL's price control. We said that:

- given the new strategic context, scenarios could help explore how the present uncertainty might start to crystallise, and illuminate possible future paths of air traffic volumes, airport costs and revenues;
- we would consider a range of options for the form and duration of the price control to help deal with any remaining uncertainty when we set it in 2021; and
- a more flexible process would be appropriate, but with a continuing emphasis on the importance of CE.

Responses to the April 2020 Update

Broad approach

1.5 HAL’s comments on the April 2020 Update’s broad approach included that:

- expansion is still in consumers’ interests and remains a key part of HAL’s long term strategy. The regulatory framework should provide flexibility to allow for the possibility of expansion resuming;
- the current framework is not well calibrated. This is demonstrated by the impact of the covid-19 pandemic, and HAL requires greater protection from risk in the future. HAL also suggested that it has failed to earn the cost of capital set in a regulatory settlement for two decades;
- the CAA should take steps to support HAL’s financeability in the short term, including by providing clarity on the treatment of early costs;
- the CAA should set out a clear plan for ensuring that both HAL’s plans and the H7 price control will properly protect consumers, building on the good work of the CCB; and
- now might be a good opportunity to allow the industry to work together to find a more commercial solution to the current issues and future challenges.

1.6 Airlines agreed with HAL that the sector faced an unprecedented crisis, but took a different view of the approach set out in the April 2020 Update:

- there was general support for focusing on a two runway airport and an emphasis on the importance of airport charges being affordable in the future to support the recovery of passenger traffic;
- BA/IAG suggested that HAL, airlines and the CAA should work collaboratively to find mechanisms to deal with the issues raised by uncertain future traffic volumes;
- there was support for our position that Heathrow airport retains market power and that the CAA should continue to regulate HAL;
- VAA supported the CAA continuing work on H7, noting that the scale of the change that has occurred since the Q6 price control decisions were taken in early 2014 means that a further extension of the Q6 price control would not be in the best interests of passengers; and
- the AOC/LACC said that they did not support any move to a “light touch” form of regulation such as that seen at Gatwick airport.

Use of scenarios

1.7 HAL agreed that understanding potential scenarios can help it better to understand the potential impact of the covid-19 pandemic on its forecasts and plans for H7. It also said that engagement should focus on the delivery of outcomes for stakeholders linked to the scenarios, not the scenarios themselves. It said it should continue to use its “driver-based” method to estimate future passenger volumes, costs and revenues, and that a “bottom up” approach to estimating these elements would be inappropriate.

1.8 BA/IAG said that the value in developing the framework for such scenarios is in ensuring key building block elements are logically tied together. Operating costs, commercial revenues, capital plans and other areas all need to be linked to a form of scenario, and an appropriate price control outcome needs to result from them. AOC/LACC agreed that the development and use of meaningful scenarios, incorporating iterative engagement from airlines as well as HAL, is a pragmatic and flexible approach for developing the H7 price control.

1.9 The LAANC said that, in the interests of respite for local communities, any scenarios should respect existing planning rules.

Uncertainty mechanisms

1.10 HAL considered that both risk sharing mechanisms and trigger mechanisms could help to mitigate many of the risks associated with setting a price control in an uncertain environment. It stressed the need for a mechanism to manage larger shocks. An adjustment mechanism could also provide clarity on when the CAA would step in to review the price control.

1.11 Airlines also supported work to consider measures to address the current uncertainty. They agreed that we should consider potential trigger mechanisms, although in the case of traffic risk sharing, several airlines cautioned that any such mechanism should not seek to "de-risk" HAL completely.

1.12 There was less support for other possible measures. Respondents only supported a shortening of the price control period if there was a clear case for change.

Process and the timetable for the price review

1.13 Most respondents to the April 2020 Update agreed with our proposed approach, and there were suggestions for further changes to our processes:

- HAL agreed with a more streamlined process, expressing a desire for further details from the CAA particularly in relation to the consultations that will be issued in 2021. It stressed a need to reduce the regulatory burden and avoid complex new processes;
- BA/IAG said that stakeholder engagement is critical to an effective regulatory process, and supported more workshop-based discussions to gather evidence for the price control;
- VAA supported greater informal stakeholder engagement, also observing that airline resources are currently severely constrained so that the level and depth of airline engagement may be lower than previously;
- AOC/LACC supported the overall approach including more use of feedback and 'workshop' sessions. They highlighted the importance of agreeing "principles of engagement" so that all parties are aware of the expectations and requirements upon them; and

- the HCEB encouraged the CAA to gather views from the all stakeholders, including local communities and the wider public.

CAA views

Building on our broad approach

1.14 Consistent with the views of stakeholders, we intend to retain our focus on a price control for two runway airport. In relation to expansion, we note that stakeholders have a range of views and, at this stage, we intend to retain the option of dealing with these matters by adjusting or resetting HAL's price control.

1.15 We note comments from HAL on the potential use of a "commercial deal", under which CAA could step back from its current regulatory role and allow HAL and the airlines to use to develop an agreed framework for H7. We also note that airlines and airline representatives are sceptical about the introduction of a lighter touch approach to regulation. As we have previously explained, the lighter touch arrangements at Gatwick airport first emerged in parallel with the development of price control proposals (towards the end of the price control review leading up to Q6). Bearing this in mind, we do not see our work on HAL's price control preventing the emergence of a more commercial approach, if HAL and airlines were to agree a suitable way forward.

1.16 HAL has made a number of comments about the need for the regulatory framework to address risk and reward appropriately and for greater certainty on the regulatory treatment of early costs. As we explain below, we will consider adapting the form of the price control to deal with uncertainty differently. We will also seek to ensure that we adopt a balanced approach to risk and reward in designing the regulatory arrangements, including our approach to assessing financeability, setting incentives and the cost of capital. These matters are discussed further in chapters 3 and 4. We also deal with the regulatory treatment of early costs in Appendix C of this document.

1.17 More broadly, as noted in the Executive Summary, if HAL makes representations that we should reopen the regulatory arrangements that support the existing commercial deal that is in place for 2020 and 2021, we will consider them carefully.

1.18 Airlines commented on the importance of airport charges being affordable and supporting the recovery of passenger traffic. We support these comments but note that it is also important that HAL can be efficiently financed. As indicated in the April 2020 Update, if the recovery of passenger traffic is relatively slow, there may be significant challenges in reconciling these objectives. In these circumstances, we would seek to use maximum flexibility to develop price control arrangements that deliver these twin aims.

1.19 We note HAL's comments on the importance of having a clear plan to ensure both HAL's plans and the price control will properly protect consumers. We consider it is timely for us to set out more information on our approach to these matters, and this is discussed further below.

Furthering the interests of consumers

1.20 The April 2020 Update stated that we would continue to put the interests of consumers at the heart of our work pursuant to our statutory duties under CAA12. This section expands on our approach to these matters, taking account of our decision to conclude the work of the CCB following its helpful report[4] on HAL's IBP.

1.21 Our established policy and continued focus will be on ensuring that the regulatory regime responds to, and delivers on, the core needs, priorities and preferences of consumers. This will mean building on the success of the SQRB scheme, so that it:

- continues to meet the needs of consumers and airlines; and
- facilitates the smooth introduction of OBR.

1.22 HAL's approach to its RBP and OBR will need to be driven by a robust understanding of what consumers value and reflect suitable levels of service and

4 See the CCB's report on HAL's Initial Business Plan: https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Consumers/20200226%20CCB%20Report%20on%20IBP_REDACTED_20200521.pdf

resilience. At the same time, it will also have to reflect the greatly changed circumstances in the sector and provide appropriate support for the recovery of passenger numbers.

1.23 The CCB played an important role in providing independent scrutiny and challenge to HAL on the development of its IBP, its approach to consumer research and engagement, and OBR. It is important that we find a way forward that reflects both the importance of this role and the broader challenges that both HAL and the sector in general face. We propose the following approach to ensure consumers remain at the heart of the regulatory process:

- HAL's approach to OBR and its RBP: HAL should develop a strategy to deliver an appropriate level of service to consumers and airlines that reflects their core needs and priorities both (i) in the short term and during the recovery period; and (ii) over the longer term so that HAL can fully develop its approach to OBR;
- Approach to consumer research and engagement: in ensuring the RBP is informed by the needs, priorities and preferences of consumers, HAL should refine, and build on, its existing consumer evidence base with emerging intelligence and, where appropriate, through new research and engagement that will assist HAL in developing an RBP that is consistent with providing the outcomes that consumers expect;
- Airline insights: it will remain appropriate for HAL to try and lever on airlines' extensive consumer insights and intelligence and, where practicable, this information should be used to support the development of OBR. This insight should be used to supplement any new research and engagement undertaken by HAL to ensure that the RBP is consistent with providing the outcomes that airlines expect for the consumers they serve;
- Stakeholder engagement: we will broaden our approach to stakeholder engagement and develop a better understanding of the perspective of the PSG;
- The CCB's report on the IBP: we expect HAL to address the findings and recommendations in the CCB's report on the IBP where relevant. In particular, HAL should address the CCB's key finding on the need for a

clearer link and "golden thread" between its consumer research, future plans and OBR proposals; and

- CAA consumer advocate role: we will provide scrutiny and challenge of HAL's plans to ensure that they are grounded in robust consumer insight and reflect consumers' core needs and priorities. In doing this, we will be assisted by expert advice from the CAA's Consumer Panel acting as our "critical friend". We will consider commissioning further external support and assistance if it is necessary to support our work on OBR and/or assessment of HAL's RBP.

1.24 While we recognise the important role that airlines play in understanding the views and interests of their customers, direct research and engagement is important to gain further insight into consumers' priorities and preferences.

1.25 Chapter 2 and Appendix E sets out further information on our expectations for HAL's RBP to reflect these matters.

Scenario analysis

1.26 Given the uncertainties arising as a result of the impact of the covid-19 pandemic, we view the development of meaningful scenarios as a fundamental starting point for the development of "joined up" outcomes in respect of capex, opex and commercial revenues in the RBP. Given this, we disagree with HAL's view that engagement should focus on the delivery of outcomes for stakeholders linked to the scenarios, but not the scenarios themselves. There would be advantages in a consensus view of the scenarios between airlines and HAL as a starting point for the development of the RBP.

1.27 We expect HAL to work with airlines to develop appropriate scenarios, with this engagement starting as soon as practicable and allowing for the evolution of views. These agreed scenarios:

- should deliver outcomes consistent with consumers' needs and priorities; and
- provide the basis for an effective, integrated RBP.

1.28 Our detailed guidance and requirements for scenario analysis are set out in Appendix E.

Form of control

Traffic risk sharing

1.29 The outlook for passenger traffic at Heathrow airport is likely to remain uncertain as we develop the H7 price control. For this reason, our current view is that there may be a strong case for including some form of traffic risk sharing mechanism in HAL's price control. Such mechanisms have operated for an extended period at a number of other major European airports.

1.30 A traffic risk sharing mechanism would directly address one of the key sources of uncertainty for the H7 review. As well as affecting HAL's revenues from airport charges, changes in passenger volumes will also have implications for opex and commercial revenues. By carefully calibrating any traffic risk sharing mechanism, we could take account of the likely impact of traffic changes on all of the regulatory "building blocks".

1.31 We agree with the airlines that any new mechanism should not aim to protect HAL from all traffic-related risk. It is important that HAL continues to bear some risk and will, therefore, be incentivised to facilitate a rapid recovery in traffic levels. Nevertheless, by reducing, rather than eliminating, HAL's exposure to traffic risk in H7, we can reduce the risks and avoid unnecessary upward pressure on the cost of capital.

1.32 We will discuss with HAL and airlines the potential role of a traffic risk sharing mechanism and the principles that could be applied. Before such a mechanism could be introduced, detailed work would need be required on the design of the mechanism and the degree of risk sharing. This could vary, for example, depending on the degree of divergence between forecast and actual traffic levels.

1.33 One potential disadvantage of some traffic risk sharing mechanisms is that they could lead to higher charges for airlines and customers at a time when they are already dealing with the consequences of lower than expected demand. We are open to considering ways to mitigate such disadvantages, such as the use of RAB adjustments rather than immediate increases in airport charges.

Price control reopeners

1.34 HAL has suggested that we consider the introduction of “price adjustment triggers”. We are aware that some other regulated companies have specific “reopener” provisions associated with their price controls. One example is the provision for Ofwat to carry out a “substantial effect determination” if an unforeseen circumstance has an impact equal to at least 20 per cent of a company’s turnover.

1.35 A specific reopener for HAL’s price control could provide additional certainty about when a change to an existing price control might be appropriate. Nonetheless, there are issues about how such provisions might operate in practice. For example, the use of rigid materiality thresholds can distort incentives, fail to reflect important aspects of the underlying context and the operation of these provisions can prove contentious.[5]

1.36 As a possible alternative way of providing additional certainty, rather than introducing a new reopener provision, the CAA could consider providing policy guidance on the types of circumstance that might justify a reopening of an existing price control. Such guidance could provide a more nuanced description of CAA’s likely approach under a range of different situations, avoiding some of the rigidities associated with specific licence conditions.

1.37 A further important consideration is that the role of any reopener or policy guidance would depend on the nature of any traffic risk sharing mechanism, since a risk sharing mechanism may help to mitigate the impact of events that might otherwise need to be dealt with by reopening the price control.

Other options

1.38 Our current view, similar to that of several respondents, is that it would be premature to consider shortening the duration of the H7 price control at this stage.

[5] For instance in 2008 Ofwat decided against amending Sutton and East Surrey Water’s price control even though it agreed that the materiality threshold had been satisfied (and this decision was upheld following an appeal to the Competition Commission).

However, this is an option that we could consider in future if it became clear that a five year price control might not be in consumers' best interests.

Regulatory programme and approach to engagement

1.39 We welcome the feedback received we have received on our approach to process and timetable. We intend to take forward these matters by:

- hosting a webinar for all interested stakeholders shortly after the publication of this consultation, as highlighted in the Executive Summary . If feedback on this suggests we should, we will consider holding further events at strategic points in the H7 review;
- being proactive in CE, with a particular focus on ensuring this process takes account of the interests of consumers;
- augmenting our contribution to CE with a series of targeted workshops and less formal sessions on key regulatory issues, particularly those which receive less focus as part of CE;
- streamlining our documents and consultations so that they focus on key issues and use working papers where appropriate;
- seeking to understand more the views of the PSG/HCEB and other stakeholders that represent consumers; and
- noting HAL's desire for further details of the process during 2021, we propose to clarify the key stages of the final period of the H7 review following our assessment of HAL's RBP later this year, when we expect that some of the present uncertainty will have reduced.

Summary

1.40 We reaffirm key elements of the vision set out in the April 2020 Update:

- our focus will be on a price control for a two runway airport (with the option of dealing with capacity expansion by adjusting or resetting HAL's price control);
- scenarios should be used to help explore possible future paths of air traffic volumes, and airport costs and revenues;

- we will consider traffic risk sharing mechanisms and price control re-openers to help us deal with remaining uncertainty in setting the H7 price control in 2021; and
- we will adopt more flexible and agile process to setting the price control, but with a continuing emphasis on the importance of CE.

1.41 Taking account of the responses to the April 2020 Update and our evolving thinking, we will further build on the above key elements as follows:

- we will develop processes to ensure that the interests of consumers remain at the heart of the regulatory process; and
- we will consider how best to deliver a price control consistent with efficient financing arrangements for HAL and affordable charges for airlines that best supports the recovery of passenger traffic at Heathrow airport.

Views invited

1.42 Views are invited on any aspect of the issues raised in this chapter and, in particular, on:

- the key elements of our approach set out in the summary of this chapter; and
- our proposed approach to furthering consumers' interests described above.

Chapter 2

Developing HAL's revised business plan

Introduction

2.1 The IBP was published in December 2019 on the basis that expansion was proceeding. Given the changed circumstances, the IBP is substantially out of date and HAL has committed to producing an RBP in the Autumn of 2020.

2.2 This chapter summarises our guidance for the RBP and builds on and modifies the Updated Business Plan Guidance we produced for HAL's IBP. Although the present level of uncertainty and the difficulties that the sector faces will create real challenges for HAL in producing its RBP, it is essential that the RBP is as robust and informative as practicable and reflects consumers' core needs and priorities for a two runway airport. It should also capture:

- the outcomes of CE;
- HAL's latest thinking on traffic scenarios and efficient levels of costs; and
- HAL's views on the form and duration of price control arrangements best suited to dealing with any remaining uncertainty.

2.3 This Chapter:

- summarises key features of the IBP and views on it, and the issues from this that are relevant for the RBP;
- describes our priorities for the RBP;
- provides further information on how HAL should progress its work on consumer engagement and OBR; and
- invites views on key issues.

2.4 Further detail of our RBP guidance is set out in Appendix E.

Summary of the IBP

2.5 We assessed HAL's IBP against the Updated Business Plan Guidance. We also took into account the views of airlines and the CCB.[6] Once the circumstances changed, we paused our work on the IBP, but summarise below key features of the IBP, views on it and the implications of these views for the work HAL needs to undertake in preparing the RBP.

Key features of the IBP

2.6 Our preliminary view was that the IBP covered all the main areas necessary to support the price control review. Its key features and elements included:

- strategic choices (an option for prioritising savings and an option for prioritising services);
- an investment/capex plan focused on the delivery of expansion and two other portfolios of projects: "Create Capacity" and "Maintain and Improve". Investment in the existing asset base fell into the latter portfolio;
- a "top-down" forecasting method for opex and commercial revenues which projected opex and revenues forward from a base year using estimated elasticities for passenger growth, rather than the "bottom up" approach used for the Q6 price control. HAL said its base year level of opex was efficient and, therefore, that it would start H7 with an efficient level of opex;
- a continuation of the existing "core" and "development" capex governance framework and related processes; and
- OBR proposals, including six consumer outcomes in the context of four wider stakeholder outcomes, twenty-six measures and a set of alternative measures. Its "prioritising savings" targets were mainly based on maintaining existing Q6 price control service performance levels. Its incentive design was informed by the Q6 price control and cross-sector

[6] See footnote 4

precedents, consumer insights and whether or not performance was wholly within HAL's control.

2.7 We do not currently expect construction for expansion to restart during H7. If expansion restarts, we will treat it as an add-on to the price control. This, and the impact of the covid-19 pandemic on traffic volumes, means that several key assumptions used to construct the IBP are no longer appropriate. These include assumptions on traffic forecasts, the capex plan, financing and financeability and several other key building blocks.

2.8 HAL provided initial views on the requirements for its RBP in response to the April 2020 Update. It said that its IBP method for estimating opex and commercial revenues remains fit for purpose and it intends to provide a "Building Block Update" in July 2020 on this basis. We understand this will update many of the assumptions in the IBP, but may use the same or similar models and/or approaches to make forecasts, while taking account of the current circumstances. This update would be more useful for consumers and stakeholders if it also were to address the validity of HAL's underlying models and approaches, especially given the radically changed circumstances of the sector.

Feedback on the IBP from key stakeholders

2.9 In response to our request for key stakeholders' feedback on the IBP, the airline community and the CCB provided formal feedback. Since then, the airline community has developed its thinking on requirements for the RBP, providing further views in response to the April 2020 Update. This section summarises airlines' feedback. The CCB's feedback is discussed later in this chapter.

2.10 On opex and commercial revenues, the airline community generally did not support the forecasting methodology used in the IBP, considering HAL's approach to using "top down" "drivers" and forward-looking elasticity assumptions[7] for opex not to be appropriate for robust forecasting. Instead, they

---

[7] For example, HAL's opex forecasts accounted for growth using top down elasticity assumptions for passenger volumes and terminal size.

said that the RBP should identify key “bottom up” cost and revenue drivers, linked to planning scenarios. Furthermore, airline feedback was that analysis should be widened to include efficient comparators other than airports, such as other transport modes, or shopping centres. For commercial revenues, forecasts should incorporate benefits derived from capital investment projects, such as valet parking.

2.11 On capex and the capital planning framework, airlines were keen to see the capital plan analysis linked to agreed scenarios. They also suggested:

- the evolution of the capex governance process, for example, by reviewing the current “gateway” process; and
- improved analysis of benefits, including “benefits realisation” analysis to show how far estimated benefits of a project have been delivered.

2.12 Airlines considered that HAL’s approach to consumer engagement in the IBP had been used to justify unnecessary increases in investment. They considered the Q6 SQRB scheme should remain in place for H7, with adjusted measures and metrics to benefit the consumer interest further. They remained opposed to bonuses for outperformance and said OBR should focus only on the regulated entity.

Overall approach and priorities for the RBP

HAL’s overall approach to the RBP

2.13 The RBP is a key opportunity for HAL to provide robust information and evidence that will support the price control process for H7 and influence the design of the regulatory regime. It should also:

- provide a positive, integrated plan for stakeholders;
- improve the scope and depth of stakeholders’ engagement; and
- improve HAL’s business planning and delivery for H7 period.

2.14 We expect HAL’s RBP to address consumers’ and industry stakeholders’ current and future requirements in the context of the current highly uncertain conditions. Where appropriate, it should draw on good practice from other regulated sectors.

2.15 To be effective the RBP should be:

- transparent and publicly available to all stakeholders;
- supported by a robust evidence base, drawing on industry best practice;
- well structured and well integrated between different elements of the plan;
- designed to reflect consumer views and preferences to the fullest extent practicable;
- based on efficient costs;
- focused on addressing both the financeability and the affordability of airport charges in the context of the challenging circumstances that the sector is likely to face during H7; and
- deliverable.

2.16 While our initial assessment of the IBP was that it went some way to satisfying some of these objectives, the RBP can, and should, go further.

2.17 We intend to facilitate development of an effective RBP by taking an active role in CE discussions on the detailed form and content of the RBP. To support HAL in delivering an effective RBP, we have produced updated guidance at Appendix E. This aims to strike a balance between:

- the need for HAL to provide high quality, transparent, disaggregated information to inform medium term planning for Heathrow airport; while
- avoiding unreasonable burdens on HAL, for example, by aiming to minimise requirements for HAL to collect new data, or to develop entirely new approaches to its planning.

Priorities for traffic, costs and revenues for the RBP

2.18 Our assessment of traffic, costs (both capex and opex) and commercial revenues in the IBP provided insights which remain important for the RBP. These building blocks are critical to business planning and intrinsically connected: passenger volumes drive commercial revenues directly, and have a significant impact on both opex and capex levels.

2.19 Our requirements aim to build on HAL’s existing planning and forecasting approach, for example, in providing for a reasonable disaggregation of traffic, cost and revenue estimates. For instance, we expect that opex forecasts for H7 should be capable of reflecting significant changes in the levels of staff between terminals and activities. We also note that HAL’s Regulatory Accounts include opex at a more disaggregated level than in the IBP. We expect the RBP, therefore, to contain opex estimates for each planning scenario at a level of detail that facilitates understanding of changes in relevant activities, and supports the objectives and principles above.

2.20 Nonetheless, the current uncertainties around future traffic volumes mean that very detailed “bottom-up” forecasts of traffic, costs and revenues are unlikely to be useful for consumers and stakeholders in the short term. If uncertainty reduces during the rest of 2020 and 2021 such that the range of scenarios under consideration can be narrowed, we would then expect HAL to provide more detailed information to reflect stakeholders’ reasonable needs and expectations. We will engage with HAL and key stakeholders during CE to assess the scope and benefits of such an approach.

2.21 We are also of the view that HAL's approach to planning for costs and revenues should be integrated and closely linked to passenger volume scenarios. For example, if a particular scenario assumes that a terminal will remain closed for a significant period of time, we would expect that, for that period:

- opex estimates will reflect the present significant reduction in operational activity, such as material reductions in staff and utility costs for that terminal;
- commercial revenues from that terminal will be at, or close to, zero, as all retailers and most other revenue generating assets will be closed; and
- the capex plan will show that no investment is planned in that terminal, unless it is required for refurbishment or otherwise in advance of reopening it.

2.22 The RBP should provide scenario-based estimates for traffic, costs and revenues at a suitable level of disaggregation such that the estimates can reflect variations in demand responses and cost drivers for each scenario. If a particular scenario assumes that some geographic markets recover more quickly than others, the estimates of commercial revenues for the recovery period should reflect variations in the return of revenue between geographic markets.

2.23 Effective capex planning requires an effective process for "sifting" and prioritising potential projects, to ensure that HAL makes the best use of its resources. While HAL already carries out business case analysis on capex projects during its project development process, we agree with the airline community that this process should be enhanced. For each individual business case, HAL should:

- identify expected outputs and quantified benefits (including any incremental revenues and operating costs) to allow monitoring of actual benefits; and
- provide an explanation of how the project or portfolio delivers value for money for customers and consumers during H7, recognising that consumer needs and preferences may well have changed as a result of the impact of the covid-19 pandemic or other factors.

2.24 HAL's RBP should also demonstrate the impact that a particular level of traffic has on operational resilience for that scenario. We expect that HAL's analysis of operational resilience will be linked to the method it uses to estimate those operating costs that relate to operation of its infrastructure.

2.25 In summary, for traffic, costs and revenues, the RBP should:

- apply an integrated approach to planning and estimating volumes;
- present key elements of a flexible framework for medium term planning for H7 that takes account of variations in demand responses and cost drivers for individual scenarios;
- present an approach to capex planning that takes account of expected project outputs and estimated benefits for customers and consumers; and
- demonstrate the impact of traffic levels on operational resilience.

2.26 Nonetheless, we recognise the need for all RBP requirements and guidance to be proportionate and not unduly difficult to implement. We have engaged in initial discussions with HAL on the main principles underlying key requirements and guidance set out in this chapter and Appendix E. We will discuss further the detail and content of the RBP with HAL and airlines during CE.

Consumer engagement and OBR in the RBP

2.27 In 2017, we set our OBR policy and appointed the CCB with the intention of moving towards a more consumer focussed approach to service quality in H7. Since then, HAL has undertaken a significant consumer research and engagement programme to inform its approach to OBR, with challenge and insight from airlines and the CCB. HAL set out its approach to consumer engagement and OBR in the IBP.[8]

2.28 In February 2020, the CCB provided its report on HAL's IBP. The CCB considered that HAL had undertaken extensive consumer research and engagement, and commended HAL's ambition to produce an IBP based on consumer insights. However, it considered the IBP was deficient in translating this engagement into proposals which reflect consumer preferences. The CCB expressed particular disappointment with the OBR proposals because the "golden thread" between outcomes and consumer insights was not reflected in HAL's proposed measures, targets and incentives. We broadly agree with the CCB's key findings on these matters.

Impact of the latest developments

2.29 The covid-19 pandemic is likely to have an impact on consumers' future priorities and preferences, with a greater focus on safety, health and cleanliness. Public health requirements, such as social distancing and health screening, are also likely to have an impact on the passenger journey to and from the airport as well as on operational and service quality processes at the airport.

2.30 While it is not clear how consumer priorities will change over time, HAL and the airlines are working to review and propose updates to the SQRB scheme (with CAA support) so that consumers and airlines receive an appropriate level of service over the short term and recovery period in the different scenarios being considered.

8 See paragraph 2.6 above.

Guidance for the RBP

2.31 It continues to be in consumers' interests for HAL to develop its approach to OBR based on the principles below. HAL's approach should:

- be informed by robust consumer insights in delivering for consumers (i) reflecting their priorities and preferences, (ii) drawing on existing insight and (iii) building on this with new research where appropriate;
- include 'outcomes', 'measures', 'targets' and 'incentives';
- build on any updated form of the SQRB scheme over the short term and recovery period (see above); and
- include performance reporting targeted at consumers.

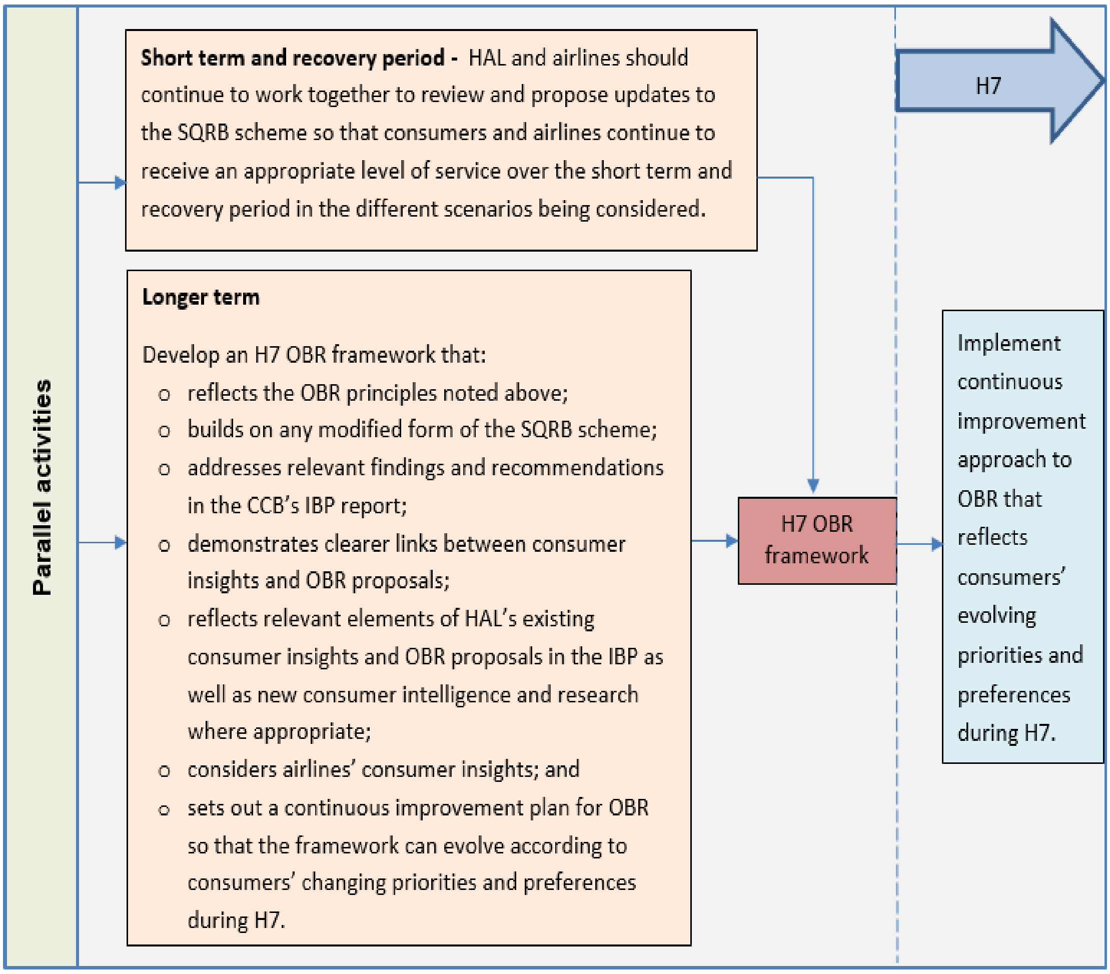
2.32 We do not agree with the airlines' suggestion that the SQRB scheme should be the focus of licensed based regulation in H7. OBR remains central to delivering for consumers, although the SQRB scheme may have a role in supporting OBR and in incentivising HAL to deliver services to support its airline customers. The short term review of the SQRB scheme will also be an important input into supporting airlines in the short term and recovery period as well as in setting a direction of travel to support the future shape of OBR.

2.33 In adapting to the new challenges raised by the impact of the covid-19 pandemic, HAL will need to understand and reflect consumers' evolving needs and priorities in its business plan and approach to OBR to help rebuild consumer confidence. In doing this, HAL should both:

- update the SQRB scheme for the short term and recovery period; and
- develop the H7 OBR framework and plan for continuous improvement over the longer term.

2.34 This work should be undertaken in parallel, and a modified form of the SQRB scheme should be appropriately brought together with HAL's work to develop the OBR framework. This approach is illustrated in Figure 1.

Figure 1: OBR strategy and methodology



2.35 Figure 1 refers to a "continuous improvement" approach to OBR that reflects consumers' evolving priorities and preferences during H7. This broad approach was proposed in HAL's IBP and should be adapted to meet the challenges of the new circumstances that the sector is facing.

2.36 We summarise below the three requirements for consumer engagement and OBR that we expect HAL to focus on for inclusion in the RBP:

- HAL should develop an OBR strategy over the short term, recovery period and longer term. As a minimum, this should focus on delivering consumers' and airlines' core needs and priorities so that they continue to receive an appropriate level of service over this time (see Figure 1 above);
- HAL should consider which elements of its existing consumer research and engagement remain relevant for the RBP. HAL should refine and build on

its existing consumer evidence base with emerging intelligence and, where appropriate and practicable, through new research and engagement; and

- HAL should consider what the implications of its future scenarios might be for the service quality that consumers and airlines will expect and should receive. To the extent practicable, HAL should demonstrate a clear link between its consumer insights and future plans for each scenario being assessed, drawing on existing consumer insights, new intelligence and research to support these scenarios where possible.

2.37 Obtaining the insights of both airlines and consumers will both help HAL to develop an RBP that is designed to provide the outcomes that consumers and airlines expect and assist us to understand both perspectives better.

2.38 Further guidance on these requirements are set out in Appendix E.

Views invited

2.39 Stakeholders views are invited on the issues raised in this chapter and, in particular, how best we can continue to engage with HAL and other stakeholders to ensure that HAL has the best opportunity to develop a meaningful and high quality RBP.

Chapter 3

Efficiency incentives: capital expenditure

Introduction

3.1 A key objective of our policy for expansion was to create appropriate incentives for capital efficiency, so promoting the overall efficiency and affordability of the programme. While, absent expansion, much less capex will be needed, the current challenges facing the whole aviation sector reinforce the importance of efficient spending and ensuring value for money.

3.2 Nonetheless, in these new circumstances, we consider that an evolutionary approach would work best and we should build on the approach used for Q6, including continuing with the "core and development" capex framework, while making improvements to it and setting clearer incentives for efficiency.

3.3 We have gathered early views from HAL and some airlines on these proposals and will seek to work collaboratively with HAL and airlines through 2020 and early 2021 to develop our approach further and apply it to the H7 capex programme.

3.4 This chapter sets out:

- our criteria for building on the Q6 price control arrangements and developing new capex efficiency incentives;
- the broad approach we intend to adopt for capex incentives; and
- the high level requirements for HAL's RBP and the next steps in our work to develop capex incentives.

Criteria for developing new incentives

3.5 We have developed the following criteria for the incentive framework, based on our work and feedback from stakeholders. In particular, we consider these criteria are in line with the comments from stakeholders in response to the January 2020 Consultation and the April 2020 Update. Using these criteria will allow us to build on the existing arrangements and support the development of a set of incentives that best furthers the interests of consumers.

3.6 Our criteria include that the updated incentive framework should:

- build on the approach to core and development capex and governance used for Q6 price, implementing improvements to address issues identified in practice and introducing new incentive arrangements, where appropriate, to reduce significantly, or eliminate, the need for *ex post* efficiency reviews by the CAA. It should also preserve the vital role of airlines in helping to assess HAL's project proposals, delivery and quality standards, and costs;
- provide clear, simple and symmetrical financial incentives for capex overspending and underspending, that are proportionate, allocate appropriate risks to HAL, and minimise difficulties associated with cost allocation and the administrative burden of implementation;
- not place unreasonable risks on HAL so that the overall capex programme is financeable in a cost effective and efficient way. The incentives must also retain flexibility for HAL to design and implement the H7 capex programme, allowing for appropriate and efficient changes in scope during H7; and
- ensure that any revenue adjustments arising from the incentives lead to the charges paid by airlines reflecting efficient levels of capital spending. Efficient costs should be linked to the delivery of project standards (including appropriate outputs and deliverables).

Broad approach

3.7 This section builds on the criteria set out above and provides a summary of the broad approach we intend to adopt for the capex incentives to apply in H7. Further details will be set out in a working paper to be published shortly. We will work with stakeholders to develop this approach further during 2020 and 2021.

3.8 We address the following issues:

- the appropriate balance of cost, timing and quality incentives;
- the proposed treatment of capex categories and incentive rates;

- the role for delivery obligations and timing incentives associated with these capex categories;
- our approach to setting and updating cost baselines to deal with uncertainty;
- our approach to the reconciliation of incentives during and at the end of H7; and
- governance arrangements.

Balance of incentives

3.9 Having reviewed feedback from stakeholders and experience from the Q6 price control, we propose to make the following changes to the balance of incentives:

- incentives to plan and incur capex efficiently should be clearer and more consistent over time. The incentives should also be strengthened, where practicable and reasonable, increasingly taking the place of *ex post* reviews and the application of the existing approach to trigger payments for a large number of key capex projects;
- incentives around the quality and benefits of capex should be strengthened, by linking the capex baseline to agreed delivery obligations and quality requirements. This should also mitigate the risk that HAL prioritises underspending over the delivery of the outputs and benefits that it has agreed with airlines;
- a more targeted set of timing incentives should be adopted, which will involve modifying and refining the existing approach to trigger payments. These should apply to capex categories for which the timing of delivery is particularly important and where there is evidence that stronger cost incentives might not be sufficient to compensate for delays. Backstop arrangements should be developed strongly to disincentivise lengthy delays. We consider that this would be proportionate given the stronger cost incentives (although cost incentives can incentivise timely delivery as delays may also lead to capex overspending, there is also the possibility that cost incentives alone might encourage HAL to postpone difficult to deliver but important projects).

3.10 The changes from Q6 to the broad approach in H7 are summarised in Figure 2 and set out in more detail in this section.

Figure 2: Summary of broad approach in H7

Approach in Q6	Broad approach in H7
Core and development framework with vital role for airlines	Similar to Q6, retain core and development framework with vital role for airlines
Ex post assessment of inefficient capex at end of period	*Ex ante* incentives on over/underspend linked to quality of deliverables, with *ex post* reviews only by exception
Ex ante financing cost incentive (around 13% on average)	*Ex ante* incentive rate to be higher than Q6, with adjustment for financing costs
Trigger payments penalise HAL for late delivery of projects	Trigger payments to be more targeted and symmetrical
Charges reflect development and core capex allowances, updated during period	Similar to Q6, charges reflect development & core capex allowances, updated during period
Gateway process and governance at portfolio and project levels	Similar to Q6, but with enhanced governance at portfolio and project levels

Treatment of different cost categories and incentive rates

3.11 The H7 capex programme will comprise projects that maintain assets, improve assets and create additional capacity or new services. To monitor capex delivery and set incentives at the appropriate level, we propose to split the capex programme into a manageable number of capex categories based on:

- clearly defined outputs being delivered; and
- any significant differences in the degree of risk and controllability.

3.12 Within each category, the "core" and "development" capex would be separately identified for each year, in line with the approach already used in the Q6 price control, with appropriate enhancements to the governance process. For example, T5 Plus and T1 Baggage were identified as two potential examples for capex categories by our consultants before HAL paused its work on expansion.

3.13 Under this approach, each capex category would be subject to an appropriate efficiency incentive rate that would set out HAL's share of the capex overspend or underspend compared to a baseline. To keep this simple, we intend to apply the same symmetrical incentive rate across all capex categories, with exceptions only being used where the capex in a particular category is shown to have significantly greater risk and/or HAL to have less control over the outturn spending. In these cases, we might consider a lower incentive rate to reflect the higher level of risk. We note, however, that an initial assessment by our consultants on non-expansion capex did not identify any such exceptions.

3.14 We will develop proposals on the efficiency incentive rate as part of our work on developing the incentive arrangements, which will be an important part of our overall assessment of HAL's broader risk and reward package. Nonetheless, our initial view is that the incentive rate should be higher than that used in the Q6 price control (on average around 13%),[9] especially as the incentive would take the place of *ex post* reviews and some timing incentives. We do not consider that the incentive rate will be likely to be higher than that observed in other sectors (where "sharing factors" of 40-50% are typically used).

Setting delivery obligations

3.15 To balance the incentives to plan capex efficiently, we need to ensure that HAL also faces incentives to deliver the outputs and benefits that have been agreed with airlines.

3.16 We propose that, for each capex category, one or more delivery obligation ("DO") will be set out that describes the output to be delivered by HAL and the expected timing of the delivery of that output. Each DO should include a detailed list of quality requirements that can be used to assess whether the DO and associated benefits have been delivered. We expect these would be developed during the capex planning process and agreed as part of the capex baseline at Gateway 3 in the governance process. Subsequent changes to DOs or individual quality requirements during H7 would need to be agreed with airlines, where practicable, and be demonstrably in the interests of consumers. It would also be

[9] The average implied incentive rate over Q6 is 13% but it is higher than this at the start of Q6 and lower than this at the end of Q6. It is based on HAL not recovering the financing cost associated with capex overspend or underspend during the Q6 price control compared to the baseline set at Gateway 3.

necessary to consider any appropriate changes to the capex baseline made to reflect these changes.

3.17 We expect HAL and airlines to work collaboratively to develop the DOs and list of quality requirements, taking account of the interests of consumers. These would then be agreed with the CAA. The level of detail will vary by capex category and DO. We will provide some initial examples of the form these might take in the working paper that we will publish shortly.

Timing incentives

3.18 We do not expect trigger payments to be required for most capex categories. The capex efficiency and quality incentives will provide an incentive on HAL to deliver works on time since delays are normally associated with overspending. For those capex categories where there is clear evidence that airlines and consumers would suffer significantly from the benefits lost by late delivery, we consider it will be important to put additional weight on timely delivery by applying trigger payments. We consider these should be discussed between HAL and airlines and should be symmetrical (so that they include a bonus for early delivery) unless there is evidence that this is inappropriate.

3.19 For capex categories that do not have associated trigger payments, we would look to reconcile the efficiency incentives at the end of H7.[10] Alternatively, we may set a backstop date for such reconciliation in the next price control period to mitigate the risks of undue delays in delivery. In any case where delivery is delayed and sufficient progress is not being made by the end of H7, we could also consider setting an additional penalty for non-delivery by the backstop reconciliation date.

3.20 We have identified an issue with the Q6 price control incentives that has the effect of potentially incentivising HAL to delay capex to reduce the size of the incentive applied to any capex overspend. We intend to rectify these difficulties

[10] By reconciliation, we mean that the incentive payments are calculated and applied to forward-looking RAB or revenue, together with any associated financing cost adjustments.

for the H7 price control period by making financing cost adjustments at the time when the incentives are reconciled.

Setting the cost baseline and dealing with uncertainty

3.21 For each capex category, we will need to set capex baselines for each of core and development capex for the H7 period. Either during, or at the end of, H7, capex baselines could be updated as required to reflect the following issues:

- movement of projects from being development to core capex (by updating development and core capex baselines);
- agreements between HAL, airlines and the CAA that individual development projects should no longer be taken forward (downwards adjustments to capex baselines);
- non-delivery or under-delivery of the DO and quality requirements (downwards adjustment to capex baselines); and
- agreed changes in capex, DO or quality requirements, (upwards or downwards adjustment to capex baselines). This could include any changes in project scope or to respond to factors outside HAL's control.

3.22 We expect that the covid-19 pandemic will have a fundamental impact on the capex programme and will mean that HAL's needs to develop plans in an uncertain environment. As part of designing a more flexible framework to respond both to this uncertainty and protect consumers, we expect to set an overall envelope for capex required to maintain HAL's assets, with "tramlines" to act as upper and lower "bounds" for this envelope. These tramlines would be flexible to change in line with agreed updates to the capex baselines. Should forecast or outturn capex fall outside these tramlines, we would conduct a detailed review of the capex programme during H7, working with HAL and airlines. At this stage, we consider it is appropriate to focus on essential "maintain capex" and other projects that are particularly important to consumers, rather than including more discretionary projects, but we could keep this under review as the H7 capex programme is developed.

Reconciliation of incentives

3.23 We have considered two main options for the timing of reconciliation of the efficiency incentives:

- undertaking all reconciliation at the end of H7 in cases where the DO is complete; or
- reconciling incentives for some capex categories during H7 where this is practicable (for example, for some maintain capex categories), with the other categories reconciled at the end of H7.

3.24 There is merit in the second option and reconciling incentives for some capex categories during H7 where this is practical (as timely reconciliation may sharpen the impact of the incentives). We will need to revisit this once the H7 capex programme is better understood by HAL and airlines.

3.25 We set out some principles we are considering for the reconciliation process below (further details will be set out in the working paper referred to above):

- the RAB would be updated annually to reflect actual capex incurred across the capex portfolio;
- regulated charges would be set based on baseline capex, reflecting the associated capital charges (depreciation and allowed return) and updated during H7 for agreed changes to the capex baselines. Charges would also reflect any bonuses or penalties under timing incentives and the revenue portion of any "within period" reconciliations (as discussed below);
- during H7, the capex incentives would be reconciled for certain "maintain capex" categories, where the outputs have both been delivered (as measured against the relevant DO) and it is practical to assess the associated quality requirements. This reconciliation would involve:
  (i) comparing outturn capex with the baseline and multiplying any over or underspending by the incentive rate; and
  (ii) applying the incentive adjustments and associated financing cost adjustment to the RAB or revenue;

- other capex categories would be reconciled at the end of H7 where the output has been delivered (as measured against the relevant DO) so that we would be able to assess the associated quality requirements;
- for any capex categories where reconciliation is not possible by the end of H7 because delivery has been delayed, we would set a backstop date for reconciliation in the next period and consider a potential penalty for late delivery after this date; and
- if outturn or forecast capex falls outside the tramlines around the envelope for "maintain" capex and important projects during H7, then this would lead to a review of the capex programme as a whole.

Governance arrangements

3.26 We have started our *ex post* review of capex in Q6 and have reviewed the initial findings from the IFS on the Q6 price control governance arrangements.[11] These have highlighted a number of areas where the Q6 price control capex governance improved on the approach in previous periods, while also identifying important areas for further improvement.

3.27 As part of the CE process between HAL and airlines, we encourage HAL and airlines to work through the details of the governance arrangements to be used for H7, including making the necessary improvements and supporting the new incentive framework. Based on our review, we understand these improvements might include developing:

- more effective processes for airlines and the IFS to scrutinise project costs and DOs, such as:
  - (i) clear roles and responsibilities for the Capital Portfolio Board and other governance and working groups;
  - (ii) more transparency at the Capital Portfolio Board on the overall capex strategy;

[11] The IFS learning points from the Q6 price control for H7 was presented as a working draft to HAL, airlines and CAA.

(iii) reviewing ways to ensure sufficient and suitable attendance at each governance group;

(iv) clarifying the role of the IFS, and

(v) clarifying the level of scrutiny at each level of project, capex category and portfolio;

- more effective monitoring of project "Gateway" milestones, so that the start of projects is not unduly rushed or delayed, and the optimal solutions are identified and selected;
- greater alignment and compliance by HAL with agreed processes and procedures, such as cost planning and benchmarking; and
- clear criteria for determining the levels of independent expert review for particular projects. This should be proportionate to the risks from overspending, so that more focus might be required on larger and more complex projects to improve assets or create capacity.

3.28 We will consider further how to ensure that the interests of consumers are appropriately reflected in capex governance arrangements.

Requirements for the RBP and next steps

3.29 We intend to apply the approach set out in this chapter to the H7 capex programme in the RBP. Bearing this in mind, HAL should ensure that the RBP contains detailed information on its proposed capex programme and, to the extent practicable, bring forward its proposals for incentives based on the criteria and broad approach set out in this chapter and the working paper referred to above.

3.30 To support this approach, we have held working level sessions with HAL and some airlines which have influenced the development of the thinking set out in this chapter. During 2020, we expect further engagement and working sessions will be needed to clarify and refine the principles we have set out, and how they should be applied to the capex programme ahead of the RBP. We would, therefore, encourage collaborative working between HAL, airlines and CAA ahead of the RBP to:

- develop proposed capex categories and baselines, and determine how these can be applied to the different passenger growth scenarios;
- propose associated delivery obligations and quality requirements for each capex category;
- set out which capex categories might require additional timing incentives; and
- develop enhanced governance arrangements for capex.

3.31 We expect this engagement to be part of CE, but there will be a need for ongoing development after this during 2020 and 2021, through targeted workshops and discussions. The IFS may also need to have an important supporting role in commenting on proposals.

3.32 We expect to take stock and provide an update on the capex incentive framework in the "way forward" document we intend to publish in Q1 2021. In the summer of 2021, we will provide our view on the draft capex incentives framework in our initial proposals for the H7 price control, and then update this in the final proposals later in 2021.

Views invited

3.33 We would welcome views on any of the issues raised in this chapter and, in particular, on:

- the criteria and broad approach to capex incentives identified in this chapter; and
- how best to improve capex governance arrangements.

Chapter 4

Financeability and the cost of capital

Introduction

4.1 This chapter provides an update on our policy on financeability and the cost of capital following the CMA's Provisional Findings on NERL's RP3 price control and HAL's decision to pause expansion.

4.2 Nonetheless, it is too early to take account of the impact of the covid-19 pandemic, as the medium term impact on HAL, the aviation sector more widely, and financial markets is not yet clear. Further work will be needed to adapt our approach to take account of these issues.

4.3 We are conscious that current circumstances are creating financial pressure on HAL and that, if the recovery in passenger traffic is relatively slow, this may create difficult issues for the price review. It may not be straightforward to identify levels of airport charges that easily support both HAL's financeability and an affordable level of charges for airlines (and airlines are under particular financial pressure as a result of the major reduction in demand for air travel). If necessary, we will adopt maximum flexibility in seeking to establish price control arrangements that deliver these twin aims.

Financeability

4.4 It is important that the price control we set for HAL allows it to finance investment efficiently. While the level of capex will be much lower, given we are focusing on HAL operating a two runway airport with expansion paused, HAL will continue to have a very substantial RAB to finance as well as its ongoing investment.

Our approach to Gearing

4.5 A key factor in assessing financeability is the balance between debt and equity financing ("gearing").

4.6 In the context of expansion[12] we were considering the appropriateness of the notional gearing assumption used for the Q6 price control of 60%, given the need to ensure a robust assessment of the financeability of expansion. We noted that we were exploring more closely aligning the notional financial structure with a relatively strong credit rating, and this might lead to an assumption of gearing between 65% and 70%.

4.7 Circumstances have now changed considerably and we will need to reconsider our approach to these matters. Nonetheless, there will remain clear advantages in an approach based around HAL retaining access to cost effective investment grade debt finance and we will want to assume a capital structure and level of gearing consistent with this approach.

4.8 In considering these matters, we will have regard to the work produced by our consultants, Flint. In the report we have published to accompany this consultation, Flint assumed a range for notional gearing of 52.5%-60.0%. This estimate will need to be updated in due course to reflect the notional gearing assumption we consider is appropriate in the light of the emerging evidence and market conditions.

4.9 We will also consider whether it is appropriate to assess an alternative financial structure that is more akin to HAL's actual financing structure alongside our assumed "notional" financial structure. However, we note that it is HAL's responsibility to manage any financeability issues arising from its choice to adopt a higher level of gearing than in the notional structure.

Longer term certainty and commitment

4.10 We previously explored the merits of determining some elements of the price control for a period of greater than the "normal" five years in order to provide greater certainty to stakeholders in the context of expansion. We also explored the possibility of requiring HAL to demonstrate that it has appropriate commitments in place for equity financing. Given the pausing of expansion and

[12] See paragraphs 3.45-3.49 of the January 2020 Consultation.

the current level of uncertainty, we no longer see a persuasive case for pursuing this work.

Calibrating the price control

4.11 Our approach to issues such as credit ratings and profiling regulatory depreciation can have a significant impact on financeability, the level of the price control and the cost of capital. We have already discussed our approach to credit ratings above in the section on gearing.

4.12 We have consulted on a number of occasions regarding the potential for using regulatory depreciation as a tool to move cash between price control periods to manage financeability and affordability. Alongside this, we have considered other policies such as the use of a nominal cost of debt allowance that could be used to achieve a similar objective.

4.13 In the absence of expansion, there is less likely to be a need to accelerate cashflows from future periods to H7 to support financeability. At the same time, these policies could potentially still be useful in H7 in the event that a financeability concern emerges, or to manage affordability and to smooth the profile of charges.

Equity financeability

4.14 We have previously set out our initial thinking on how we will assess financeability from an equity perspective.[13] This included a discussion of a number of possible metrics that could form the basis of an assessment of equity financeability.

4.15 Even in the absence of expansion, we consider that assessing equity financeability constitutes a useful “cross check” on the internal consistency of the overall financial package. As a result, we are minded to retain the approach to assessing equity financeability set out in the January 2020 Consultation as part of our overall financeability assessment. This would involve examining a range of

[13] See paragraphs 3.54-3.64 of the January 2020 Consultation.

metrics with the intention of being able to create a "dashboard" of measures that will capture the long run level, timing and variability of returns to equity.

Allowed tax costs

4.16 In the January 2020 Consultation, we discussed our preferred approach to setting an allowance for corporation tax costs. This approach would involve using the estimates of the tax costs in our financial modelling, based on a gearing level consistent with that used to set the cost of capital, to calculate an allowance for corporation tax. This would be separate from the WACC, which would be calculated on a "vanilla"[14] basis.

4.17 We consider that this approach should provide a reasonable and transparent estimate of the tax costs that HAL will incur in practice and are minded to apply this method in setting the allowance for taxation.

4.18 We also discussed tax uncertainty and tax "clawback" mechanisms.[15] The advantage of a tax clawback mechanism is that it would recover, for the benefit of customers, the tax benefits accruing to HAL from adopting a higher level of gearing than the notional level. A tax uncertainty mechanism would seek to pass on to customers some of the risks that are outside reasonable management control, such as changes in corporate tax rates. We are minded to include both for H7 to help manage uncertainty and remove the specific incentive for HAL to increase its gearing unduly during H7. At the same time, we recognise further work would be necessary to define these mechanisms.

Developing our thinking on the cost of capital

4.19 The cost of capital represents the return that investors require in order to persuade them to commit capital to a business given its perceived risk exposure. We use the cost of capital to provide an allowed return on HAL's RAB in order to:

[14] "Vanilla" in this context refers to the calculation of the allowed return prior to the inclusion of an allowance for corporate taxation.

[15] See paragraphs 2.60-2.66 of the January 2020 Consultation.

- provide an appropriate return for shareholders, proportionate to the risks that they face, so that shareholders are willing to invest in HAL and the regulatory framework can provide HAL with incentives to manage its business efficiently;
- support an appropriate equity financing buffer that should allow HAL to access relatively low cost debt finance; and
- provide an appropriate return to debt investors to allow HAL to continue to access low cost debt finance.

4.20 We commissioned an independent view of the cost of capital for H7 from our advisors, Flint. This updates the analysis we published last year, and incorporates our views on the impact that the CMA's review of RP3 will have on the H7 cost of capital. However, it does not take account of the impact of the covid-19 pandemic. We will need to undertake further work on these matters during the price control review.

4.21 Even so, there is merit in consulting on this assessment of the cost of capital at this stage. This is because we want to establish a clear baseline for our further work, and many of the issues will be relevant to the further work we will undertake to assess the impact of the covid-19 pandemic.

4.22 We note that both the direction and magnitude of the impact of the covid-19 pandemic are still unclear. We will be monitoring developments over the coming months closely and reflect new information as it becomes available. We will be looking to HAL to provide its own evidence of this impact in the RBP, to the extent this is available.

Cost of equity

4.23 The cost of equity finance is typically calculated using a company specific estimate of relative risk (equity beta) and market wide estimates of the RFR, TMR and equity risk premium.

Equity beta

4.24 The analysis used by HAL in its IBP to estimate equity beta appeared to exhibit a number of methodological differences compared with the approach we had previously set out. These may be summarised as:

- measurement period: we had based our estimates on two year and five year periods, while NERA (on behalf of HAL) had additionally considered a one year period;
- frequency of stock return data: we had based our estimates on daily and weekly data, while NERA relied exclusively on daily data;
- measurement of net debt: we had relied on data sourced from Bloomberg, while NERA had estimated net debt for the comparator airports based on the figures in those airports' annual reports; and
- views of relative risk: we considered that the level of risk exposure is broadly equivalent, while NERA considered that Fraport exhibits a lower level of systematic risk than HAL.

4.25 HAL noted in its IBP that the principal area of divergence was the use of local as opposed to Europe-wide equity indices for estimating comparator equity betas. This alone accounted for most of the difference in the estimates of parameters.

4.26 The work that Flint has undertaken also suggests that the use of Europe-wide equity indices is more appropriate than local indices, and Flint based its estimates on this approach. In adopting this approach, Flint had regard, among other factors, to the CMA's approach to estimating the equity beta in its work on NERL's RP3 price controls (which used airports as comparators for NERL).

4.27 More generally, aside from minor methodological differences, Flint's approach to estimating the equity beta of HAL is broadly consistent with the CMA's Provisional Findings for NERL. The following points are common to each of Flint's and the CMA's assessments:

- inclusion of AENA within the comparator set for HAL;

- consistent relative risk assessment, namely, that HAL exhibits similar risk exposure to Aéroports de Paris; a greater level of risk exposure than Fraport and lower risk exposure than AENA;
- use of trailing averages alongside spot estimates;
- use of a debt beta for comparators of 0.05 and 0.1 for HAL; and
- continued use of two year and five year measurement periods.

4.28 Flint's assessment diverges from that of the CMA in the following respects:

- primary reliance on daily data; and
- use of average gearing over the relevant measurement period rather than current gearing.

These divergences do not, however, lead to significant differences in the equity beta estimate for HAL.

4.29 With respect to the impact of the covid-19 pandemic, we will need to consider a number of issues that could arise, including:

- whether the time period and frequency of data used to estimate comparator betas is appropriate; and
- whether the impact of the covid-19 pandemic will have a symmetric impact on HAL and its comparators.

Market-wide parameters

4.30 We previously presented a range of evidence regarding the market-wide parameters: the RFR and the TMR. We concluded on a range of -1.5% to -1.0% (RPI-real) for the RFR and 5.1% to 5.6% (RPI-real) for the TMR.

4.31 In its IBP, HAL disputed a number of elements of our assessment of the TMR, including:

- the inflation index used to deflate historic nominal equity returns;
- the type of average used to evaluate historic equity returns; and
- the dividend growth assumption used to estimate future equity returns.

4.32 HAL also adopted a different approach to estimating the RFR. Whereas we estimated the RFR based on forward yields on index-linked gilts, HAL said that it was appropriate to use forward yields on nominal gilts and deflate these using an inflation assumption.

4.33 Flint considered the evidence in respect of the TMR, including the CMA's view in the Provisional Findings for RP3, and concluded that the CMA's proposed approach and range (5.0%-6.0% RPI-real) were both appropriate. It similarly considers that the CMA's approach to estimating the RFR is appropriate, although it notes that an adjustment is needed to take account of the different timing of H7 and RP3. On this basis, Flint estimated an RFR of -2.1% RPI-real for H7.

4.34 It is likely that the approach to estimating the TMR will need to be revisited once evidence regarding the impact of the covid-19 pandemic becomes available. Consideration will need to be given to various questions, including:

- whether the use of long-term historical data under the CMA's approach fails to adequately capture any aspect of the impact of the covid-19 pandemic; and
- whether there is a case for adjusting the TMR estimate to reflect any potential impact.

4.35 While the covid-19 pandemic may well have an impact on the RFR, the approach to estimating the RFR set out above is likely to capture this impact, since it is based on relatively up-to-date and forward-looking financial market data.

Cost of new debt

4.36 We previously set out a proposal to set the cost of new debt by reference to the iBoxx 10Y+ A/BBB indices, and to update the cost of new debt based on the relevant index values in each year of the price control.

4.37 In its IBP, HAL agreed with the use of this index, but said that two[16] uplifts were needed to the index, to reflect:

- the higher cost of HAL's debt relative to the index; and
- HAL's contention that index-linked debt is more expensive than nominal debt, which would not be reflected in the index.

4.38 Flint considered both proposed uplifts and concluded that there is no basis for either to be included.

4.39 We are aware that both HAL and other airports have been disproportionately affected by the impact of the covid-19 pandemic compared to the rest of the economy. This has been reflected in recently depressed issuance volumes of, and higher traded yields on, airport bonds compared to those of businesses in other sectors. It is unclear at this stage how long this divergence may last. If these market conditions persist, it may be necessary to consider adjustments or alternatives to the iBoxx index as a benchmark for the cost of new debt.

Cost of embedded debt

4.40 Our previous estimates for the cost of embedded debt for H7 were based on historical values for an index of publicly traded debt securities. We used an average of the A and BBB rated 10Y+ iBoxx indices. We considered that a 15 year averaging period would be appropriate, on the basis of an assessment of HAL's outstanding funding.

4.41 We also introduced a downward adjustment of 48 basis points ("bps") to reflect the expected retirement of a proportion of embedded debt during H7. Because this debt was raised in the early years of the averaging period, and interest rates have been falling over this period, the remainder of the embedded debt would be expected to be cheaper on average than the debt that will retire over H7.

4.42 In its IBP HAL:

[16] HAL also suggested an uplift to reflect the need to issue foreign currency-denominated debt in the context of expansion.

- has said we should use HAL's actual cost of embedded debt, on the basis that to do otherwise would risk underestimating HAL's actual cost of capital which would be inconsistent with our "financing duty".[17] HAL suggested that if the cost of embedded debt was to be estimated based on an index of debt securities, an uplift should be applied corresponding to the spread of HAL's actual cost of debt above the index yield. It proposed that a spread of 25 bps should be applied to the yield on the iBoxx 10Y+ year A/BBB index;
- suggested that the cost of embedded debt should be estimated based on an averaging period of 20 years as an averaging period of 15 years would exclude a substantial proportion of debt relevant to the assessment; and
- did not include an adjustment to reflect the "retirement" of older embedded debt. However, it did introduce a downward adjustment of 29 bps to reflect the expectation that raising new debt in 2020 and 2021 would be cheaper than HAL's current embedded debt.

4.43 Flint considers that it is appropriate to continue to estimate the cost of embedded debt by reference to a trailing average of the iBoxx 10Y+ A/BBB indices. In the light of the evidence that HAL has presented on the longevity of its debt issuance programme, it agrees with HAL that a 20 year average is the appropriate measurement period. However, it does not consider that any uplift is warranted to reflect the spread of HAL's debt over the index. Flint also agrees that an adjustment to the index to reflect the retirement of early embedded debt over H7 is appropriate.

4.44 If the covid-19 pandemic has a longer-term impact on the indices we have used to estimate the cost of HAL's embedded debt, we may need to consider adjustments or alternatives to the iBoxx index as a benchmark for the cost of HAL's embedded debt.

17 This is the duty in section 1(3)(a) CAA12 for the CAA to have regard to the need to secure that each licensee is able to finance its provision of airport operation services in the area for which the licence is granted. For further information on the CAA's duties under CAA12, see Appendix A.

Views invited

4.45 Views are invited on any aspect of the issues raised in this chapter and, in particular, on:

- the approach adopted by Flint and summarised above for estimating cost of capital for H7 prior to the impact of the covid-19 pandemic being felt; and
- how we should best take account of the impact of covid-19 on HAL's cost of capital.

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

Glossary

Acronym/term	Definition
AOC	Airline Operators' Committee (for Heathrow), a private company limited by guarantee.
APOC	The Airport Operations Centre.
The April 2020 Update	CAA publication CAP1914 "Economic regulation of Heathrow: programme update". See: www.caa.co.uk/CAP1914.
The August 2019 Working Paper	CAA publication CAP1832 "Economic regulation of Heathrow Airport Limited: working paper on financial resilience and ring fencing" See: www.caa.co.uk/CAP1832.
BA/IAG	British Airways plc/International Airlines Group (owner of British Airways).
Budget	Annual budget that HAL submits to the CAA and other stakeholders on expansion-related costs. Further detail on the annual budget and statement of costs associated with obtaining planning permission (Category B costs) is set out in the Budget Guidance.
Budget Guidance	CAA publication CAP1651 "Guidance on preparation of the annual budget and statement for those costs associated with obtaining planning permission for a new northwest runway". See www.caa.co.uk/CAP1651.
CAA ("us"/"we")	The Civil Aviation Authority.
CAA12	Civil Aviation Act 2012.
CAA Consumer Panel	A non-statutory body established to act as a "critical friend" to the CAA. It provides expert advice to make sure that the consumer interest remains central to CAA policy development.
Capex	Capital expenditure.
Category A 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

Acronym/term	Definition
	2016. For more information please see Appendix C to the July 2019 Consultation.
Category B costs	Costs associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow. For more information please see Appendix C to the July 2019 Consultation.
Category C costs	Costs incurred by HAL in connection with implementation and construction of new capacity, up to entry-into operation. For more information please see Appendix C to the July 2019 Consultation.
CCB	Consumer Challenge Board: in order to strengthen the link between consumer outcomes and priorities and the regulation of Heathrow, the H7 Consumer Challenge Board (CCB) was established by the CAA in partnership with HAL and the airlines that currently use Heathrow.
CE	Constructive Engagement: a process mandated by the CAA that requires the airport operator to discuss its business plan with the airlines before we need to reach a decision on the appropriate price control.
CMA	The Competition and Markets Authority
CMA Provisional Findings	CMA provisional findings report in relation to the NERL RP3 regulatory appeal.
Commercial revenues	Revenues HAL derives from services to passengers, such as retail, food and beverage, *bureaux de change*, advertising, car parking and car rental, or from services to airlines, check-in desks, office rental, airline lounges and warehousing.
Consumers	As defined in CAA12, consumers are passengers and cargo owners, both now and in the future.
Core and development capex	Core capex is capex that has been through Gateway 3 (investment decision stage) of capex governance, in line with the approach for the Q6 price control. Development capex is capex at an earlier stage of development.

Acronym/term	Definition
The December 2019 Consultation	CAA publication CAP1871 "Economic regulation of Heathrow Airport Limited: policy update and consultation on early costs of capacity expansion". See: www.caa.co.uk/CAP1871.
The December 2017 Consultation	CAA publication CAP 1610 "Economic regulation of capacity expansion at Heathrow: Policy update and consultation" See: www.caa.co.uk/CAP1610.
DfT	The Department for Transport.
DO	Delivery Obligation, as defined in the CAA's capex incentives proposals.
Early costs	Expansion-related costs that are incurred by HAL prior to obtaining planning consent.
Equity beta	Company specific estimate of risk relative to the whole market.
Expansion	HAL's programme to expand Heathrow airport by the construction of a new northwest runway and associated infrastructure in accordance with the NPS.
H7	The next HAL price control, assumed to be in place from 1 January 2022. If set for the usual five year period, this will run for the years 2022-2026.
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport.
HCEB	Heathrow Community Engagement Board: the Airport Consultative Committee and the Community Engagement Board for Heathrow Airport.
Heathrow West	Heathrow West Limited, a company set up by the Arora Group to promote the "Heathrow West" proposal.
IATA	International Air Transport Association, a global trade association representing airlines.
iBoxx indices	The Markit iBoxx Corporates Indices represent investment grade fixed-income bonds issued by public or private corporations and are produced by IHS Markit. For the purpose of calculating HAL's cost of debt, we have used two of these indices corresponding to A-rated and BBB-rated bonds respectively. Both of these comprise sterling-denominated bonds of 10-year or greater maturity.

Acronym/term	Definition
IBP	HAL's Initial Business Plan. This was published in December 2020 in response to the Updated Business Plan Guidance. See: https://www.heathrow.com/company/about-heathrow/economic-regulation/h7-update.
IFS	The Independent Fund Surveyor for Heathrow, which is jointly appointed by HAL and the airlines, with a duty of care to the CAA. The scope of the IFS role is broadly to assure that capital funds are invested efficiently to meet agreed project objectives.
iH7	Interim H7 price control. Runs from 1 January 2020 until 31 December 2021.
Initial tests	Tests which the CAA considered Arora should meet for the CAA to undertake detailed work on the regulatory framework that might apply to any element of capacity expansion developed by The Arora Group/Heathrow West. For more information see Appendix E of the March 2019 Consultation.
IPCR	Independent Planning Costs Reviewer appointed by the CAA under the Planning Costs Recovery Policy Statement.
The January 2020 Consultation	CAA publication CAP1876 "Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues" See: www.caa.co.uk/CAP1876.
The July 2019 Consultation	CAA publication CAP1819 "Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable". See: www.caa.co.uk/CAP1819.
The June 2017 Consultation	CAA publication CAP 1541 "Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow". See: www.caa.co.uk/CAP1541.
LAANC	Local Authorities Airports Noise Council for Heathrow, an umbrella local authority organisation representing the interests of residents around Heathrow.
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport.

Acronym/term	Definition
The March 2019 Consultation	CAA publication CAP1782 "Economic regulation of capacity expansion at Heathrow: policy update and consultation". See: www.caa.co.uk/CAP1782.
NERL	NATS En Route plc
NPS	The Airports National Policy Statement published on 5 June 2018 produced by the Government under the Planning Act 2008.
OBR	Outcomes Based Regulation. Our policy was set in our Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control (see www.caa.co.uk /CAP1540) and updated in the Updated Business Plan Guidance.
The October 2018 Consultation	CAA publication CAP 1722 "Economic regulation of capacity expansion at Heathrow: policy update and consultation". See: www.caa.co.uk/CAP1722.
Opex	Operational expenditure.
ORCs	Other Regulated Charges.
PCM	Price Control Model.
The Planning Costs Recovery Policy Statement	CAA publication CAP1513 "The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: Policy statement". See: www.caa.co.uk/CAP1513.
PSG	Passenger Services Group, part of the HCEB.
PR19 determination	Ofwat's December 2019 decision in relation to the five year price control settlement for water companies in England and Wales. See: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Overview-of-final-determinations.pdf
Q6 or Q6 price control	The "Q6" price control is the price control for the period from 2014 to 2018, the approach to which has subsequently been successively extended to cover 2019-2021.
RAB	Regulatory Asset Base.
RBP	Revised Business Plan.

Acronym/term	Definition
Regulatory Year	Means for each of the seven years from 2015 to 2021, the twelve month period beginning on 1 January and ending on 31 December (as defined in HAL's licence granted under CAA12).
RFR	The risk-free rate.
RHC	Richmond Heathrow Campaign, a joint initiative of The Richmond Society, Friends of Richmond Green and The Kew Society to combat Heathrow expansion and its effect on Richmond Town, Richmond Hill and Kew.
RP3	The NERL Reference Period 3 price control that was originally expected to run from 1 January 2020 to 31 December 2024 (currently under regulatory appeal to the CMA).
SQRB	Service Quality Rebated and Bonuses scheme.
Statement	Annual year end statement that HAL submits to the CAA which outlines expansion-related costs that it has incurred. Further detail on the annual budget and statement of costs associated with obtaining planning permission (Category B costs) is set out in the Budget Guidance.
The Updated Business Plan Guidance	Guidance included as an Appendix in CAA publication CAP1819 "Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable". See: www.caa.co.uk/CAP1819.
TMR	Total market return.
VAA	Virgin Atlantic Airways.
WACC	Weighted Average Cost of Capital.
Wind-down costs	Expansion-related costs that HAL has incurred since the Court of Appeal's judgement in February 2020.

Appendix C

Regulatory treatment of HAL's early expansion costs

Introduction

1. The December 2019 Consultation addressed the early programme costs that HAL expected to incur in advance of obtaining planning consent for expansion. Our approach acknowledged that, to deliver expansion in a timely way, HAL would have needed to incur planning (Category B) and early construction (early Category C) costs before it obtained planning consent.

2. Since publishing the December 2019 Consultation, the significant events affecting the aviation sector generally, and expansion in particular, have led HAL to pause its expansion programme, stopping nearly all work on seeking planning consent for expansion at Heathrow.[18] This significant change in circumstances has led us to reconsider, and further consult on, the recovery of the early costs of expansion that HAL has incurred.

3. This appendix sets out our proposal to refocus our policy on these costs and:

   - briefly summarises the December 2019 Consultation and stakeholders' views on it;
   - updates our proposed regulatory treatment of expansion costs incurred by HAL up until the end of February 2020;
   - sets out our approach to the future efficiency reviews of these costs;
   - describes our initial thinking on the treatment of programme wind-down costs incurred by HAL after 1 March 2020; and

[18] Details of these events are outlined in the Executive Summary.

- discusses our approach to any future spending on expansion.

The December 2019 Consultation

4. The December 2019 Consultation was developed in the context of HAL's escalating forecasts of early costs.[19] Our approach focussed on furthering the interests of consumers by incentivising the delivery of expansion in a timely and efficient manner. Nonetheless, we acknowledged that, to achieve this, HAL would have needed to incur a level of early Category C costs which we considered was in the interest of consumers.

5. We proposed to strengthen the governance and regulatory incentives that would have applied to HAL's early expansion costs, recognising stakeholders' concerns about the increases in HAL's estimates for those costs. These proposed arrangements included:

   - enhanced reporting;
   - implementing caps on the total amount of Category B and early Category C costs that HAL would have been allowed to recover;
   - reducing HAL's return on these costs if planning consent were not granted; and
   - modifying HAL's licence to create formal governance arrangements for early Category C costs.

Stakeholder views

6. Most of the stakeholder comments covered policies which we are no longer pursuing, so we have not summarised the specific detail of these

[19] At the time of the December 2019 Consultation, HAL had said that to retain a target of 2026 for the opening of the new runway, it would need to bring forward the timing of certain spending so that total early costs would need to be about £2.9 billion (2014 prices). This included spending of over £500 million on Category B costs and £2.4 billion on early Category C costs (2014 prices), before it obtained planning consent. This was a very significant increase on its earlier estimate of around £1 billion (2014 prices).

responses here.[20] Elements of the responses that remain relevant to informing our refocussed policy are summarised below.

7. HAL disagreed with key aspects of our proposal. It said that our risk sharing approach did not provide a "fair bet" to investors and this would jeopardise future investment. HAL strongly disagreed with our proposed approach to allowed returns on early expansion costs, suggesting higher levels of return. HAL also proposed that investment should be recorded in the RAB as it is spent, but acknowledged that the recovery of costs would not start until the start of H7.

8. Airlines supported our proposal to strengthen risk sharing arrangements and strongly argued that HAL should not be allowed to recover any expansion costs if it unilaterally withdrew from the planning process.

9. Airlines considered that our proposed return on early costs was too generous to HAL and would over reward its investors. One airline suggested that expansion costs should be remunerated at the cost of debt rather than the Q6 price control cost of capital (5.35%) or the "iH7" interim price control cost of capital (4.83%) we had proposed. It considered our proposal provided an incentive for HAL to spend quickly which risked unnecessary spending. Other airlines also disagreed with our proposal, saying that the returns we had proposed were not consistent with recent evidence on the cost of capital.

10. Heathrow West suggested that it would not be appropriate for the CAA to support the recovery of early Category C costs until the fate of the NPS is known. It also requested that the CAA replicate its policy on the recovery of HAL's planning costs for the cost that Heathrow West has incurred for its planning application.

[20] A full set of stakeholders' responses to the December 2019 Consultation can be found on our website. See: https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Consultations-and-policy-documents/.

Responding to the changed context

11. HAL decided to pause its work on expansion in March 2020, stopping nearly all work and spending on preparing its application for planning consent and early construction activities. Airlines support HAL's decision to stop spending on expansion in the light of the current circumstances.

12. Given this, we have decided to consult on a refocussed and simplified policy to address the circa £500m of early expansion costs that HAL has incurred up to the end of February 2020.[21] This updated proposal represents a significant change in our approach from that consulted on in the December 2019 Consultation. However, we consider that this different approach is appropriate in the light of the new circumstances.

13. The April 2020 Update set out our response to the changed circumstances in the aviation sector in broad terms. While it did not specifically discuss the treatment of HAL's early costs, we did receive views from stakeholders on these matters.

14. HAL requested a clear timeline for our final policy on the treatment of early expansion costs. It said that while the Court of Appeal's judgment had changed the nature of HAL's spending in the short term, it still needed certainty on how the costs will be treated to:

- provide clarity on when and how costs already invested will be recovered; and
- allow any future spending to be carried out with confidence to ensure that, if the NPS is reinstated, expansion can be delivered in a timely manner to maximise the benefits for consumers.

15. HAL also expressed the view that its costs of appealing against the Court of Appeal's decision fall within the definition of Category B costs.

[21] HAL decided to pause its work on expansion in March 2020 after the Court of Appeal judgement at the end of February 2020.

16. One airline highlighted the importance of resolving outstanding policy decisions on expansion costs and said that, should HAL incur any additional spending following the Court of Appeal's judgment, it will be important to:

- maintain expert, independent scrutiny of HAL's spending; and
- ensure airline involvement in the governance of these costs.

17. Another airline said that any costs incurred after the Court of Appeal's decision should be at HAL's risk.

A re-focused approach

18. Our approach focuses on the costs that HAL incurred before it paused its work on expansion (around £500 million of, mostly Category B, costs).[22] We consider that it is no longer necessary or proportionate to have separate polices for Category B and Category C costs, so our simplified approach considers the treatment of all expansion costs incurred by HAL up to the end of February 2020.

19. We also consider that the following aspects of our previous policy proposal are no longer appropriate:

- risk sharing arrangements depending on whether HAL would have made a successful planning application;
- recovery caps for costs incurred in 2020 and 2021;
- enhanced reporting requirements of budgets and spending; and
- a new licence condition on governance arrangements.

[22] At the time HAL decided to pause expansion, HAL had incurred around £504million, consisting of £394 million of Category B costs and £110 million of Category C costs. We understand from HAL that certain programme costs (e.g. internal transfer of colleagues to the expansion programme) are accounted for on a quarterly basis so are not included in this estimate of spending up to the end of February 2020.

Regulatory treatment of expansion costs incurred up to the end of February 2020

20. Our policy on the first £265 million of early expansion costs was set out in the Planning Costs Recovery Policy Statement. To ensure the stability of the regulatory framework and avoid retrospective changes to our approach, this policy will remain in place as far as practicable. However, we are proposing some updates to this policy where needed to address the changed circumstances.

Risk sharing arrangements

21. Our previous policy included an 85/105 risk sharing mechanism on the first £265 million of HAL's costs. These arrangements were designed to encourage HAL to develop a high-quality planning application.[23]

22. We also said that we reserved the right to decide whether HAL should be allowed to recover less than 85% of its efficiency incurred costs[24] in certain limited circumstances where HAL had "unilaterally withdrawn" from the planning process.

23. The position is now different as HAL has effectively been forced to pause its plans for capacity expansion, and there is no clear timetable for any restarting of the expansion programme. In these circumstances, it would not be reasonable simply to wait for the resolution of these matters before deciding on the regulatory treatment of these costs. HAL commenced its spending on planning costs in 2016 and prolonging any further decisions on the regulatory treatment of these costs would risk creating undue regulatory uncertainty.

24. Therefore, it is appropriate that we respond to the changed circumstances and in the absence of an ongoing process for capacity expansion we no

---

[23] A successful application would have attracted a 5% bonus on the efficiently incurred costs added to the RAB, while an unsuccessful application would have let to a 15% penalty.

[24] This clause covered all Category B (planning) costs, including those above £265 million.

longer intend to apply any adjustments for risk sharing (but will continue to subject costs to efficiency testing). Our revised approach acknowledges that the original risk sharing incentive is no longer appropriate. This is because:

- it was focused on encouraging HAL to make a high quality planning application, as the planning process is now suspended, this is not relevant; and
- it is also clear that HAL has not unilaterally withdrawn from the process.

25. This approach would also be consistent with the long established regulatory principle that efficiently incurred capital costs are added to HAL's RAB. It will apply to the £500m in Category B and C costs.[25]

Recovery of HAL's expansion costs

26. As well as having due regard to the advantages of regulatory stability and HAL being able to recover efficiently incurred costs, we need to have regard to the advantages for consumers in an approach that provides for affordable airport charges. Therefore, while efficiently incurred expansion costs will be added to HAL's RAB[26] (and HAL may provisionally recognise them in its regulatory accounts),[27] we do not propose to allow HAL to start to recover these costs before 2022.

27. Consistent with our previous policy, we intend to make an allowance for financing costs in the period up to 2022 using:

---

[25] See footnote 5.

[26] Consistent with our existing policy, the first £10 million of Category B costs incurred per year are recovered through an adjustment to airport charges through the "per passenger correction factor" in the price control Condition in HAL's licence. See notice to modify HAL's licence available at: https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/

[27] All expansion costs must be transparently identified and separately reported in HAL's regulatory accounts.

- the Q6 cost of capital of 5.35% for the period up to the end of 2019; and
- the iH7 cost of capital of 4.83% for 2020 and 2021.

28. We have considered airline representations that these levels of allowed return would be too high but consider that they remain appropriate given the adverse impact of the present level of uncertainty on financial markets and, in particular, the cost of debt finance for the aviation sector.

29. Further, as part of the H7 price control review we will:

- disallow any expansion costs that we consider are inefficient (which could require HAL to adjust its provisional estimates for making additions to the RAB); and
- determine the profile of cost recovery (depreciation) and level of allowed returns from 2022[28] for expansion costs, taking account of the overall affordability of airport charges and HAL's financeability.

Assessing the efficiency of expansion costs

30. Category B costs incurred by HAL up to the end of 2018 have been subject to annual reviews and scrutiny by the IPCR. These reviews considered whether HAL had appropriate evidence to support its planning costs, and whether those costs had been appropriately categorised and efficiently incurred.

31. We have used the IPCR's advice to inform our annual efficiency reviews to determine the level of efficient planning costs that should be added to HAL's RAB.[29,30]

---

[28] For the period from 1 January 2022.

[29] IPCR Heathrow Expansion Programme covering the period 2016 and 2017, January 2019. See www.caa.co.uk/CAP1750 and supplementary report www.caa.co.uk/CAP1751.

[30] Appendix D of this document contains a summary of the most recent IPCR review of expansion costs incurred by HAL during 2018.

32. We also acknowledged in the December 2019 Consultation that the IPCR's reviews had demonstrated the difficulties in benchmarking and assessing the efficiency of these planning costs. Nevertheless, we intend to continue the efficiency reviews of HAL's remaining expansion costs for 2019 and 2020 but will make some changes to the way we carry out these assessments to learn from the work undertaken to date, including:

- themes emerging from our ongoing efficiency assessment of HAL's Q6 capex; and
- the difficulties that we have encountered in reviewing expansion costs to date.

Our proposed approach for future efficiency reviews

33. Consistent with our previous approach, we will expect HAL to demonstrate its early expansion costs were efficiently incurred. Bearing in mind the improvements in HAL's reporting arrangements, we do not intend to appoint an IPCR for 2019 and 2020, although we are still considering the detailed scope of work and the need for external advice to support our assessment.

34. In deciding whether spending is efficient, we will consider the information that HAL provides as part of the wider existing airport - airline governance processes. This will include reports produced on HAL's expansion costs by the IFS on behalf of the airlines and HAL. The scope of the IFS's review of HAL's expansion costs includes a review of the relevance, timeliness and efficiency of the activities undertaken, and corresponding cost incurred, by HAL.

35. When considering whether expansion costs should be added to HAL's RAB and are in the interest of consumers, we will consider whether they are;

- supported by appropriate evidence;

- have been categorised correctly between "business as usual" and "expansion" activities (to guard against potential "double counting" of costs);[31] and
- efficiently incurred.

36. Instead of carrying out annual reviews, we propose a single assessment process in two stages, covering HAL's 2019 Category B and Category C costs and those incurred up to the end of February 2020.

37. HAL submitted its 2019 Category B Statement of costs and supporting information to the CAA and airlines on 1 May 2020. However, we will be requesting further information from HAL so that we can also assess the efficiency of HAL's spending on early Category C costs. We expect HAL to provide the following additional information to support our assessment:

- an updated Budget, and Statement information for all Category C spending incurred up to the end of February 2020; and
- supporting information and evidence to demonstrate that early construction expenditure has been appropriately and efficiently incurred.

38. Where applicable, information provided should be consistent with the reporting principles set out in our Budget Guidance.

39. To inform our review of HAL's costs, we will also request views from airlines on our approach to scrutinising HAL's costs. This will help us to identify specific areas of HAL's spending where they consider that we should focus our review and/or request further evidence from HAL.

[31] Our policy for Category B and early Category C costs is now aligned, so the categorisation of costs between planning and early construction activity will not be an important consideration for the 2019 and 2020 reviews, but the categorisation between "two runway" activity and expansion remains important.

Expansion programme wind down costs

40. HAL has continued to incur costs associated with the expansion programme after the Court of Appeal's judgment. The costs that HAL has incurred after the 1 March 2020 include costs of pausing and demobilising its expansion programme, which we refer to as "wind down" costs. We understand from HAL that further costs of pausing expansion are likely to continue until Q3 2020[32] and are forecast to be in the region of £46 million.[33] This spending includes costs such as residual staff costs, costs associated with fulfilling supplier contractual commitments, and HAL's pre-existing agreements relating to property acquisition.

41. We intend to finalise the approach to the recovery of these costs once the full nature and extent of spending has been confirmed by HAL. Nonetheless, we would expect HAL to be able to recover efficiently incurred costs. As part of this process, we would expect HAL to provide evidence to airlines for review by the IFS to justify these costs as part of the existing airline/airport governance arrangements, including demonstrating that the costs were unavoidable, have been efficiently incurred and properly allocated.

42. We plan to start this review later this year once HAL's spending on the expansion programme has stopped (or is close to zero).

Costs of appealing to the Supreme Court

43. In addition to the wind down costs discussed above, there will also be costs associated with HAL's appeal against the Court of Appeal's decision to the Supreme Court.

[32] We understand that there may be some ongoing expansion costs that will continue beyond this period, for example spending on ground investigation monitoring sites.

[33] An estimate of spending from March 2020 to December 2020. HAL notes that this estimate excludes redundancy and colleague displacement costs which are still being finalised through a consultation process, as well as costs to support the legal process for HAL's appeal to the Supreme Court.

44. As discussed earlier in this appendix, we have already received mixed views from airlines on the treatment of HAL's appeal costs. HAL considers that these costs should be classified as Category B costs and should be treated as such.

45. Our initial view is that HAL's costs of appealing to the Supreme Court are an ongoing strand of HAL's expansion work. As a result, we consider that appeal costs incurred by HAL after the end of February 2020 should, as far as practicable, be treated in the same way as costs incurred before that date.

46. However, the Supreme Court's judgment may, itself, have an impact on the level of costs that HAL incurs,[34] and this will not be available until sometime after the hearing of that appeal, which we understand is likely to take place later this year. We would want to take the judgment into account in deciding on the regulatory treatment of these costs.

Future spending on expansion

47. If the expansion programme recommences at some point in the future, we would expect HAL to consult on detailed, evidence based, robust and properly costed budgets for both early costs and the wider programme. Once the budgets were finalised, it would be important to have effective controls on any spending and for HAL to be able to demonstrate spending was efficient and value for money. We would also reconsider our approach to the regulatory framework, including how best to create incentives for a high quality planning application. As noted in the April 2020 Update, we could address capacity expansion through an "add on" to the H7 price control, if the need arises.

[34] The judgment may give rise to an order for costs that may enable HAL to recover costs, or may, conversely make it liable for other parties' costs.

Views invited

48. Views are invited on any of the issues relating to the regulatory treatment of early expansion costs and, in particular, our proposals to add in the region of £500 million of these costs to HAL's RAB, subject to a final efficiency review.

Appendix D

IPCR of early expansion costs incurred in 2018

Introduction

1. As discussed in the Executive Summary and in Appendix C, HAL has paused expansion. Before it decided to do this, it had incurred costs in the region of £500 million. We have already assessed the efficiency of HAL's spending during 2016 and 2017 (which related to obtaining planning permission for expansion) in accordance with the Planning Costs Recovery Policy Statement and the Budget Guidance.

2. This appendix covers our assessment of the efficiency of Category B costs incurred by HAL during 2018. In assessing the efficiency of these costs, we have built on our experience of assessing costs in 2016 and 2017 and taken into account the policy and guidance noted above.

Our previous efficiency assessments

3. We previously commissioned the IPCR to carry out an *ex post* review of the Category B costs incurred by HAL in 2016 and 2017.[35] The role of the IPCR was created to provide ongoing assessment of the reasonableness of the Category B costs incurred. It was established to provide an independent view on cost efficiency, to drive the robust reporting of costs, and provide advice on the processes being followed.[36]

---

[35] The recovery of costs associated with obtaining planning permission for a new Northwest runway at Heathrow airport: initial proposals ("the July 2016 Consultation"): see www.caa.co.uk/CAP1435. See Appendix B.

[36] See paragraph 5.3 of the Planning Costs Recovery Policy Statement.

4. We consulted on the findings of the IPCR and decided that certain Category B costs would not be included in HAL's RAB. These costs included;

- £0.3 million of costs which related to the period before the Government's policy decision on expansion on 25 October 2016,[37,38] and
- £1.7 million of Category B costs which were included in HAL's 2017 Statement covering staff costs incurred prior to the Government's policy decision, as well as some costs which were not incurred during 2017, but which we said would be reviewed as part of the 2018 IPCR review.

5. We said that HAL could submit further evidence on certain limited issues which we would consider before we made our final decision on costs to be added to HAL's RAB. We noted that;

- low value invoices would only be allowed if HAL was able to provide a breakdown of these costs, in sufficient detail to allow scrutiny by the IPCR, within two weeks of the publication date of the July 2019 Consultation; and
- we would consider whether to reclassify any costs that were disallowed because they were incurred before 25 October 2016, if HAL demonstrated that the information submitted as part of the planning process is not materially different from the information submitted to the Airports Commission or the Government prior to 25 October 2016[39].

[37] We determined that these were Category A costs, but HAL considered these to be Category B costs.

[38] HAL requested that a further £3.9 million of costs, which it did not report in the Statement of costs, should be added to its RAB. These costs were not allowed as they also related to the period before the Government's policy decision on expansion on 25 October 2016.

[39] See paragraphs 10 and 11 of Appendix B of the July 2019 Consultation.

6. Our final decision on the recoverability of Category B costs incurred during 2016 and 2017 is summarised in Table D.1. HAL did not submit evidence on the low value invoices referred to above, so we will not allow £1.4 million of these Category B costs to be added to HAL's RAB.

Table D.1: Summary of the recoverability of Category B costs in 2016 and 2017

Category B costs £m	2016	2017
HAL's Statement submission	4.4	77.8
Costs not allowed	0.3	1.7
CAA initial view on costs to be added to HAL's RAB[40]	**4.1**	**76.1**
Low value invoices	0.3	1.1
Total costs not allowed[41]	0.7	2.8
CAA final of costs to be added to HAL's RAB	**3.7**	**75.0**

Source: CAA

7. We have not received any persuasive justification from HAL that costs we considered were Category A costs should be re-categorised to Category B costs, so we have not made any further adjustments to our view of Category B costs.

Review of Category B costs incurred during 2018

8. HAL was required to provide an annual Statement setting out the Category B costs it had incurred during 2018 in sufficient detail to allow effective scrutiny.

9. In January 2019, we re-appointed PwC as IPCR to assess the Category B costs incurred by HAL during 2018. The IPCR was instructed to consider:

[40] See Appendix B of the July 2019 Consultation.

[41] Individual figures in the table do not sum to totals due to rounding.

- whether the planning costs identified were supported by appropriate evidence;
- whether the costs identified were correctly categorised as Category B costs; and
- whether there was evidence to indicate the Category B costs had been efficiently incurred.

10. The review took place between May and December 2019. PwC's overall approach was to review HAL's Statement of costs and supporting schedule of costs which detailed invoices and accruals, as well as other supporting information and evidence, such as payroll data and purchase orders. The approach that PwC took is described in more detail in the IPCR report published alongside this consultation.

Key findings of the IPCR report

11. Based on the evidence reviewed, PwC considered that HAL's Category B costs were supported by appropriate evidence and correctly categorised. Following a review of supporting information, and responses to several questions, PwC was able to reconcile:

- the Statement to the 2018 schedule of costs; and
- the schedule of costs to the supporting evidence, using a sample approach.

12. The previous review by PwC of Category B costs incurred during 2016 and 2017[42] identified several broad opportunities for HAL to manage the programme in a more effective way and to provide greater assurance on efficiency. Following its review of HAL's 2018 Category B costs, PwC noted that these issues had not been fully dealt with by HAL, as discussed below.

[42] Independent planning cost review Heathrow Expansion Programme Covering (2016 and 2017) www.caa.co.uk/CAP1750

Establishing a single baseline

13. Previously, PwC had identified that HAL did not have a clear and single integrated baseline plan through to obtaining planning consent that aligned requirements and scope with the associated time, cost and risk. It found that this issue remained when it reviewed HAL's 2018 costs. HAL had provided evidence of some examples of integrating scope, schedule and/or cost, but nothing that provided a single baseline plan through to obtaining planning consent that aligned all components of the plan.

14. While HAL did have multiple documents that relate to scope, time, cost and risk, the alignment between these documents remained unclear and discrepancies were identified. The documents did not establish a robust baseline position from which to measure and manage performance and control delivery. PwC noted further areas for development:

- <u>deliverables to obtaining planning consent</u>: HAL had not provided evidence which definitively set out the baseline scope and deliverables required for 2018 or up to obtaining planning consent. While HAL has provided several documents containing varying levels of scope detail, the documents did not establish a robust baseline scope from which to direct and manage the delivery of the programme; and
- <u>integrated schedule</u>: HAL had developed several schedule documents to record and monitor activities, from high level programme activities to a detailed schedule activity. PwC noted that the different schedules were not systematically linked, and it remained unclear how high level management information was updated to reflect appropriate changes in lower level schedules.

15. HAL advised that a baseline schedule was established in September 2018 for activities through to obtaining planning consent and that this had been consistently reported in the monthly "Status Reports" (September 2018 to December 2018). PwC noted that, as HAL developed its schedule

management process, there was an opportunity to improve systems and processes, which in turn would support efficiency.

Core programme control processes

16. PwC identified several core control processes were not in place. This finding was consistent with its review of the 2016 and 2017 Category B costs, including:

- change control: HAL did not operate a programme level change process for the expansion programme to manage the baseline scope, cost, schedule and risk; and
- timesheet system: HAL did not have a timesheet system that recorded internal staff time spent on the expansion programme. PwC suggested that a timesheet system would support the overall allocation of time to expansion and would enable analysis of planned time against actual time to indicate the efficiency of the delivery of key activities.

17. HAL advised that a timesheet system was being considered for expansion during 2019.[43]

CAA views

18. PwC was able to reconcile all Category B costs as correctly recorded. PwC did not identify or quantify any specific elements of HAL's 2018 Category B costs which it considered were inefficient, although it noted that there were several areas for potential improvement in HAL's management of these costs.

19. HAL's latest Statement of costs reported £118 million of Category B spending in 2018 (see Table D.2). PwC confirmed that these costs were correctly allocated to Category B.

[43] The IPCR could not validate this as part of its review of 2018 costs.

20. We recognise that it is challenging to assess the efficiency of costs associated with planning activity, which by their nature, are difficult to benchmark. While PwC has identified some remaining weaknesses in HAL's management processes we also note that HAL has improved on the processes it has in place since the start of the capacity expansion programme in late 2016. The IFS had also reviewed these costs as part of the joint airline/airport capital expenditure governance arrangements. The IFS review highlighted some concerns over programme management and control processes, similar to the PwC findings on that theme. The IFS did not identify any evidence to suggest that we should disallow any HAL expenditure on Category B activities in 2018.

21. Bearing the above in mind we intend to allow the costs shown in the table below to be added to HAL's RAB, but will consider representations from stakeholders before making final decisions on these matters.

Table D.2: Category B costs incurred during 2018

Category B costs £m	2018 Statement of costs
Colleague costs[44]	18.9
Programme leadership	7.6
Future Heathrow	5.8
Consents	11.4
Community and stakeholder	1.0
IT	2.8
Ground investigation	10.7
Regulation and strategy	2.9
Integrated Design Team	52.6
Property	2.3

[44] Colleague costs in HAL's May 2020 Statement of costs were adjusted down by £0.4 million to reflect that these costs have been recategorised from capex to opex reflecting IAS 16 accounting rules.

Category B costs £m	**2018 Statement of costs**
Other	0
Category B capex	116.0
Category B opex	2.2
Total Category B costs[45]	**118.2**

Source: HAL's Statement of costs 2018[46]

Next steps

22. We welcome stakeholder views on our proposal to not to make any adjustments for efficiency and allow HAL to recover the planning costs that it incurred during 2018. These costs will be treated in accordance with our policy on early costs when it is finalised. Appendix C sets out our proposal to add efficiently incurred costs to HAL's RAB at the start of the H7 price control.

23. We are due to commence work on assessing the efficiency of costs that HAL incurred during 2019 and up to the end of February 2020. Further detail on our proposed approach to this assessment can be found in Appendix C.

[45] A total of £118.195 million, rounded to 3 decimal places.

[46] This table is based on the latest Statement of Category B costs received from HAL on 1 May 2020.

Appendix E

Guidance for the revised business plan

Introduction

1. As discussed in chapter 2, the CAA will assess the RBP as a key part of setting the H7 price control. This will involve consideration of both how well HAL has met our requirements and feedback from the airline community and other interested stakeholders. We expect HAL to produce the RBP in the Autumn of 2020, recognising and reflecting the significant uncertainties that are likely to remain at that stage. We expect the RBP to reflect:

- consumers' evolving needs and priorities;
- the outcomes of CE;
- HAL's latest thinking on traffic scenarios and efficient levels of costs; and
- HAL's views on the form and duration of the price control arrangements best suited to dealing with any residual uncertainty.

2. We have reviewed the Updated Business Plan Guidance, to understand:

- which criteria are still relevant;
- which need to be updated; and

- what new criteria we need to include in the light of recent developments.

3. The outcome of this review is set out in the updated requirements below.

4. We acknowledge that the present level of uncertainty and the difficulties that the sector faces will create real challenges for HAL in producing its RBP, and specifically a RBP which meets all our requirements. However, it is essential that the RBP is as robust and informative as practicable, and reflects consumers' core needs and priorities for a two runway airport that is affordable to airlines.

5. As noted in chapter 2, we will work with HAL and airline stakeholders over the coming months in a flexible and pragmatic way to enable HAL to interpret and develop this guidance in a way that best supports the production of a high quality RBP.

6. Where, in the light of the current uncertainties in the sector, HAL or airline stakeholders consider that the requirements we have set out below are not the best way of achieving our priorities for the RBP (as set out in chapter 2), we are open to discussing alternative approaches.

Criteria for high quality business plans

7. Our guiding principle for this guidance is to set clear expectations for HAL which strike an appropriate balance between the need for HAL to provide high quality and appropriately detailed information, while not being overly burdensome.

8. We have reviewed good practice in business planning guidance issued by other regulators, such as Ofwat and the Office of Rail and Road (ORR). Regulators use a range of approaches when providing guidance to regulated companies. Ofwat, for example. provides templated tables specifying detailed information which regulated companies must provide.[47]

9. Having reviewed these various approaches and noting the current uncertainties, we consider that our approach in this guidance strikes the right balance between the need to obtain high quality information, while not placing an undue burden on HAL. In particular, we do not consider that specifying a level of detail similar to Ofwat's guidance would be proportionate.

10. Turning to the criteria themselves, the first is that the RBP should be:

- transparent, and publicly available to all stakeholders;
- supported by a robust evidence base, drawing on industry best practice;
- well-structured and well-integrated between different elements of the plan;
- designed to reflect consumers' views and preferences to the fullest extent practicable;
- based on efficient costs and financing assumptions;
- affordable (including in terms of affordability of charges to airlines); and
- deliverable (including in respect of financeability)

(criterion C01).

[47] See Ofwat's May 2018 document "Delivering Water 2020: Our methodology for the 2019 price review. Updated guidance for the final business plan data tables" available at: https://www.ofwat.gov.uk/wp-content/uploads/2017/12/PR19-Final-guidance-on-business-plan-tables-May-2018-update-v2.pdf.

11. We also require HAL to:

- link revenues and costs clearly to recovery scenarios for passenger numbers, taking account of recent developments including, in particular, the impact of the Covid-19 pandemic. HAL should also clearly identify risk, contingency and efficiency assumptions throughout its plan **(criterion C02)**;
- present all financial, cost and revenue data in the RBP in nominal and real prices, with real values in 2019 prices (or an alternative price base with clear justification provided). HAL should specify what price index it has used (for each item if different indices have been used) to convert data from nominal to real prices. We also require HAL to use a consistent base year when forecasting any quantified elements of the plan. HAL should provide a clear justification and evidence for the choice of base year as part of its forecasting methodology **(criterion C03**); and
- ensure its Board reviews and approves the RBP, certifying that it is consistent with the criteria set out in this guidance and fully explaining any divergence from these criteria **(criterion C04)**.

Updated guidance for the RBP

Scenarios for passenger numbers

12. Chapter 1 describes how we expect HAL and the airlines to work together to develop joint, integrated scenarios for passenger numbers to inform the RBP. The table below sets out specific guidance on this issue.

Table E.1: RBP criteria for scenarios for passenger numbers

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Scenarios	**C05**	Jointly agreed scenarios should take account of the following factors: ▪ scenarios or forecasts of economic activity, both for the UK economy as a whole and for the economies of the key passenger destinations served by air transport services from Heathrow; ▪ the impact on passenger demand of current and potential future quarantine measures, or other restrictions of movement across borders, by both UK Government and other governments; ▪ the impact of other restrictions in airports or on board aircraft (such as social distancing requirements) on airport and airline fleet capacity.	Effective scenario development requires that HAL and airlines take account of key factors that best practice and current circumstances suggest will have an impact on passenger numbers. In particular, restrictions relating to the Covid-19 pandemic have had a direct impact on passenger numbers, since (for example) most potential passengers have been advised by Government not to travel by air unless it is essential.	New criterion
Scenarios	**C06**	Jointly agreed scenarios should be developed in a way that presents integrated outcomes for passenger numbers, capex, opex and commercial revenues in the RBP at a suitable level of disaggregation. Given the requirements of criterion C05, scenario analysis should be disaggregated, as a minimum, into key geographic markets.	Passenger numbers, capex, opex and commercial revenues are intrinsically linked. So, coherent scenarios need to present integrated outcomes for these elements. Geographic markets will be affected in different ways depending on current and future restrictions on movements in those markets.	New criterion

Consumer engagement and outcome-based regulation

13. Chapters 1 and 2 provide a detailed update on our policy on consumer engagement and OBR, including how we expect HAL to take account of consumers' needs, priorities and preferences in its business plan and approach to OBR. In the table below, we have set out specific guidance on these matters.

Table E.2: RBP criteria for consumer engagement and OBR

Work group	Criterion number	Description of criterion	Rationale	Type of criterion
OBR	**C07**	HAL should develop an OBR strategy over the short term, recovery period and longer term. As a minimum, this should focus on delivering consumers' and airlines' core needs and priorities so that they continue to receive an appropriate level of service over this time. HAL's focus should be on two areas which must be progressed in parallel: ▪ update the SQRB scheme for the short term and recovery period; and ▪ develop the H7 OBR framework and plan for continuous improvement of the framework over the longer term. Any modified form of the SQRB scheme should be appropriately brought together with longer term work to develop HAL's H7 OBR framework. The H7 OBR framework should be developed to take account of new consumer insights and other developments in the sector so that OBR remains responsive to consumers' evolving needs. See chapter 2 for further explanation of this approach.	This approach will help ensure HAL's approach to the SQRB scheme and OBR remains fit for purpose for consumers and airlines in the light of the impact of the Covid-19 pandemic and for a two runway airport. It will also support recovery and help build consumers' confidence which will benefit the sector as a whole.	New criterion

Work group	Criterion number	Description of criterion	Rationale	Type of criterion
		A section of the RBP should set out HAL's strategy and a methodology for bringing this work together as well as the progress made in doing so.		
Consumer engagement	**C08**	In ensuring the RBP is fully informed by consumers' core needs, priorities and preferences. HAL should: ▪ consider which elements of its existing consumer research and engagement remain relevant for the RBP; ▪ refine and build on its existing consumer evidence base with emerging intelligence and, where appropriate and practicable, through new research and engagement; ▪ update its existing consumer research and engagement strategy, setting out how it intends to engage with consumers to understand their core needs, priorities and preferences; ▪ consider airlines' consumer research and insights; and ▪ address relevant findings and recommendations in the CCB's IBP report on consumer research and engagement and continue to follow the CCB's principles of good consumer engagement. In doing this, HAL should consult the CAA and airlines on its future research and engagement plans and reflect the feedback it receives in its work on the RBP. HAL should also demonstrate how it will manage	HAL has already undertaken a significant amount of consumer research and engagement which should be refined to reflect the new circumstances and challenges presented by the impact of the Covid-19 pandemic and for a two runway airport. This work is needed to provide assurance to the CAA and airlines on which elements of HAL's existing consumer insights remain credible and relevant absent expansion.	Building on IBP guidance

Work group	Criterion number	Description of criterion	Rationale	Type of criterion
		practical issues on consumer participation and results that may have been distorted by the impact of the Covid-19 pandemic.		
Consumer engagement	**C09**	HAL should consider what the implications of its future scenarios might be for the service quality that consumers and airlines will expect and should receive. To the extent practicable, HAL should demonstrate a clear link between its consumer insights and future plans under the range of scenarios being assessed, drawing on existing consumer insights, new intelligence and research to support these scenarios where possible.	It is in consumers' interests that HAL considers how future scenarios can deliver on consumers' needs and priorities.	New criterion

Capital expenditure and capital efficiency incentives

14. Chapter 2 sets out our views on elements of HAL's IBP, including capex. Chapter 3 sets out our proposals for capex incentives. In the table below, we have set out key requirements for the RBP on capex and capex efficiency incentives.

Table E.3: RBP criteria for capital expenditure and capex efficiency incentives

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Capex	**C10**	The RBP should set out capex proposals at a sufficiently detailed level of dis-aggregation. For each project at a sufficiently advanced stage of development, HAL should identify key categories of costs, such as:	The level of detail in relation to project costs for the "Create Capacity" and "Manage & Improve" portfolios in the IBP was not sufficient to allow for robust analysis. Arcadis reviewed HAL's IBP capex plans. The review found that not enough information was provided by HAL to	Building on IBP guidance

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
		▪ leadership and logistics; and ▪ risk and contingency. We will discuss and agree the full list of categories with HAL and airlines in advance of the publication of the RBP.	establish whether it had followed best practice in forecasting costs. To assess HAL's capex plans, the CAA will need to have more detailed information about individual projects (including to inform our categorisation of capex).	
Capex	**C11**	HAL should clearly identify risk, contingency and efficiency assumptions in its capex proposals, both ▪ at the project level; and ▪ at the overall portfolio level.	The IBP allowed for £7.3bn (28%) of contingency but did not provide adequate detail on how risk and contingency allowances had been arrived at. The CAA needs to understand how HAL has developed its assumptions for these allowances, as these are material elements in our assessment of HAL's capex.	Building on IBP guidance
Capex	**C12**	HAL should identify expected outputs and benefits associated with each project. The RBP should set out how the capex programme delivers value for money, on a whole life cost basis, for customers and consumers during H7. This should include an estimation of measurable benefits.	Consumer and airline priorities have changed substantially. HAL should show it has engaged with these new priorities and developed a capex programme that delivers on them. Airlines and customers will be likely to have an increased focus on value for money in H7. HAL needs to demonstrate clearly why the projects it has chosen to include in the RBP represent value for money for airlines and consumers and deliver what airline customers and consumers want.	New criterion

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Capex efficiency incentives	**C13**	HAL should set out its understanding of our proposed broad approach to capex incentives and how it has taken account of this in the RBP, including any key assumptions.	HAL's IBP assumed that the Q6 capex efficiency incentives would remain broadly unchanged. This consultation sets out our views on the broad approach to capex efficiency incentives. We expect HAL to work together with airlines to propose how to apply the broad approach to the capex portfolio in the RBP and to propose improvements to the capex governance regime for H7. We will work during 2020 and 2021 to apply the broad approach to capex incentives, taking into account HAL's RBP. The RBP should contain sufficient detail to model the impact of those incentives on affordability and financeability.	Building on IBP guidance
Capex efficiency incentives	**C14**	The RBP should contain detail on the capex portfolio and, where capex programmes are sufficiently developed, initial views on: ▪ capex categories, and "core" and "development" capex; ▪ delivery obligations ("DOs") and quality requirements; and ▪ any timing incentives.		Building on IBP guidance
Capex efficiency incentives	**C15**	HAL should provide details of the proposed governance process to support the capex incentives, including how it will address the issues arising from the Q6 arrangements identified by the IFS and CAA.		Building on IBP guidance

Opex and commercial revenues

15. Chapter 2 provides our views on quantified elements of HAL's IBP, including opex and commercial revenues. In the table below, we have set out key requirements for the RBP on opex and commercial revenues.

Table E.4: RBP criteria for operating expenditure and commercial revenues

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Opex and commercial revenues	**C16**	HAL should consider whether its forecasting methodology remains appropriate in the context of the impact of the Covid-19 pandemic and the Court of Appeal's judgment. Forecasts should be fully explained, taking account of past performance, the impact of measures to address the impact of the Covid-19 pandemic and expected operational efficiency and commercial revenue generation.	The top down forecasting approach of the IBP provided limited information on actual planned work or what HAL intended to deliver during the H7 price control period. To assess HAL's forecasts properly, we need HAL to provide more information in support of its investment plan. We consider that disaggregated estimates of opex and commercial revenues would facilitate a more detailed understanding of HAL's forecasts. For example, for opex, our assessment of staff costs would consider changes in staffing levels (including staff mix) that HAL has assumed over time.	New criterion
Opex and commercial revenues	**C17**	We expect the RBP to set out consistent historical and forecast data at a level of detail that supports appropriate scrutiny by the CAA and airlines. We expect historical data to cover the Q6 period as a minimum and we expect HAL to ensure that all historical data included in its RBP submission is fully reconcilable to its published Regulatory Accounts.	HAL's IBP presented high level categories of opex and commercial revenues but only included one year of historical data. We require more detailed historical and forecast information, presented on a consistent basis, to allow comparisons across the historical and forecast	New criterion

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
			periods, so that we can fully assess HAL's short term forecasts.	
Opex and commercial revenues	**C18**	HAL should demonstrate that its forecasts of opex and commercial revenues are integrated with other areas of the RBP: opex forecasts should be clearly linked to anticipated operational activity (e.g. increased use of a particular terminal by passengers) and changes in service quality during the H7 period. HAL should show that its opex and commercial revenue forecasts are consistent with planned capital investment. Evidence should be provided to demonstrate that a range of operating and capital solutions have been considered to deliver the activities and levels of service planned for H7 efficiently. The RBP should clearly show how the best and most efficient options have been selected, and how optimum value for money will be achieved.	The IBP provided limited evidence or explanation to demonstrate that, when developing its opex and commercial revenues forecasts, HAL had considered interactions with the other areas of its plan. For example, the CCB noted that the link between opex and any improvements in service quality was not clear. To assess HAL's opex forecasts, we need to understand the links between opex and capex investment as well as planned operational changes during H7. This also applies to our assessment of HAL's commercial revenue forecasts. For example, we would expect opex security forecasts to take account of capital investment on security measures that HAL has made during Q6, and any capital investment it is planning during H7.	Building on IBP criteria

Cost of capital and financeability

16. Chapter 4 provides a full update on our policy on financeability and the cost of capital. We consider that the business plan guidance we provided previously in the Updated Business Plan Guidance remains broadly valid, and we make a number of updates to this guidance below. In the table below, we have set out what we consider are the key requirements for the RBP in relation to these two areas.

Table E.5: RBP criteria for cost of capital and financeability

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Cost of capital	**C19**	HAL's proposal for 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.	Unchanged from the Updated Business Plan Guidance.	IBP guidance
Cost of capital	**C20**	In estimating the efficient cost of capital for its business plan, HAL should align this with: ▪ recent UK regulatory precedent (including the CMA decisions on RP3 and Ofwat's PR19 determinations wherever available); ▪ market evidence on cost of capital parameters; and ▪ the business risks it faces.	The requirements set out in the Updated Business Plan Guidance continue to be relevant, but it is no longer appropriate for these to refer to expansion. In addition, the regulatory precedents to which we expect HAL to have regard have now include the	Building on IBP guidance

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
		Where HAL proposes to depart from this guidance or recent regulatory precedent, we would expect high quality and detailed evidence to support HAL's assumptions.	most recent determinations (RP3 and PR19 respectively).	
Financeability	**C21**	HAL should provide robust evidence that its RBP is financeable and affordable. Analysis of affordability and financeability should be conducted under the same range of planning scenarios as provided in the RBP. This assessment should also be undertaken with reference to the CAA's statements on financeability policy and we would expect HAL to examine the same key metrics. Stress testing is not required for the RBP but will be necessary in 2021.	In the light of the current economic situation, HAL should consider a range of paths to recovery and assess the implications for affordability and financeability. Stress testing should be undertaken after the RBP only once there is greater certainty in terms of the path to recovery.	Building on IBP guidance
Financeability	**C22**	HAL should outline what structural and regulatory options and/or changes would best support the credit rating it targets in the RBP, while being consistent with the interests of stakeholders. The assessment of the targeted credit rating for each relevant scenario should consider the net impact of having a higher or lower credit rating.	In the IBP, HAL considered the gross impact (and not the net impact) of having a BBB rather than an A- credit rating. There are costs and benefits associated with any given level of credit rating. Therefore, to assess the impact on the interests of consumers of the credit rating HAL proposes to target and suitable	Building on IBP guidance

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
			alternatives, we will require a rounded assessment of costs and benefits for different levels of credit rating.	
Financeability	**C23**	HAL should consider the appropriate notional financial structure taking into account the guidance provided on financeability and cost of capital in chapter 4. Analysis should include an evaluation of the advantages and disadvantages of different notional financial structure options developed by HAL.	In the light of recent events and the CMA's provisional findings, we need to consider what the appropriate notional financial structure should be.	New criterion
Financial modelling	**C24**	Analysis of affordability and financeability should include a baseline assessment using the CAA's price control model ("PCM"). If assumptions are not detailed in the business plan itself, a data book detailing the rationale for the assumptions adopted in the RBP should be provided. HAL should discuss with the CAA any structural and formula changes required to the PCM in advance of submitting the RBP to agree a version of the PCM for HAL for use in the submission.	We require a stable version of the PCM to review the RBP efficiently and with confidence that the outputs it provides are accurate. The use of models other than the PCM in preparing the IBP was not acknowledged. To ensure transparency and comparability between different models used, a commentary and reconciliation of results to the PCM is required when another model is used.	IBP guidance

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
		If HAL uses models other than the PCM in the RBP, they should be accompanied with commentary and analysis reconciling the results to those of the PCM.		

Other regulated charges ("ORCs")

17. This consultation does not deal with ORCs in detail. Therefore, we have provided more detail below in relation to the information that we expect to see in the RBP to enable us to assess HAL's IBP proposals in this area and set out our key priorities for H7.

18. HAL's IBP proposals presented "evolutionary changes" to the ORCs, including reallocating some costs between ORCs and the airport charge or moving to commercial pricing models. HAL also proposed amending some elements of the pricing principles and scope of costs to make an explicit reference to the impact of external policy changes and to incentivise the use of more sustainable electricity and colleague travel offers.

19. All of HAL's proposals have the potential to remain relevant to a two runway airport. These proposals were new to the airlines and early discussions during CE have indicated that HAL would need to consider proposed changes to risk profiles more carefully.

20. In the light of the impact of the Covid-19 pandemic, we understand that HAL is now considering a more in-depth review of ORCs which could result in some more fundamental changes, including to the governance arrangements. We expect HAL

to consider the impact of any changes both individually and collectively to assess the implications of those changes on matters such as risk allocation and on the level of airport charges.

21. The table below sets out our guidance for the RBP on its proposals for ORCs.

Table E.6: RBP criteria for ORCs

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
ORCs	**C25**	The rationale for any cost reallocation needs to be clear and robust, with the implications for changes in risk and incentives explained. HAL needs to highlight why these changes would be in the interests of consumers.	HAL needs to provide justification for its proposals. The IBP did not provide enough explanation of the reasons and implications of the proposed changes.	New criterion
ORCs	**C26**	For each ORC, HAL needs to explain the rationale for the proposed treatment of over and under-recovery mechanisms clearly and demonstrate why this would be in the interests of consumers.	A key principle of ORCs is that costs should be passed through to relevant charge payers transparently.	New criterion

Resilience

22. This consultation does not cover the issue of resilience in detail. Therefore, we have provided more detail below in relation to the information that we expect to see in the RBP to enable us to assess HAL's IBP proposals in this area and set out our key priorities for H7.

23. The IBP discussed how HAL will build on its existing operational resilience measures and infrastructure to deliver better outcomes for passengers and airlines, mapping resilience to the consumer outcomes, particularly in relation to predictable and reliable "end to end" journeys and the need for passengers to feel secure and supported at the airport. It also described improvements to airport support infrastructure such as information technology, the Airport Operations Centre ("APOC") and winter preparedness. These measures are still relevant to a two runway airport.

24. The IBP noted that increased airfield capacity from expansion would increase the resilience of the airport and addressed how it would maintain resilience during construction. HAL also discussed the impact of the proposed "early growth" programme, and how it intended to mitigate the impact of this approach. These measures will not be relevant for the RBP but can be considered subsequently if work on expansion resumes.

25. A focus on resilience will need to be maintained throughout H7. Although we can expect that the operation of the airfield will be more resilient as a result of reduced traffic in the early years of H7, the potential for passenger numbers to recover to pre-2020 levels in later years means that current mechanisms for dealing with scarce capacity should be maintained, reviewed and refined.

26. The table below sets out guidance for the RBP in relation to resilience.

Table E.7: RBP criteria for resilience

WorkGroup	Criterion number	Description of criterion	Rationale	Type of criterion
Resilience	**C27**	HAL should explain how it plans to maintain resilience as passenger numbers increase through H7.	Resilience remains a key consumer requirement, especially minimising delays and cancellations, so they can have confidence that they will have a predictable and reliable journey. Some factors that have previously affected resilience at the airport, such as runway capacity being reduced during bad weather to levels below demand, may not be an issue in the early part of H7 as the industry recovers from the impact of the Covid-19 pandemic. These may, however, become more important in the latter part of H7. HAL should set out how it will maintain its key resilience processes for dealing with capacity constraints over the period of H7.	New criterion
Resilience	**C28**	HAL needs to set out its plans for terminal management and accommodating a recovery of passenger numbers over the H7 period.	Constraints on terminal capacity may become an issue as passenger numbers recover. HAL should demonstrate that it has clear plans to avoid terminal over-crowding.	New criterion

Appendix F

Financial resilience and ring fencing

Introduction

1. This appendix updates our work on the financial resilience and ring fencing rules for HAL. We started this work in the context of expansion and discussed these issues in consultations leading up to the August 2019 Working Paper.[48] These set out and refined the purpose of our approach and considered a number of possible changes to HAL's licence. We had not reached firm conclusions as to whether and, if so, what changes might be required to protect consumers.

2. We set out below how much of this work we consider is still relevant in the current circumstances and propose a more limited way forward.

Our work to date

3. Our work on these matters sought to address the risk of consumer detriment arising from disruption to services and investment if HAL were to experience financial distress. We have said that, even if financial distress for HAL would be a low probability event, it would be likely to have a high impact that would not be in the interests of consumers.

4. We considered that the size of the investment required for expansion would create new construction and financing risks for HAL, while HAL's licence contains only relatively weak rules on financial ring fencing, so does not readily protect consumers from these risks.

5. We also noted that HAL's "financing platform" has indirect benefits for consumers as it both:

[48] See the June 2017 Consultation, the December 2017 Consultation and the October 2018 Consultation.

- enables HAL to raise large quantities of debt finance; and
- replicates many protections of a "full" financial ring fence (albeit for the protection of bond holders, rather than consumers).[49]

6. Therefore, in considering how best to protect consumers, we focused on changes that would not cut across HAL's financing platform.

7. While we recognised that consumers and bondholders have a common interest in HAL's financial stability, their interests might diverge if HAL suffered financial distress. This might justify further protections for consumers.[50] In this context, we discussed changes to HAL's licence to mitigate:

   - the risk that HAL would not have sufficient resources to operate its business; and
   - the impact of any financial distress if it arose.

Responses to the August 2019 Working Paper

8. Although stakeholders broadly supported the principle of a cost/benefit analysis of possible changes to financial ringfencing conditions, beyond this high level approach, stakeholders' views diverged.

9. HAL opposed change on the grounds that its debt and equity investors have a common interest in resilience that protects consumers even in times of financial distress, and the existing resilience regime has been sufficient up to now. It said that oversight by the credit rating agencies and

[49] These protections include restrictions on disposing of assets, and liquidity and credit rating obligations backed by provisions to restrict the payment of dividends if they are breached.

[50] To ensure that our approach was proportionate, the August 2019 Working Paper sought to:

- ensure responsibility for financial stability remained with HAL's directors and shareholders;
- avoid obligations "cutting across" the financing platform; and
- avoid making finance more difficult or expensive to obtain.

the liquidity requirements of its financing platform made a sudden crisis unlikely, while the proposed changes would be expensive and their enforcement uncertain. Instead, the CAA should focus on setting a price control that enables HAL to maintain an A- credit rating.

10. Airlines' views diverged. IAG said that our approach was too generous, being designed to protect investor returns, while being vague about the problem it sought to solve. VAA was concerned about the risk of over regulation, but supported elements of our approach, including a more specific resources obligation, targeted rules on dividends and clarifying the ultimate controller obligation. It felt that we should do more to require information from HAL and that we should be prepared to form our own view of HAL's financial position.

11. Heathrow West did not comment on the specific changes. However, it considered that diversification of capital investment would mitigate risk.

12. Other stakeholders provided broad support for enhanced measures with some arguing for a tougher approach that put the onus on shareholders to avoid risks to the taxpayer and protect the environment. A number of them questioned expansion and HAL's finances more generally.

Modifying our overall approach

13. Given that HAL paused its work on expansion in response to the Court of Appeal's judgment, the reasons for, and focus of, our work have necessarily changed. We also note that HAL's financing platform has provided a liquidity buffer which is of particular importance during the present period of very low traffic and, consequently, reduced revenues.

14. In this light, while still aimed at informing whether we should introduce licence modifications alongside the H7 price control, we consider that our work should now have a narrower focus. So, it will concentrate on changes that clarify the licence and make it more consistent with the regulatory regime as a whole. In addition, we are considering whether any

changes may be beneficial in the light of the present challenging circumstances.

Measures no longer under active consideration

15. In narrowing our focus, we have decided to discontinue consideration of the measures that were most relevant to managing the challenges of expansion. So, the following measures will not be considered further at this stage:

- credit rating obligations; and
- cash/dividend lock ups.

16. We will, however, keep HAL's financial position under review to see whether these, or other measures we have previously discounted, might warrant re-consideration as circumstances develop.

Measures we are currently considering

17. We are continuing our work on the measures discussed in the August 2019 Working Paper discussed below.

Sufficiency of resources

18. To ensure that the licence is internally consistent, there is merit in ensuring that the sufficiency of resources obligation requires HAL to ensure that it has sufficient operational and financial resources to operate to an appropriate standard.[51] This would be a relatively minor change to make the obligation more robust by explicitly requiring HAL to have sufficient assets to operate Heathrow airport in accordance with the licence.

[51] See paragraph 2.27 of the August 2017 Working Paper which considered making clear that sufficient resources must be maintained to enable HAL not just barely to provide airport operation services at Heathrow, but to do so in accordance with the licence.

Compliance certification

19. To build on the experience currently being gained in the usefulness of resources certificates in the current challenging circumstances, there may be merit in separating certification of sufficiency of operational and financial resources. Our work will consider of whether the certificates should expressly require consideration of cash and liquidity as well as giving greater individual focus to each of financial and operational resources.[52]

20. Alongside this, we are considering whether to bolster the evidence required in support of resources certificates. This work is ongoing and will seek to identify whether additional assurance would be beneficial in the light of the experience we gain in the development and use of scenarios during the current price control process. For example, we will consider whether scenarios would be useful for HAL to demonstrate that it has undertaken appropriate stress testing and mitigation planning in providing its certificates.

21. As part of this, we will also review HAL's obligations to provide information to its bond holders in its financing platform. We will consider whether requiring HAL to provide the same information to the CAA as it does to its bond holders may address this issue without creating a material compliance burden on HAL.

22. We will also consider whether more onerous obligations should apply if HAL were to enter financial distress.

[52] See paragraph 2.27 of the August 2017 Working Paper which considered specifying that "sufficient resources" includes (i) cash, financial facilities and access to liquidity as well as other financial resources, and (ii) operational and physical assets. We are considering whether this latter element may best be achieved by separating the certification of financial and operational resources, or by greater clarity within the existing certificates.

Clarifying HAL's ultimate controller obligations

23. As noted in the August 2019 Working Paper, there is merit in clarifying the definition of HAL's "ultimate controller" so that it does not apply to HAL's shareholders. This could be achieved by making clear that the ultimate controller is a holding company of the licensee which is not itself a subsidiary of another company.[53]

24. The August 2019 Working Paper also expressed a concern that the ultimate controller undertaking should ensure that both it and HAL's affiliates provide the CAA with the information that they hold on request. We consider that this is still an appropriate aim of the undertaking, not least as we are aware that HAL uses a service company for some functions and, therefore, some information relevant to HAL may not be held by HAL itself. This would be limited to ensure group companies did not have to hold information that they would not otherwise hold for their functions within HAL's group.

25. We consider that a relatively simple addition to the ultimate controller undertaking that ensured that every subsidiary of the ultimate controller holds the records HAL may reasonably need to carry on the activities permitted under its licence would achieve this without creating additional burdens for HAL or its group companies.

26. Finally, to raise the profile of compliance activities within the group as a whole, we are continuing to assess whether there is merit in requiring HAL to confirm annually to the CAA that it has written to the ultimate controller reminding it of the undertaking.

Regulatory accounting and financial information

27. Alongside the issues above, we will review the regulatory accounting and other financial information provided by HAL to streamline it where

[53] Using the definitions of "holding company" and "subsidiary" section 1159(1) Companies Act 2006.

practicable and ensure it is consistent with the approach we are developing to the H7 price control.[54]

Next steps

28. As a number of these issues are closely related to the way the next price control develops, we will develop our thinking on these issues over the coming months and will seek to engage with stakeholders during that process. For example, we will review regulatory accounts rules in the light of relevant developments to the price control (such as incentives and risk sharing), the uses to which such information is put and whether some or all of it could be provided by different means.

29. If stakeholders have any views on the matters set out in this appendix we should welcome comments as part of this consultation process.

[54] However, despite being mentioned in the December 2017 Consultation, we no longer consider that a prohibition on cross subsidies merits consideration as part of this review. HAL's current group structure does not appear to create a significant risk of cross subsidies and such a rule could inadvertently undermine the clarity of the "single till".

Appendix G

Alternative proposals for expansion by Heathrow West

Introduction

1 We last consulted on issues raised by potential alternative arrangements for the delivery of expansion in the March 2019 Consultation. We explained that Heathrow West was proposing to make a planning application to build a new terminal to the west of Terminal 5, and that it considered such development could be delivered in conjunction with, and to support, HAL's development of a new northwest runway.

2 At the same time as HAL paused its expansion programme in March 2020, as a result of the Court of Appeal decision that the NPS had not been lawfully produced, Heathrow West also paused its work programme.

3 Given there is now a high degree of uncertainty regarding the future of expansion, we do not consider it is appropriate to comment on the issues raised by Heathrow West's proposals in detail. However, given that Heathrow West had made significant progress in relation to the "initial tests" that we had previously set out, we summarise our view on that work below. Clearly, should circumstances change, Heathrow West may choose to restart its work, including in relation to developing an application for planning permission.

Background

4 In the March 2019 Consultation, we set initial tests for Heathrow West, to help us understand its proposals. The tests were primarily a way for the CAA to prioritise its resources while we ascertained whether Heathrow

West 's proposals were credible, plausible and deliverable.[55] The initial tests comprised sixteen questions about Heathrow West 's proposals which sought a range of evidence on:

- safety and security;
- consumer benefits;
- deliverability and operability;
- the proposed regulatory framework; and
- compliance.

5 We stated that this approach would involve the following steps:

- an initial study by our technical consultants, Arcadis, to identify any particularly difficult or contentious issues;
- Heathrow West setting out clear and convincing plans for seeking planning permission and demonstrating meaningful progress in resourcing and carrying those plans forward; and
- understanding Heathrow West's initial views on the commercial and regulatory arrangements that might support its proposals (including in relation to how they would be financed and work with the rest of the airport) and how, in principle, these could further the interests of consumers and airlines.

6 We said that if Heathrow West was able to provide convincing evidence and assurance in relation to these tests, there may be a case for further work by the CAA on the regulatory framework.

7 Having considered responses to the March 2019 Consultation and taken technical advice from our consultants, Arcadis, on the areas we would expect Heathrow West's proposals to cover at that stage, we refined the list of initial tests, notifying stakeholders of these revisions in August 2019. This refined list can be seen at Appendix A of the Arcadis report.

[55] See Chapter 4 and Appendix E of the March 2019 Consultation.

Assessment of the initial tests

8 In February 2020, Arcadis provided a final version of its report which concluded that Heathrow West had provided evidence of sufficient progress against the initial tests. Arcadis found that Heathrow West had developed a range of evidence that was of adequate maturity to support this finding, and that it had appointed relevant resources to continue the development of its proposals. The Arcadis report is published alongside this consultation document.

9 The CAA has reviewed the evidence provided by Heathrow West, and the report by Arcadis. We consider that the progress made on the tests alongside other evidence demonstrated that Heathrow West's proposals were reasonably mature and credible, and would likely be sufficient to allow CAA to commence more detailed work on them.

10 That said, given the Court of Appeal's decision, and the significant impact of the Covid-19 pandemic on the aviation industry as a whole, we will not consider undertaking further work on Heathrow West's expansion proposals unless circumstances change sufficiently to justify us recommencing this work.