Economic regulation of Heathrow Airport Limited: H7 Initial Proposals

Section 3: Incentives and other issues

CAP2265D

Published by the Civil Aviation Authority, 2021

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

First published October 2021

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

The latest version of this document is available in electronic format at: www.caa.co.uk/CAP2265D

Contents

Chapter 12

Capex incentives

Introduction

12.1 In considering how best to further consumers' interests in relation to the costs of the AOS provided at Heathrow airport, we are required to have regard to the need to promote economy and efficiency on the part of HAL. Ensuring that we have appropriate incentives for HAL to make capital investments efficiently is a core means by which we seek to achieve this.

12.2 Promoting capex efficiency remains a priority in the context of a two runway airport: the impact of the covid-19 pandemic emphasises the importance of capex being made efficiently and delivering value for money for consumers. We remain of the view that forward looking ("*ex ante*") incentives, where HAL shares a proportion of the benefits of delivering capex projects below budget and experiences a proportionate disbenefit for any over-spend against budget is the best way to create such incentives.

12.3 The incentives we set involve setting a "baseline" against which HAL's capex efficiency can be assessed. As we have noted previously[1] and in chapter 3, the various capital investment plans provided by HAL through the H7 process provide insufficient information to allow for detailed scrutiny. The information that HAL has provided to date has been based almost entirely on "top-down" projections rather than on an assessment of the costs of specific projects and programmes supported by structured business case analysis and cost estimates.

12.4 As a consequence, further work remains to be done on certain aspects of the incentive framework such as establishing each of the capex category baselines and the associated deliverables at the start of the price control. To address this, these Initial Proposals set out our expectations for HAL to provide additional information and explore the possibility of stronger licence obligations on HAL to ensure that at the very least HAL has clear obligations to provided robust information as part of the "core and development" process that we envisage operating over the H7 period.

12.5 In this context, this chapter sets out:

- background information on our process to date;
- a summary of stakeholder views including a description of HAL's proposal for an alternative incentive framework;
- our views on stakeholder feedback;
- our Initial Proposals for the capex efficiency framework; and

[1] See for example para 18 of the April 2021 Way Forward Document.

- next steps and implementation including our approach to further licence obligations on HAL with respect to the provision of information on capex.

12.6 Appendix D provides more detail on aspects of our Initial Proposals, including capex categories, setting delivery objectives and obligations, the incentive rate, and timing incentives. Appendix H sets out our analysis of the proposed H7 capex incentives framework, against the CAA's duties as set out in CAA12.

Background

12.7 Over the last four years, we have consulted a number of times on our approach to capex efficiency incentives for the next price control. Our earlier consultations on these matters were in the context of capacity expansion where we said it was necessary to create appropriate incentives for capital efficiency to promote the overall efficiency and affordability of the programme.

12.8 While the expansion programme has paused, and much less capex will be needed during H7, creating stronger and clearer incentives on HAL to invest efficiently remains a key objective to furthering the interests of consumers regarding the cost of AOS by promoting economy and efficiency on the part of HAL.

12.9 In the past we have assessed cost efficiency of capex on a backward looking ("*ex post*") basis. This approach has typically involved us carrying out an efficiency review on a sample of investment projects after they had been completed. In previous consultations we said that this type of *ex post* efficiency framework has limitations including that it tends to be difficult due to the time elapsed since the investment was made and the normal information asymmetry between regulated company and regulator. It is also particularly contentious. Further, finding and quantifying evidence of inefficiency does not necessarily mean that the remaining expenditure has been incurred with the same level of efficiency that might be expected from an airport subject to the normal commercial incentives of a competitive market. For these reasons, we consider that stronger incentives are needed to protect the interests of consumers from the increased costs that they would otherwise face were HAL to make inefficient capex investments.

12.10 In this context, we consider that action is needed to strengthen the capex efficiency incentives on HAL, building on the positive features of the current arrangements. To achieve this, we have proposed a forward looking ("*ex ante*") incentive framework which includes financial incentives for the timely and efficient delivery of capex. Under such a framework the cost baseline, the associated outputs and the rules for dealing with variances and changing the arrangements are typically fixed before the project begins.

12.11 We have discussed our proposals for these new capex incentives as part of our ongoing engagement with stakeholders, including meeting with HAL and airlines separately to discuss our proposed approach. More recently, we held trilateral workshops to discuss implementation of the new framework and we plan to continue this engagement beyond our Initial Proposals.

Summary of our proposed changes to capex incentives

12.12 Through our previous consultations we have set out criteria for developing enhanced incentive arrangements and the broad approach that we have been developing for the H7 period. This is based on retaining key aspects of the current capex governance arrangements that appear to be working well, including HAL and airline engagement during the governance process, the IFS providing the role of an expert independent reviewer, and the flexibility of the core and development framework. Core capex refers to capital for those projects developed to a level that permits a firm investment decision; development capex refers to those that have not yet reached this stage but will do so later in the control period.

12.13 The April 2021 Way Forward Document confirmed our intention to introduce enhanced forward looking capex incentives, which build on the existing Q6 capex arrangements and aims to both incentivise efficient capex and enable the capital plan to respond to changing circumstances during the H7 period. In summary we suggested:

- clear symmetrical *ex ante* incentives to strengthen the existing capex efficiency arrangements, so that HAL bears a predetermined share of any under- or overspend against capex baselines;
- HAL's capex programme will need to be split 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;[2]
- a baseline established for each category of capex, linked to one or more delivery obligations which can be used to assess whether HAL has delivered the outputs and benefits agreed with airlines; and
- flexibility that allows capex baselines to be updated during the H7 period in specific circumstances,[3] provided that any changes are subject to appropriate governance arrangements and are agreed by airlines.

12.14 We also said that:

- *ex ante* incentives should be applied to all of HAL's H7 capex plan because we had not identified any areas of the plan that HAL should not be able to properly plan or reasonably control;
- we intend to apply the same symmetrical incentive rate across all capex categories, and we will set the strength of the incentive taking account of our overall assessment of HAL's broader risk and reward package in the price control as a whole; and

---

[2] Examples of capex categories for H7 include security capex (around £420m) and T2 baggage (around £180m).

[3] See table M2, Appendix M to the April 2021 Way Forward Document.

- we consider that a new mechanism is needed so that, in the event of significant changes in the external environment during H7, decisions around large changes to the overall capital envelope can be agreed by airlines and reviewed by the CAA.

Figure 12.1: Summary of our proposal for H7 (April 2021 Way Forward Document)

Approach in Q6	Our proposal for 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 (no *ex post* review of costs for H7 capex projects)
Ex ante financing cost incentive (around 13% on average)	*Ex ante* incentive rate to be higher than Q6, same symmetrical rate applied to all of HAL's capex plan
Trigger payments penalise HAL for late delivery of projects	Trigger payments to be more targeted and offer a modest reward for early delivery, also consulted on whether it is appropriate to set a penalty for late delivery of a capex category
Charges reflect development and core capex allowances, updated during period	Similar to Q6, charges reflect agreed changes to capex baselines, updated during period
Gateway process and governance at portfolio and project levels, with IFS providing the role of an expert independent reviewer	Similar to Q6 with continued role of IFS, but with enhanced governance and reporting of capex categories and delivery objectives / obligations
Capex envelope set at start of price control	A mechanism so that HAL can request changes to the overall capex envelope but only in the event of significant changes in the external environment

Stakeholder views

12.16 HAL provided a summary of its proposal for a capital efficiency framework in its updated RBP. It commissioned consultants (Jacobs),[4] to advise on this issue and develop a set of criteria against which to assess whether HAL's capex programmes are suitable for *ex ante* incentives. Based on this review, HAL has proposed that only certain capex categories should be subject to *ex ante* incentives.[5]

12.17 It proposed an *ex ante* incentive rate of 15% which it suggests is appropriate for H7 and that all remaining capex should be incentivised under the existing *ex post* framework.

[4] Jacobs report on H7 Capital efficiency, June 2021. Submitted by HAL in response to the April 2021 Way Forward Document.

[5] Including its asset replacement programme and small sub-categories of the commercial revenue (protect existing revenues) and efficient airport (protecting efficiencies) programmes.

12.18 HAL mostly disagreed with our overall approach of applying *ex ante* incentives to all capex. Among other things it argued that:

- we have not made the case for an *ex ante* incentive framework and that a change to the existing *ex post* framework is not necessary because it already provides appropriate incentives on HAL to deliver capex efficiently;
- delivery obligations are not required for the asset replacement programme since requirements in relation to this type of capex investment already exist as part of HAL's service quality framework (and will be included within the H7 OBR framework);
- the existing core and development framework is flexible enough to address the level of uncertainty for the H7 period. HAL has also proposed a qualitative licence condition which would allow for a review of any material changes across building block assumptions in H7 (such as capex); and
- further clarification and guidance are needed on how specific aspects of our proposal would work in practice.

12.19 In contrast, airlines broadly supported our proposed approach and recognised the need for improved incentives:

- they agreed with our proposal to introduce *ex ante* incentives to HAL's entire capex plan, particularly given the outcome of the recent Q6 ex post capex efficiency review;[6]
- they said that a 15% incentive rate is not sufficient to incentivise efficient capex investment during H7 and instead consider that rates seen in other sectors would be more appropriate (for example, BA referred to incentive rates in the region of 30-40% in its response);
- airlines do not support HAL's proposal to use OBR measures instead of delivery obligations to assess whether HAL has delivered the agreed outputs of the capex investment;
- airlines consider that it is important to maintain triggers to incentivise HAL to deliver key projects on time, and ensure HAL is not unduly earning a return when projects had not been delivered to the agreed plan. They did not support all of the changes that we proposed to the trigger mechanism including rewards for early project delivery;
- airlines agreed that a separate mechanism (beyond the existing core and development framework) is needed to address any significant changes to the overall capital envelope that may be required during H7; and
- they also consider that the CAA needs to have an enhanced role in the capex governance arrangements during H7, particularly during the introductory phase of the new framework; this will ensure that projects, delivery obligations and capex categories are appropriately documented.

[6] See Appendix E.

Our views and Initial Proposals

12.20 We remain of the view that we need to make improvements and enhancements to the existing capex framework to create stronger, more appropriate and clearer incentives for HAL so that capex is incurred efficiently in the interests of consumers

12.21 Our approach involves building on the strengths of the current arrangements including the governance arrangements that involve HAL and airlines working together to agree projects to take forward so that HAL's capital programme benefits from the expertise of airline stakeholders and delivers appropriate outputs for airlines and passengers. We also support the existing core and development framework but want to strengthen the change control arrangements to better address significant changes in HAL's overall capex programme.

12.22 The weaknesses of the present arrangements have been illustrated by our experience of our recent *ex post* reviews of Q6 capex and early expansion costs. These reviews have confirmed the extent to which assessing efficiency on an *ex post* basis is both difficult and contentious. For example, HAL and airlines often have very different views on whether a project has been delivered efficiently and assessing efficiency after a project has been delivered is challenging given the quality and depth of the information provided by HAL. Our recent review of the T3 Integragted Baggage project (T3IB) recognised that concerns were expressed about the sudden increase in spending by HAL of £40 million against a budget of £90 million.[7] On the basis of the information available it was difficult to establish a clear case for inefficient spending but significant concerns remained about HAL's approach to project planning and cost control. Under an *ex ante* approach, there would be greater incentives on HAL to plan appropriately and deliver consistently within budgets.

12.23 Unless there is a clear case for an exception the enhanced incentives framework should apply across HAL's capex portfolio because:

- in general, HAL has not made a strong case that different capex categories warrant different treatment; and
- different treatments would tend to create additional complexity and implementation challenges. For example, there is a risk of gaming by HAL if there were to be different categories where capex were treated differently.

12.24 More generally HAL's proposal for capex efficiency has not significantly changed since we last commented on the proposal set out in its RBP: in the absence of new and persuasive evidence, we have broadly retained the views we set out on HAL's proposal in the April 2021 Way Forward Document[8] and summarised above. We explain our latest views on key issues further below.

[7] See paras 1.23 to 1.27 of our April 2021 Consulation.

[8] See pages 106 to 107 of Appendix M, April 2021 Way Forward Document.

Capex categories

12.25 Drawing on work by Jacobs, HAL proposed that three of the nine capex categories it has included in its updated RBP plan should be subject to *ex ante* treatment. Together, these would account for around 40% of its H7 proposed capex plan.

Table 12.1: HAL proposed capex categories and *ex ante* treatment

Capex category	% of the H7 portfolio	Suitable for *ex ante* treatment
Asset replacement – asset maintenance	36%	✓
Asset replacement – generational renewals (T2 baggage)	5%	X
Regulated security (compliance and transformation)	20%	X
Commercial revenue – protect existing revenues	2%	✓
Commercial revenue – generate incremental revenues	17%	X
Efficient airport – avoid material opex increases	2%	✓
Efficient airport – automation and digitalisation	9%	X
Carbon and sustainability	5%	X
Future ready airport	4%	X

Source: HAL updated RBP, Table 3, Chapter 6.1

12.26 While generally a helpful submission, we consider that the Jacobs report does not offer a balanced view and we do not agree with its main conclusions. For example, when considering complexity of capex activity, the report overlooks some key differences between airports and other sectors:

- HAL's assets are confined to a specific operational site, compared to rail, water, or electricity assets that are spread around the country (often buried in complex urban environments);
- HAL's assets are relatively new compared to other industries (particularly rail and water) which have older assets of uncertain condition.

12.27 Arcadis has reviewed HAL's proposed capex programmes to assess whether they need to be modified to meet our requirements for the purposes of setting incentives. Arcadis recommended that:

- most programmes proposed by HAL comply with the CAA definition of a capex category with similar risk and controllability characteristics; but
- due to the variability of the "delivery risk" for projects included within the Asset Management and Future Ready airport categories, it is necessary to split these programmes into further capex categories that can better reflect our definition of a capex category.

12.28 We have included more detail on this in Appendix D and in the Arcadis report which we have published alongside this document[9].

12.29 We have set our Initial Proposals for the structure of capex category baselines in Table 12.2 which reflects the key findings from the Arcadis review applied to our Initial Proposal for the H7 capex envelope.

Table 12.2: CAA proposed capex categories

Capex category	Indicative baseline, 2018 prices (RPI-real)
Asset management – tunnels	HAL to provide further information
Asset management – baggage	HAL to provide further information
Asset management – IT / technology	HAL to provide further information
Asset management – terminal	HAL to provide further information
Asset management – airfield	HAL to provide further information
Asset management – landside	HAL to provide further information
T2 baggage	£180 m
Security[10]	£420 m
Carbon and sustainability	£38 m

Source: CAA

12.30 Where practicable, we have included an initial baseline for each capex category. We expect HAL to provide indicative forecasts for the new asset management categories as soon as possible. We also expect HAL to provide an indication of the amount of spend within each category that is core capex.

12.31 HAL's updated RBP also included spending for the Crossrail Contribution (£78m). We have included this as part of the H7 capex baseline proposed (see Chapter 3). However, we do not consider this is suitable for *ex ante* treatment because it is a fixed contribution that has been deferred from Q6, rather than a new investment decision. So, it has not been included in the capex categories in Table 12.2.

12.32 We also note that some of the projects HAL included in its asset management programme are projects that were already underway before the start of H7 (such as the Cargo Tunnel and Main Tunnel projects). We set out our views on transitional arrangements in the April 2021 Way Forward Document and we

[9] HAL RBP Update - Review of capex categories and delivery objectives, Arcadis, October 2021 www.caa.co.uk/cap2266C

[10] This includes only the "Regulated Security" element included in the RBP update 1 "Protect the Business" portfolio.

consider that this approach remains appropriate for our Initial proposals.[11] Where a project has already started and is materially underway before the start of H7 (in other words it has advanced beyond G3[12]), it will be treated under the existing Q6 framework and not under the H7 incentive framework. These transitional projects should be excluded from any indicative capex category baselines.

12.33 Based on information we have reviewed from HAL in the updated RBP, we estimate that these exclusions represent around 18% of our proposed H7 capex baseline. HAL has included £418 million of what it describes as "continued investment" projects, but it is not clear whether all of these projects have already started and have passed capex governance gateway G3. In addition, our understanding is that the T4 Hold Baggage Screening ("HBS") project (£50m) has also not passed G3 and, therefore, we propose treating it under the H7 *ex ante* incentive framework. We expect HAL to provide evidence to demonstrate which projects have already passed G3 and so should be treated as legacy projects and excluded from the H7 *ex ante* framework.

12.34 We intend to engage with HAL and airlines further on our proposals for capex categories and transitional arrangements so that we can establish appropriate capex category baselines for our Final Proposals.

Delivery objectives and obligations

Setting delivery obligations

12.35 We do not agree with HAL's proposal that metrics from the OBR framework should be used instead of delivery objectives to assess whether quality requirements have been met for a particular capex category. Service quality measures are designed for a different purpose: to incentivise and improve performance and quality of service at Heathrow airport. Therefore, they generally capture elements of delivery beyond specific capex programmes. For example, opex could have an impact on performance against some of these metrics. In addition, capex by its nature might be contributing towards longer-term outcomes, so HAL's delivery of a capex category might not have an impact on service quality measures immediately.

12.36 For these reasons, we consider that it is important to develop delivery objectives and obligations for each capex category which will be used to assess whether HAL has delivered the outputs and benefits that have been agreed with airlines, at the point in time when we undertake our reconciliation of capex incentives.

12.37 HAL has included a list of "Programme Mandate one pagers" which set out a high-level objective for each programme in its plan. These objectives do not meet the definition and criteria that we set out in the April 2021 Way Forward Document, including the requirement that they should be "SMART".[13]

---

[11] See para 78-79 of of Appendix M, April 2021 Way Forward Document.

[12] G3 stands for Gateway 3 and is the point at which the investment decision is taken and the project transitions from development to core. Appendix C of the August 2020 Working Paper sets out further detail of the project gateway process.

[13] Specific, Measurable, Achievable, Realistic, Time bound.

12.38 We asked Arcadis to develop illustrative examples of delivery objectives based on HAL's capex plan which we have included in Appendix D. We intend to discuss these examples with HAL and airlines further as part of our ongoing work on implementing the framework.

12.39 Nonetheless, HAL should as soon as possible provide:

- fully developed delivery objectives for all the capex categories included in its plan;
- draft delivery obligations for any capex categories that are at a sufficiently advanced stage of development; and
- for all other capex categories, where HAL cannot define a draft delivery obligation, include an indicative date during H7 when it expects the capex categories to be sufficiently developed so that delivery obligations can be set.

12.40 We have set out examples and further guidance and we encourage HAL to work with airlines to agree suitable delivery objectives for each capex category as part of its ongoing engagement to further develop its capex plan for H7. Where HAL does not provide delivery objectives in line with CAA guidance, we will assess HAL's updated capex plan and set out our view of appropriate delivery objectives for each capex category as part of our Final Proposals.

12.41 As projects in HAL's portfolio reach G3, the high-level delivery objective set at the beginning of H7 for each capex category will be updated to reflect more the specific metrics / requirements developed for G3. During H7, and through discussions between HAL and airlines, the delivery objective will become a delivery obligation, which should reflect, for each capex category:

- outputs;
- quality requirements; and
- timing requirements.

Assessing delivery obligations

12.42 Over the period of the H7 price control and following completion of the relevant capex projects/programmes, we will assess whether the delivery obligation has been met for each capex category. If the objective has been met, the G3 baseline becomes the final capex baseline for that category. If the delivery objective has not been met, we will make an adjustment for under-delivery which is applied to the baseline, and this adjusted baseline would become the final baseline.

12.43 HAL and airlines have asked us to clarify how we will assess whether a delivery obligation has been met and how the capex baseline will be adjusted if our conclusion is that a delivery obligation was not met. As noted previously, HAL has not yet proposed suitable delivery objectives or obligations to support its capex plan and so at this stage of the process we have identified a high-level approach to the assessment of delivery obligations. We intend to:

- monitor the delivery of capex categories continually during H7, and we plan to discuss the frequency and format of reporting with HAL and airlines;

- undertake a high-level review of whether delivery obligations have been met for all capex categories that have been delivered by the backstop date;
- take a proportionate approach, for example by conducting a more detailed review of a sample of capex categories, for example where HAL and airlines do not agree on whether the obligation has been met;
- use independent / technical advisors where appropriate;
- seek views from HAL and airlines when we carry out our assessment; and
- consult on any assessment / decision on adjustments to baseline that we propose.

12.44 To the extent it is practicable and reasonable to do so we will adopt a light touch approach, particularly where there is agreement between HAL, airlines and the IFS that a delivery obligation has been met. Nonetheless the burden of proof will be on HAL to:

- demonstrate that it has met the delivery obligation; and
- keep good records of what it has delivered.

Incentive rate

12.45 In setting the new incentives we need to establish an incentive rate, which is the proportion of any under or overspend that HAL will retain/absorb compared to the G3 baseline (after this is adjusted for any under delivery).

12.46 The evidence that we have available does not suggest that any of HAL's capex categories have significantly greater risk and/or that HAL has less control over outturn spending in relation to any of them. As a result, we propose to apply the same incentive rate to most of HAL's capex categories.[14] We also intend for this to be a symmetrical rate so HAL is equally rewarded for upside and downside, to avoid distorting incentives for investment and to appropriately reward efficiency.

12.47 We are consulting on an incentive rate between 20% and 30% as part of these Initial Proposals.[15] This proposed range recognises that:

- while we do not consider that HAL has made a strong case to justify excluding the majority of its capex categories from ex ante incentives, the analysis undertaken by Jacobs on behalf of HAL illustrates that HAL will face challenges in managing costs to a budget. In particular HAL has presented some reasonable evidence[16] that the incentive rates seen in other sectors (in the region of 40-50%) are unlikely to be appropriate for H7;

[14] As noted previously, Crossrail and Q6/iH7 transitional projects will be excluded from *ex ante* treatment.

[15] Further detail of our analysis is summarised in Appendix D.

[16] Jacobs report on H7 Capital efficiency, June 2021. Submitted by HAL in response to the April 2021 Way Forward Document.

- we consider that we need to create stronger incentives for H7 compared to the 13% financing cost incentive[17] that exists in the Q6 capex framework to drive efficiency in the interests of consumers;
- we consider that setting a uniform incentive rate for all capex subject to the incentive regime will lead to a regime that is clear, avoids boundary/classification difficulties and avoids creating unforeseen consequences in the operation of the incentive;
- we are proposing further incentives on HAL to deliver capex projects on time including triggers and penalties for late delivery (see further below);
- these are new incentive arrangements and so we should proceed with a degree of caution; and
- we also recognise that the flexibility offered by the core and development framework means that the baseline against which we assess HAL's performance can be updated during the period as new information becomes available which provides a level of forecasting risk protection for HAL.

12.48 Finally, we note that we are intending to assess HAL's cost performance against the G3 capex baselines which means that the incentive rate would not apply to pre-G3 development capex that HAL incurs.[18]

12.49 We will engage further with stakeholders on the appropriate incentive rate to inform our Final Proposals.

Timing incentives

12.50 We consider that it remains appropriate to include further mechanisms in the capex framework so that HAL faces additional incentives to deliver capex on time, including:

- updates to the trigger mechanism, so that triggers are only applied to exceptional, material, complex and strategically important projects, and HAL would receive a modest reward (10% of the penalty payment) if it both delivers the project ahead of the agreed trigger date and where early delivery before the trigger date would result in clear benefits to consumers;
- where they are specified, the timing element of delivery obligations will provide an additional incentive for HAL to deliver capex categories on time; and

[17] HAL has previously provided a stylised example to demonstrate the Q6 financing cost incentive is around 13% because HAL does not recover the financing costs associated with any overspend or underspend against the capex baseline agreed at Gateway 3.

[18] Under the current core and development framework, as development capex transitions to core capex, the G3 capex baseline is updated to reflect pre-G3 development capex incurred, plus the new, forward looking capex baseline agreed between HAL and airlines as projects pass G3.

- it may also be appropriate to set a penalty for failing to deliver a capex category against an agreed delivery date,[19] which would create a strong incentive on HAL to avoid lengthy delays in delivery.

12.51 We set out further details of our proposals on timing incentives in Appendix D.

Dealing with changes to HAL's capex programme

12.52 There will continue to be uncertainty in relation to future passenger demand which will have implications for HAL's capex plan. Also, chapter 3 notes that HAL's proposed capex plan is not as developed as we had expected at this stage of the price setting process. We recognise that a flexible approach is required for H7, but we do not agree with HAL that the existing core and development framework alone provides suitable protections for consumers to address significant changes in the capex envelope.

The core and development framework

12.53 We propose to maintain the flexibility currently provided by the core and development framework in dealing with individual projects. This approach should reduce the risk of unintended outcomes (which should benefit both HAL and consumers) as the risk associated with estimating the costs of projects should be much lower once HAL commits to a baseline as part of the G3 capex governance gateway.

Dealing with significant changes in capex requirements

12.54 While it is a helpful framework it is important not to expect too much of the core and development governance arrangements, which focus on individual projects. Therefore, we are proposing a new mechanism for H7. In the event of significant changes in the external environment, decisions around changes to the overall capex envelope can be agreed by airlines and reviewed and agreed by the CAA. This process should involve the following:

- HAL must demonstrate that additional capex requirements, beyond the initial capex envelope set as part of the H7 Final Proposals, are driven by a change in circumstances from the time when the H7 determination was made. Such capex initiatives could include projects or programmes proposed by HAL in its business plan but not included by the CAA in the H7 baseline, or new initiatives responding to changed external circumstances;
- prior to making a submission to the CAA, HAL would need to consult with airlines on the need for additional capex, timelines for delivery and detailed cost information; and
- once a submission is made, the CAA would review the level of consultation carried out and the quality of the information provide to stakeholders by HAL. Where HAL and airines are in agreement we would only intervene if we had a significant concern that new capex was not in consumers' interests; and

[19] The date beyond which penalties apply is set at a constant deadband of 12 months from the agreed date of delivery of each capex category.

- we would consult on our draft decision to allow any additional capex during H7 and then set out a final decision on these matters.

Summary of our Initial Proposals

12.55 Our Initial Proposals for the H7 capex incentive framework includes:

- a new forward looking incentive framework applied to most of HAL's capex portfolio;[20]
- a baseline for each category of capex linked to appropriate delivery objectives which will become delivery obligations during the period;
- the same symmetrical incentive rate applied to each capex category baseline, we propose a rate in the range between 20% and 30%;
- flexibility that allows the capex baselines to be updated during H7 for a particular set of circumstances provided changes are subject to appropriate governance;
- stronger incentives on HAL to deliver capex investment on time, this includes updates to the existing Q6 trigger mechanism, as well as a proposal for a further penalties for significant delays in delivering capex categories;
- reconciliation of the incentive with a backstop date of the end 2027;
- enhanced governance arrangements to reflect changes to the efficiency incentives framework; and
- a mechanism so that HAL can request changes to the overall capex envelope but only in the event of significant changes in the external environment.

12.56 We consider that these proposals will address the problems that we have experienced in the implementation of *ex post* incentives and will create an regime that effectively incentivises HAL to develop and deliver its capex programme in an efficient manner to meet the reasonable demands of consumers, while at the same time retaining benefits of the well-understood and useful core and development framework.

12.57 Given these Initial Proposals represent an important evolution of the existing capex incentive framework our approach to calibrating the capex incentives appears reasonable and proportionate and consistemt with the efficient financing of new expenditure.

12.58 As a result, and given the governance processes that we intend to place around the regime, we consider that these proposals will further the interests of consumers in relation not only to the costs that they are exposed to from HAL's capex, but also in ensuring that the airport is efficiently developed and maintained to provide an appropriate level of AOS in terms of the range, availability, continuity and quality of HAL's services.

Next steps and Implementation

12.59 We welcome the views of stakeholders on any of the issues raised in this chapter and appendices D and H and will consider these carefully as part of our work to develop Final Proposals.

12.60 We will also continue discussions with HAL and airlines on implementation issues particularly around setting appropriate capex categories, delivery objectives and obligations, enhanced governance arrangements and the process for reconciliation.

Enhanced governance arrangements

12.61 It will be important that airlines retain their vital role in capex governance arrangements so that HAL's capital programme benefits from the expertise of airline stakeholders and delivers appropriate outputs for airlines and passengers. To support this HAL should work with airlines to agree an updated Capex Protocol, Capex Efficiency Handbook, and Triggers Guidance for H7. These documents will need to reflect the new capex efficiency framework, as well as several areas that we previously identified where the Q6 capex governance arrangements can be improved.[21] We expect the documents to set out better defined and more rigorous rules and procedures that HAL will be required to follow when progressing its capex programme. For example, we expect a tighter change control process around updates that are made to capex baselines during the H7 period. Examples of these include changes for projects not taken beyond G2 and agreed project scope changes after G3.[22] We also expect to have an enhanced role in the process, for example scrutinising and monitoring adjustments to baselines and delivery obligations during the price control period. If necessary, we will support stakeholders in this process of producing revised documentation and we will intervene to finalise the drafts of the updated documents either, where HAL and airlines cannot reach agreement, or the protocol documents to do not reflect CAA guidance..

12.62 We also intend bring forward certain licence changes to require HAL to provide sufficient information to allow the capex governance process to function effectively and to comply with the capex protocol documents.

Reconciliation

12.63 We set out an overview of a proposed incentive reconciliation process in the April 2021 Way Forward Document,[23] this included a worked example that demonstrated the reconciliation calculation steps. At this stage, we have received limited views from stakeholders on our proposals for reconciliation, so we expect further engagement with HAL and airlines on this issue.

12.64 Even though it will not affect charges during H7, we intend to add to HAL's licence or include in policy guidance a description of how the RAB adjustments

[21] As set out in the June 2020 Consultation, para 3.27

[22] See table M2 of Appendix M, the April 2021 Way Forward Document.

[23] See pages 125 – 132 of the Appendix to the April 2021 Way Forward Document.

resulting from the capex incentive mechanism should be calculated. This will provide enhanced certainty to HAL and to other stakeholders.

12.65 It is important that we have the level of information that is needed to assess HAL's performance and to calculate under or overspend against final baselines. New reporting requirements will be needed for H7 to help improve transparency of capex performance and allow us to properly monitor in period adjustments that are made to each capex category baseline. We also intend to issue updated guidance and reporting requirements for H7 so that appropriate information is submitted by HAL as part of its annual regulatory accounts.

12.66 We intend to publish further information on our approach in relation to these matters as part of or alongside our Final Proposals.

Licence updates

12.67 We have identified areas of HAL's licence that in due course will need to be updated to reflect our approach to capex incentives and governance. These include the:

- capital "trigger" factor (referred to in Condition C.1.7) which is to be updated to reflect changes that we have proposed to the mechanism for H7 including the reward for early delivery; and
- consultation conditions (Condition F) to strengthen this licence condition so that HAL has to comply with the capex protocol documents.

12.68 We have identified the following further licence modifications that are likely to be necessary to support the capex framework for H7:

- given the lack of progress by HAL in developing delivery objectives and obligations to support its capex plan so far, we consider that it may be necessary and proportionate to include a licence modification which places an obligation on HAL to develop delivery obligations during the H7 period and to support the revised capex governance arrangements more broadly, in line with CAA guidance; and
- to support flexibility in the capex arrangements, it may be necessary to introduce a new licence condition that sets out our proposed mechanism for HAL to request additional capex that was not included in the capex envelope that we set as part of the price control during H7 in response to significant changes in external circumstances since the price control was set.

12.69 We have also identified some areas of the existing licence, particularly the development capex mechanism (referred to in Conditions C1.9 and C1.10), that would benefit from tighter drafting to avoid ambiguities that have existed with the Q6 capex framework. For example, the drafting could be clarified so that it is clearer that any capex that HAL incurs prior to the project going through G3 is included in the development capex mechanism and reflected in updates to the capex baseline as noted above. We plan to engage further with stakeholders ahead of our Final Proposals to seek views on whether these updates are appropriate.

Chapter 13

Other regulated charges

Introduction

13.1 Other regulated charges ("ORC"s) are charges for specified services and facilities that are collected separately to the regulated airport charges (that are subject to price control) and are in general levied on a 'user-pays' basis. Nonetheless, the costs of providing these services forms part of HAL's cost base and the revenue associated with these charges is included in the single till calculations used to set the price control and so consideration of ORCs is a necessary part of the overall price control review.

13.2 Establishing an appropriate approach to ORCs is important for the following reasons:

- so that the overall price control is calibrated appropriately, and the interests of consumers properly protected; and
- to help ensure that HAL has incentives to efficiently provide a full range of services to airlines and other stakeholders, supporting efficiency and economy and allowing reasonable demands for airport operator services to be satisfied.

13.3 This chapter sets out:

- further background information on ORCs;
- a summary of stakeholder proposals and views on key issues;
- our views and initial proposals on marginal cost pricing, the scope of ORCs, governance arrangements and the projections of ORC revenues over the period of the H7 price control; and
- implementation issues and next steps.

Background

13.4 There are governance arrangements in place that allow for joint HAL/airline working on ORCs, with the intention that these charges are set in an efficient and appropriate way. This framework was intended to provide certainty for both HAL and airlines that the costs of these services would be recovered in an appropriate way.

13.5 Until recently this framework appears to have worked relatively well but the impact of the pandemic on demand for services and the recovery of costs has revealed a number of weaknesses with the existing arrangements. For instance, the low passenger numbers coupled with the inclusion of some largely fixed elements in the cost base has led to a significant under recovery of these costs in 2021 and 2022. This has led to tension between HAL and airlines, which in turn has revealed weaknesses in the governance processes. HAL has been discussing these matters with airlines and making proposals to improve the framework for ORCs, as discussed further below.

13.6 We also need to make appropriate projections of ORC revenues to be used in the single till calculations that support the setting of the price control. These matters are discussed in the Initial Proposals section of this chapter.

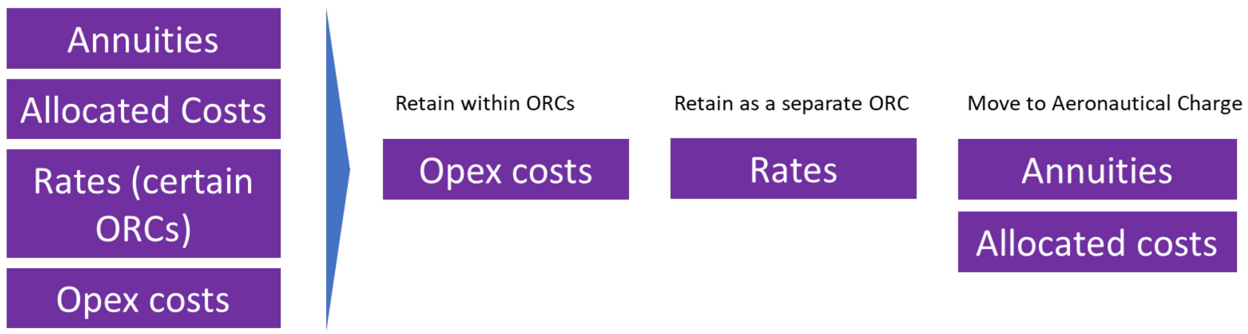
Stakeholder proposals and views

13.7 HAL proposed several changes to the ORC framework in its RBP:

- a move to a 'marginal cost' approach under which the fixed costs (known as "annuities") and allocated costs[24] would in future be recovered through the regulated airport charges rather than ORCs;
- moving all costs for check-in facilities, IT, heating and gas to be recovered through the regulated airport charges, as these are used by all passengers;
- consolidating all business rates from the regulated airport charges and individual ORCs into a single, separate ORC;
- moving charges for bus and coach services out of ORCs into individual commercial arrangements to facilitate a more differentiated service to bus and coach operators;
- introducing flexibility into the licence to allow additional ORCs to be added to the list of specified services within the H7 price control period; and
- improving the governance arrangements, particularly around dispute resolution and the role of the CAA.

13.8 It illustrated its broad approach as in the figure below.

Figure 13.1: summary of HAL's approach in its RBP



Source: HAL's RBP

13.9 In addition, HAL provided a forecast of the ORC revenues for each year of the H7 period.

---

[24] The annuities are the fixed depreciation costs for capital spend and allocated costs are a proportion of general airport operational costs, such as policing and airport security, that are currently included in the ORC unit prices.

13.10 HAL and airlines have discussed these proposals together through CE and collectively agree that most of them will make the ORC framework more effective, so allowing HAL and airlines to focus on delivering services for consumers.

13.11 Nonetheless, two important aspects of HAL's proposals were not agreed to by airlines:

- the consolidation of all business rates as a separate ORC; and
- moving charges for bus and coach services to a more commercial basis.

13.12 HAL proposed that business rates should be passed through to airlines in full, rather than the current 80/20 risk sharing arrangements. It proposed using the ORC framework to manage this pass-through and said that the ORC governance process would provide the transparency and appropriate forum for challenge and review of these costs.

13.13 In relation to moving the bus and coach services to a set of individual commercial arrangements, HAL said that the operators using these services were not in general willing to engage as a group on charging arrangements and costs and would prefer bilateral commercial discussions and negotiations.

13.14 Airlines agreed that business rates should be treated as a cost pass-through item and that the 80/20 risk sharing arrangements should be removed, but argued that they should remain in the regulated airport charge, with a new governance framework to review these costs periodically. HAL only introduced its proposal for bus and coach service in its updated RBP in July 2021, and airlines and other stakeholders have not yet expressed their views on these matters to us.

Our views and initial proposals

13.15 In the April 2021 Way Forward Document, we said we would consider whether these proposals were in consumers' interests, with a focus on those areas where HAL and the airlines did not agree. We welcome the collaboration between HAL and the airlines in reaching agreement on many of these proposals.

13.16 We agree with HAL and airlines that the downturn in passenger volumes in 2020 and 2021 (which caused a significant under recovery of revenues and led to significant price rises in 2021) has highlighted that changes in the scope and governance of the ORCs would lead to a more proportionate and effective system that would ultimately be better for consumers.

13.17 In particular, removing fixed and allocated cost elements from the ORCs where practicable and reasonable would provide for greater stability and efficiency of pricing arrangements so that significant passenger volume downturns would be less likely to result in large increases in charges in subsequent years that will ultimately be passed to consumers. Including these elements in airport charges would mean they would receive a degree of protection through the risk sharing arrangements discussed in chapter 1.

13.18 We agree with HAL and the airlines that there would be also be advantages in developing further clarity within the governance arrangements and more binding dispute resolution processes, to minimise disputes and ensure swift resolution when they do occur. This would be likely to drive better outcomes for consumers, with more efficient administration of the ORC arrangements allowing HAL and airlines to focus on delivering services to consumers.

13.19 Further details of our proposed approach are set out below.

Marginal cost approach: initial proposals

13.20 As noted above, there are advantages in reducing the scope of fixed and allocated costs that are included within the ORCs. Bearing this in mind, we intend to accept the proposals outlined above that ORCs should focus more on the marginal costs of the services provided. This will allow the governance process between HAL and airlines to focus on the costs that the airlines can influence, simplify the calculations of the unit costs on a user pays basis and will make dealing with significant downturns in volumes more manageable in future. These factors support a more focused and proportionate approach to regulation.

13.21 We consider that this change is needed to deliver the benefits of marginal cost prices to ensure that consumers (through airlines) are charged an efficient price for the services and facilities that they use and that the risk of significant price increases is minimised. We also consider that targeting the charges in this way will drive the effectiveness of the governance arrangements and so help promote economy and efficiency on the part of HAL. This change will not lead to a change in HAL’s expected profitability as these costs will be recovered instead through the airport charge.

Changes to the scope of the ORCs: initial proposals

13.22 In addition to the broad changes associated with a move to marginal cost pricing arising from the removal of fixed and allocated costs from the ORC cost base, we agree that there are benefits to some of the proposed changes to the scope of the ORCs in reflecting how:

- these services and facilities are used; and
- airlines can influence the associated costs.

For example, the benefits of IT services, heating and gas are in general spread across all passengers and so there is no compelling reason why these should by recovered separately from airport charges. Similar considerations apply to the operating costs of providing check-in desks and automated check-in terminals (in so far as all passengers use check-in services).

13.23 We also agree that there should be greater flexibility to include new ORCs within the H7 period to ensure transparency and collaborative governance of the costs and revenues of these services when they are introduced.

13.24 However, as discussed further below we are not convinced that treating business rates as an ORC is consistent with the move to a marginal cost approach. We will also reserve our decision on the treatment of bus and coach operators to allow representations from those stakeholders on this proposal.

Figure 13.2 CAA's initial proposals for services to be included in ORCs

Remove	Do not include	Requires further consultation	Potential to include (subject to future agreement and not included in the ORC forecast)
Check-in & Automation Gas Heating WLAN Common IT	Business Rates (as a separate ORC)	Bus and Coach Services	Winter Resilience Cargo Services

Business rates

13.25 We do not agree with the proposal to move business rates from the airport charge into ORCs as, in general, business rates do not represent a marginal cost. Adding such a large sum of fixed costs[25] into ORCs could lead to similar problems with under recovery to those experienced over the last two years if there is another significant downturn in passenger volumes. We also do not agree that moving business rates into ORCs would necessarily ensure transparency and/or good governance. Given the size of HAL's liabilities for business rates, a separate governance group would need to be set up in any case to ensure access to appropriate expertise and avoid distraction from discussion of the operational ORCs.

13.26 For the same reasons, we are of the view that it is important that HAL has appropriate incentives with respect to business rates. Bearing this in mind we intend to retain the existing 80/20 risk sharing arrangement to incentivise HAL to negotiate efficient revaluations with the Valuation Office. This incentive would be in the longer-term interests of both airlines and consumers.

13.27 Bringing these considerations together means that our initial proposals involve consolidating all the business rates accruing to airlines as an operating cost (as per chapter 4) and retaining the existing risk sharing arrangements. Only the residual costs allocated to third parties (around £6 million) should treated as an ORC. This should ensure that business rates are managed effectively under the price control and governance arrangements, which should be in the longer-term interest of consumers.

Bus and coach services

13.28 There may be some advantages to moving to commercial arrangements if the different operators are likely to require a differentiated level of service and are not willing to be part of a representative group. However, we note that airlines and other stakeholders have not had an opportunity to provide a formal view on

[25] Business rates in 2021 are £121m, of which £95m are recovered through the airport charge and £26m are recovered through ORC revenues. Of the latter, about £6m accrues to non-airline users.

this proposal. We will, therefore, reserve our position on these matters until stakeholders have an opportunity to comment on HAL's proposals.

Governance arrangements: initial proposals

13.29 HAL and airlines have identified new services that may need to be added to the ORC framework during H7, such as winter de-icing services and some cargo services. New services can be added to the ORC licence condition at any time through the modification provisions in the Act but this approach is not particularly well suited to addressing changes driven by commercial agreement between HAL and the airlines in a timely way.

13.30 To address this, we intend to include provisions for us to update the ORC condition by notice where there is consensus between HAL and airlines and where we are clear that this would be consistent with the interests of consumers. In doing so, we will check that the services in question are genuinely new services and that it will be appropriate to recover these costs through ORCs.

13.31 As noted in the background section, the under recovery of ORCs in 2020 and 2021 has highlighted some weaknesses in the governance arrangements and dispute resolution mechanisms. Most of these can be resolved by agreement between HAL and the airlines through an improved governance protocol. However, the licence currently only requires HAL to agree a consultation protocol and to publish the cost allocation system and pricing principles. We therefore intend to make some changes to the licence to explicitly require HAL to agree and comply with the governance protocol, including the cost allocation and pricing principles. We will work with HAL and the airlines to ensure that we have an appropriate role in determining disputes, which should allow for effective dispute resolution and a targeted and proportionate approach to regulation. This approach should mean that our role is clearly defined and we can effectively carry out any role relating to dispute resolution.

13.32 We consider that these changes are needed to ensure that the ORC arrangements retain flexibility to enable them to continue to deliver the benefits they bring to consumers over time, and help to avoid disputes between HAL and the airlines from becoming deadlocked so that a resolution cannot be found in the interests of consumers. We consider that the changes we propose are a proportionate means of dealing with these issues while retaining continuity with, and the benefits of, the current arrangements.

Forecast of ORC revenues: initial proposal

13.33 HAL provided updated forecasts for ORC revenues in its RBP update which include business rates. HAL has told us that the business rates element that is chargeable to airline users includes the £95m that is currently charged through the airport charge and another £20m which is currently recovered through the charges for individual ORC services. HAL's forecast for the services and facilities that are to remain in the ORC process (that is, excluding business rates, check -in facilities, IT services and heating and gas) is set out in Table 13.1.

13.34 In formulating these initial proposals, we have taken a conservative approach and adopted HAL's forecasts of ORCs (excluding business rates which are included in opex and we have rebased HAL's forecasts to 2020 prices) for use in the single till calculations. As noted below we will develop an independent assessment of these forecasts for final proposals.

Table 13.1 ORC forecast revenues.

ORC forecast revenues	Q6+1	iH7		H7				
£m	2019	2020	2021	2022	2023	2024	2025	2026
HAL forecast, including business rates, (2018 prices) (Source: HAL RBP update)	236	111	270	265	278	285	286	286
CAA Initial Proposals, excluding Business Rates (2020 CPI deflated prices)				163	179	189	193	196

Next steps and implementation

13.35 We welcome the views of stakeholders on any of the issues raised in this chapter and will consider these carefully as part of our work to develop Final Proposals.

13.36 As noted above we intend to propose certain changes to the licence to coordinate the licence and ORC governance arrangements more effectively and to facilitate dispute resolution. We will also seek to amend the licence to allow for the introduction of new ORCs within the H7 period.

13.37 We understand that the ORC governance group is continuing to work on refining the forecasts of ORC revenues. We will review any updated forecasts for the Final Proposals and expect to include our forecast as part of the single till calculations and as the basis for reporting differences in charges, as we did at the Q6 price control review. This will provide greater certainty to airlines on expected charges through H7 and provide additional incentives on HAL to keep costs at an efficient level.

Chapter 14

Outcome based regulation

Introduction

14.1 Consumers' interests are furthered not only by ensuring that the cost to them of the airport operation services provided by HAL is appropriate, but also by ensuring that the services HAL provides meet their needs in terms of their range, availability, continuity and quality.

14.2 HAL's existing price control contains a framework of service quality rebates and bonuses ("SQRB"). Key purposes of the SQRB scheme are to identify the service standards that consumers and airlines can expect from HAL in return for the regulated charges it receives and to incentivise good performance by HAL in these areas.

14.3 While the SQRB scheme has worked well and helped improve service quality for consumers, it is focused almost exclusively on aspects of airport operation services that are directly within HAL's control. In contrast, consumers' experience of the service provided at Heathrow is driven by the outcomes they receive in terms of service, rather than solely by the inputs provided by HAL. To address broader aspects of consumers' interests and build on the success of the SQRB scheme, we have emphasised the importance of a broader outcome-based approach in H7. This should capture a wider range of service quality indicators and be underpinned by evidence about the aspects of service quality that consumers value (including the support for HAL in reducing its carbon footprint). We consider this broader approach will ensure that consumers' interests remain at the heart of airport regulation, particularly by:

- securing that their reasonable demands for airport operation services are met in terms of the outcomes incentivised;
- promoting economy and efficiency in the way in which those outcomes are delivered; and
- supporting HAL in taking reasonable measures to reduce, control or mitigate the environmental effects of the airport.

14.4 This chapter sets out our initial proposals on the key parameters of the outcome-based regulation ("OBR") framework including the outcomes and measures to be included in the new framework. It also discusses wider issues in relation to targets, incentives, continuous improvement and implementation. Further details will be set out in a working paper to be published later this year which will include proposed changes to HAL's licence that would implement the new OBR framework.

Background

14.5 Following the December 2016 Consultation[26], we confirmed in the April 2017 Guidance[27] that we intended to transition towards OBR. We said that OBR should be an evolution of the SQRB scheme, and that HAL would be responsible for the initial development of OBR, in discussion with airlines and the Consumer Challenge Board ("CCB").

14.6 We said HAL should develop an OBR framework that is informed by robust consumer research and builds on the existing SQRB scheme. Services that HAL provides to airlines should remain a key part of the new framework, as these directly affect the service quality provided to consumers. We said that the new framework should include:

- outcomes: overarching objectives that identify the most important aspects of airport operation services that consumers value;
- measures: specific performance measures that indicate progress towards one or more outcomes;
- targets for each measure, based on evidence and taking account of consumer preferences and the scope for performance improvements;
- incentives to meet these targets, which may be either financial or reputational; and
- a "continuous improvement" approach that allows the OBR framework to be updated during the H7 period.

14.7 HAL then engaged with airlines and the CCB and drew on consumer research to develop a proposed set of outcomes, measures, targets and incentives, and a proposal for continuous improvement. These were included in its RBP.[28] Airlines also developed their own proposals for the OBR framework.[29]

14.8 We provided some high level observations on HAL's proposed measures in the April 2021 Way Forward Document, including that HAL appeared to have taken a relatively narrow view when considering financial incentives, that there appeared to be some areas of overlap, it was not always clear what action HAL would be driving in relation to certain measures, and that the use of moving annual averages can mask variability in performance. We also welcomed the inclusion of certain new reputational measures and encouraged HAL and airlines to continue to engage in order to build on areas of agreement and to narrow areas of disagreement.

14.9 Regarding HAL's proposed targets and incentives, in the Way Forward document:

---

26 See CAP1476 https://www.caa.co.uk/cap1476.

27 See CAP1540 https://www.caa.co.uk/cap1540.

28 See chapter 9.2 of the RBP https://www.heathrow.com/company/about-heathrow/economic-regulation/h7-update.

29 These are described in paragraphs 5.10 to 5.12 of the April 2021 Way Forward Document.

- we noted that HAL's proposals would result in a more generous service quality framework (in terms of its financial exposure) in H7 compared with Q6, and that there was only limited information on how HAL's targets linked to other building blocks (such as capex and opex);
- we reported our initial view that "knife edge" incentives (rather than HAL's proposed "sliding scale" approach) remain appropriate for H7, though we said we could consider whether the sliding scale approach might be applied to a limited number of targets if there was a particularly strong case for this; and
- we reported our initial view that there was insufficient evidence to support HAL's proposal to increase bonuses across fourteen measures.

14.10 We also noted that, in the light of the impact of the covid-19 pandemic, there might be a need for an approach that maintains some targets or service levels in the short term and introduces incremental improvements through targeted investment during H7 as part of "continuous improvement".

14.11 The proposed targets[30] included in HAL's RBP were based on its then proposed capex plan of £3.5 billion during H7. In its RBP update, HAL included separate sets of targets corresponding to two different capex plans:[31]

- an "optimal plan" for £4.2 billion of capex during H7, which HAL stated requires a full RAB adjustment. The targets associated with this plan (which also require an enhanced service opex overlay) are the same as those included in the RBP; and
- a 'safety only' plan for £2.5 billion of capex during H7, which HAL stated is the maximum that could be expected without a further RAB adjustment. Some of the targets associated with this plan were significantly lower than the optimal plan targets, for example:
    - the target for the proportion of passengers queueing for less than five minutes at central security search would be 33-75 per cent, compared with 95 per cent under the optimal plan and the targets for queues of less than 10 minutes would fall from 99 per cent to 46-89 per cent;
    - the target for the availability of lifts, escalators and travellators would be 97 per cent, compared with 99 per cent under the optimal plan. Other availability targets are also reduced; and
    - the target for overall satisfaction would be 4.17 compared with 4.26 under the optimal plan.

---

30 HAL's targets focused on maintaining Q6 service levels during H7 and making targeted improvements in three areas: punctuality, baggage and the passenger experience. A number of targets have not yet been set due to the need to gather sufficient baseline data.

31 See chapters 5.3 and 6.2 of the RBP update https://www.heathrow.com/company/about-heathrow/economic-regulation/h7-update.

Stakeholders' views

14.12 HAL's response to the April 2021 Way Forward Document challenged some of our observations on its proposed measures, noting that:

- it is inappropriate for it to face financial rebates where it is unable to control performance against a measure;
- there will always be some variability in monthly data, and the use of moving annual averages allows it to track whether performance is improving or deteriorating over time; and
- possible overlaps between measures simply reflect its approach, driven by consumer research, of categorising measures as overarching, core or diagnostic.

14.13 HAL also defended its proposals for sliding scale incentives and an extended range of bonuses, saying that:

- the CAA's assessment that its proposed incentive scheme is more generous is not relevant, but instead the CAA should be considering whether the structure creates the right incentives for HAL to provide a level of service quality that is in the interests of consumers;
- other sectors have recognised the value of sliding scale incentives, whereas knife edge incentives do not reflect consumer valuations and have bad incentive properties. HAL also disagreed that sliding scale incentives would be more complicated and uncertain;
- its consumer evidence shows that consumers are willing to pay more for better service and that they attach value to improved performance; and
- the current incentives are skewed to the downside and so do not provide constructive incentives that reflect the value that consumers attach to performance improvements.

14.14 In addition, HAL made a number of comments on the process that we adopted while developing our approach to implementing OBR, for example that we had disregarded the consumer evidence that it put forward and instead relied on views from airlines that are not substantiated by consumer research, and that we had deferred all decision making in the hope that HAL and airlines would agree the right next steps.

14.15 The AOC/LACC proposed an alternative set of outcomes to clarify and refine HAL's proposals. They also submitted detailed comments on HAL's proposed measures, putting forward their own proposals based on a "customer journey" approach. As well as specific suggestions for changing certain measures, a common theme of airlines' comments was that a consistent and high quality of service should be delivered to every consumer. For this reason, they said that a number of measures (including security queues, arrivals and departure management, and infrastructure availability/performance measures) should be calculated on a daily basis rather than the current monthly averages. Compared with HAL's proposals, some of airlines' proposed measures were more narrowly focused on services provided solely by HAL as the regulated entity.

14.16 Since HAL and airlines submitted their responses, they have continued to engage and have managed to reach agreement on some measures. However, some areas of disagreement remain:

- as noted above, airlines consider that a number of measures should be reported as daily rather than monthly averages;
- airlines oppose a number of measures which they consider cover airline activities (for example, "value for money of overall journey", "offers flights that I want", "reduction in Heathrow's carbon footprint") or which HAL has relatively little control over (for example, "ease of access to the airport"). In addition, they (i) favour a "Net Promoter Score" in place of HAL's proposed overarching measures; (ii) proposed an alternative set of questions for the wayfinding measure; and (iii) proposed that the new "injuries" measure should cover staff at Heathrow as well as passengers;
- the parties disagree about possible new measures for baggage performance. In the RBP, HAL proposed new measures for the "baggage misconnect rate" and "time to last bag on reclaim belt". Airlines disagree with both of these proposals, as they are outside of HAL's direct control and instead proposed several measures specific to HAL's baggage systems. We understand that some progress has been made agreeing an alternative "timely delivery" measure, although airlines still oppose HAL's original proposals and continue to support departures baggage system availability measures;
- airlines oppose HAL's proposed "departures flight punctuality" and "wheels down to doors open" measures, and instead proposed measures of arrivals and departures management to capture elements of punctuality they consider are within HAL's control. The parties discussed some options but disagree on the most suitable start and end points for these measures;
- airlines proposed new measures relating to the availability of check-in infrastructure and departure gate facilities. HAL opposes these, arguing that they are not appropriate for the OBR framework and include services that are not provided uniformly across the airport;
- airlines proposed a new security queue measure for Fast Track services. HAL opposes this on the grounds that Fast Track provides more than the minimum service that is covered by the airport charge and in at least some cases is provided to airlines and passengers on a commercial basis; and
- airlines also suggested an "available when required" approach for some asset availability measures rather than the current time-based approach, but the parties have not agreed on a way of implementing this.

14.17 A further and separate airline proposal was that services covered by "Other Regulated Charges" (such as pre-conditioned air, fixed electrical ground power, baggage and services to passengers requiring support) should be removed from the SQRB/OBR scheme and incentivised instead by a separate compensation (service credit) mechanism in the event of service disruption. The airlines note that the implementation of the new mechanism could form part of the new Other Regulated Charges protocol. They also stated that this change would not affect

HAL's total revenue at risk (seven per cent of airport charges revenue) under the OBR scheme.

CAA views

14.18 We note the issues raised by HAL relating to our overall process, as per the discussion in paragraph 14.14 above and will discuss these issues further with HAL and other stakeholders in advance of developing our Final Proposals. Nonetheless we are of the view that we have clearly signalled the direction of travel with respect to the OBR, that airport/airline engagement should be an important part of the process and that we have and will continue to properly consult on our approach.

Measures

14.19 We welcome the engagement that has occurred between HAL and airlines, and the progress that the parties have made in agreeing changes to the SQRB framework. As noted above, however, the parties disagreed on a number of important issues.

14.20 The transition to OBR has raised some detailed issues. Several of these involve striking an appropriate balance between holding HAL to account for the specific services it provides to consumers and airlines and adopting wider measures that capture other aspects of the consumer experience. In practice, we consider these issues need to be addressed on a case-by-case basis, based at least in part on assessing the importance of HAL's role in specific aspects of service quality and the implications for consumers if HAL performs poorly. There is typically a spectrum for how HAL can affect the outcomes for consumers in respect of any particular part of the airport, from having a quite limited influence to a much greater ability to affect the outcome, and we need to consider these factors in setting measures, targets and incentives.

14.21 We have made it clear that services provided by HAL to airlines (as well as those it provides directly to consumers) should remain a key part of the overall framework. This applies to possible new measures that have not previously been included in the SQRB scheme as well as existing measures.

14.22 Reflecting this view, there is a strong case for introducing new measures that track the performance of the departures baggage system and the availability of check-in infrastructure provided by HAL. Failure of these facilities could lead to significant disruption for consumers and airlines, and we do not consider HAL's argument that there are some variations in the services and facilities provided in different terminals and to different airlines to be a good reason for not including check-in infrastructure provided by HAL in the OBR framework. We consider the case is weaker at present for introducing a further measure relating to departure gate facilities, though this may change in the future, for example, as self-boarding is provided more widely across the airport.

14.23 For departures and arrivals management, we currently favour wider measures with reputational incentives, rather than narrower measures that attempt to isolate HAL's role and might be suitable for financial incentives. This reflects both the difficulty of identifying the boundaries of HAL's responsibility and also the fact that overall punctuality is affected by many other factors and at many different stages of consumers' journeys.

14.24 While still covering services provided largely or wholly by HAL, a key feature of the OBR framework is that it should also cover services that are provided to consumers by a combination of HAL and other parties (such as airlines and/or ground handlers) where this is valued by consumers. Where the role of parties other than HAL is significant, in general we expect the measure should be subject to reputational rather than financial incentives.

14.25 We therefore support the principle of including new reputational measures in the OBR framework that cover areas that are valued by consumers. A number of these have already been agreed between HAL and airlines. Among the areas of remaining disagreement, we support HAL's proposed measures for "ease of access to the airport", "last bag on reclaim belt" and the "reduction in Heathrow's carbon footprint". These measures cover areas that are important to consumers and HAL may be able to play a co-ordination role.

14.26 However, mindful that OBR forms part of our regulation of HAL's provision of airport operation services, we do not support two other measures proposed by HAL: "offers value for money for the overall journey" and "offers flights that I want" as these cover almost exclusively airline activities and over which HAL has little or no control.

14.27 Neither do we consider that OBR should be extended either to cover optional services that HAL provides to airlines and passengers on a commercial basis, or to make significant changes to the way that airlines pay for individual services. This is because any such incentives should in general be part of those commercial arrangements, not the regulatory regime. For these reasons, we do not agree with airlines' proposals to introduce a new measure for Fast Track security queues or to move some OBR rebates to a separate compensation mechanism applying to Other Regulated Charges.

14.28 Finally, we acknowledge the arguments made by airlines for the use of daily rather than monthly averages. This is an issue that should be considered further with the option of introducing changes either later in H7 or in a future period. While airlines would like this change introduced now we note that:

- many targets would need to be reset, as simply moving from monthly to daily averages without any further adjustment would be equivalent to increasing the level of the target by an unknown and potentially significant amount;
- rather than simply choosing between monthly or daily averages, it might be preferable to examine the volatility of the underlying data and the implications of different degrees of granularity. If the data is very volatile, for example, then a target for the daily average might have to be set at quite a low level in order for it to represent a reasonable (challenging but achievable) target for HAL;
- targets for security queues will need to be revisited in any case following the installation of both new scanning equipment and a new queue measurement systems; and

- with the introduction of some new or amended measures already proposed, and other uncertainties associated with the recovery period after the covid-19 pandemic, there could be risks associated with trying to introduce too many changes at the current time.

14.29 Nevertheless, we are clear that this is an important issue that merits further consideration. It is important for HAL to ensure that suitable data is recorded and retained to allow for different options to be examined thoroughly.

Targets

14.30 As noted above, HAL's RBP update included separate sets of:

- targets for an "optimal plan", which focus on maintaining Q6 service levels during H7 and making targeted improvements in three areas: punctuality, baggage and the passenger experience; and
- targets for a "safety only plan" some of which are significantly lower than the "optimal plan" targets

14.31 We asked Arcadis to assess the targets in the RBP update and provide a view on whether those in the "optimal plan" are achievable and whether those in the "safety only plan" could materialise based on the allowances we set. We will consider Arcadis' views and set out our proposed targets in the working paper. This assessment has raised some questions about the basis for the lower targets in HAL's "safety only plan." We will also engage with stakeholders further before publishing our Final Proposals, including in relation to targets that cannot be set until late 2021 or 2022 due to the need to gather sufficient baseline data.

Incentives

14.32 We continue to consider that the current "knife edge" system of rebates is more suitable for H7 than HAL's proposed "sliding scale" incentives. Among other things we note that:

- knife edge incentives are simpler and more transparent than sliding scale incentives, as there is a clear pass/fail threshold and any rebates due to airlines are clearer and less complex;
- the clear pass/fail threshold also supports the reputational element of the OBR framework, and avoids the notion of "acceptable failure" that airlines have expressed concerns about;
- we are not persuaded by HAL's argument that, under knife edge incentives, once it has missed a target it will no longer have an OBR incentive to deliver the best possible service. Among other things, this problem does not apply to those targets specified as moving annual averages. Even for targets specified as monthly averages, the lack of a regulatory financial incentive would only apply once HAL no longer had any chance of meeting that month's target. In any case HAL's alternative proposal would only expand the range in which HAL faces incentives by a small amount. In addition, there are other pressures on HAL to improve service quality in addition to the SQRB or OBR scheme;

- while the size of current rebates is relatively modest (since HAL would only pay the maximum seven per cent of airport charges revenues if it missed every single target in every terminal for at least six months in a year), there is at least a material financial incentive for HAL to meet any particular target. Under HAL's sliding scale proposal, in contrast, this incentive would be significantly weakened by being spread out over a wider range of performance levels; and
- to date, the current knife edge service quality incentives appear to have worked well at both Heathrow and Gatwick.

14.33 Similarly, we continue to consider that there is not sufficient evidence to justify HAL's proposal to increase the range of bonuses payable for performance above the relevant target. In relation to both bonuses and sliding scale incentives, HAL drew our attention to evidence from its willingness to pay and passenger priority research which shows that passengers place a clear monetary value on both increases and decreases in service levels. We do not consider that this evidence makes a strong case for either increased bonuses or a switch to sliding scale incentives as:

- it is not surprising that passengers say they would prefer better service quality to poorer service quality, and willingness to pay studies are specifically designed to assign monetary value to such stated preferences; and
- HAL has not identified specific levels of service performance that are particularly important for consumers, or evidence of how consumers' valuations of better or worse service quality performance change as performance levels improve. Results from stated preference studies that simply report a general value for performance improvements do not make a strong case either for changing the range over which HAL is incentivised (for example, by switching to sliding scale incentives) or for increasing the number of cases where HAL can be rewarded for performance over and above the minimum required level.

14.34 We will set out a proposed approach for the allocation of rebates and bonuses in the working paper for consultation. HAL included some proposed rebates in its RBP where the maximum level of rebates was allocated between measures based on a mapping against ranked consumer research findings. We have some reservations about this approach, including that:

- It appears to be based on the results of a single study, and may well be sensitive to the way that results have been weighted,[32] the specific consumer needs that respondents were asked to prioritise and the specific questions that respondents were asked. For example, the ranking is surprisingly high for certain measures, such as wayfinding, and perhaps lower than expected for others such as security queues, baggage system reclaim availability and cleanliness;[33]
- even if a larger number of studies were used, it would still be necessary to exercise caution as there are many different ways that could be used to convert result into numerical values;
- in addition, HAL does not appear to have taken account of the degree of overlap or the number of similar measures. Under HAL's approach some aspects of service quality may have more or less weight than before simply because there are a greater or lesser number of measures proposed for H7 compared with Q6;[34] and
- more generally, it will be useful both to take a high level overview of the resulting pattern of rebates, as well as examining the changes that would result from applying HAL's proposals (for example, a higher weighting for wayfinding and lower weightings for passenger security queues) and whether there is a justification for these (other than that they reflect the results of HAL's relatively formulaic approach).

14.35 A further feature of HAL's proposed rebates is that, whereas the current monthly rebates are calculated as one sixth of the annual maximum (so no additional rebates would be payable in a year if HAL had already missed a certain target six times), HAL's proposed rebates for H7 are one twelfth of the annual maximum. HAL has justified this proposed change on the grounds that it avoids the problem of weakened incentives once HAL has paid a particular rebate six times in a year. We disagree with this proposed change, as we consider that the advantages of stronger incentives (that is, one sixth rather than one twelfth of the annual maximum) outweigh the theoretical disadvantage of weaker incentives that would kick in if HAL were to trigger a particular rebate six times in a single year.

---

32 For example, we note that HAL's approach was based on rankings, with no consideration of whether the scores of, say, the first placed and fifth placed consumer needs/attributes might have been quite close to each other. This could lead to large differences between the weightings for certain attributes even though their performances in the underlying survey were quite similar.

33 Within its overall approach, the results are likely to be sensitive to the way that HAL linked each measure to a particular attribute from the survey. Security queues, for example, were covered by a general "delivers smooth progress throughout the airport" attribute, rather than anything specific to the security search process. Indeed, half of the measures in HAL's weighting exercise were covered by this single attribute. Wayfinding, in contrast, could have been linked to any of a number of attributes (HAL chose "It's easy to access, move through and exit" in preference to others including "Clear signage throughout the airport", "I know where I am (orientation)" and several others).

34 For example, HAL's proposed rebates for the availability of stand facilities are lower than in Q6 because four previous measures have been combined to form a single new measure in HAL's proposals for H7.

Initial proposals

14.36 As we have said consistently in our consultations since 2017, we propose to transition towards an outcomes focussed approach to service quality regulation for H7 as we consider that this will better further the interests of consumers in this area. This approach will incorporate, and build on, the current set of financial incentives for measures that are under HAL's direct control. It will also be expanded to incorporate reputational incentives for services that are delivered jointly by HAL and other parties (such as airlines and ground handlers), based on evidence about the service quality attributes that consumers value.

Outcomes

14.37 We propose to accept HAL's proposed outcomes, which we consider cover the main aspects of airport operation services that are important to consumers. These outcomes can be traced back to the results of HAL's consumer research and were supported by the CCB. They are:

- an airport I want to travel from that offers me a good value choice of flights;
- I am confident I can get to and from the airport;
- I have a predictable and reliable journey;
- I feel comfortable and secure at the airport;
- I have an enjoyable experience at the airport; and
- I feel cared for and supported.

14.38 While airlines have proposed an alternative set of outcomes to refine and clarify HAL's proposals, there is significant overlap between the two sets of proposals and we consider that the outcomes HAL has proposed are broad enough to cover the airlines' proposals. We note that HAL's proposed outcomes also cover some measures (such as "reduction in Heathrow's carbon footprint") that may not fit in so obviously within the airlines' proposed outcomes.

14.39 More importantly, the role of outcomes is to help identify overarching aspects of airport operation services that are most important to consumers, which can then be reflected in a more detailed set of measures. It is the measures, rather than the higher level outcomes, that are included in HAL's licence with associated targets and incentives.

14.40 For this reason, we consider it better to take account of particular views and evidence when deciding which measures to adopt, rather than attempting to refine HAL's broader outcomes. One implication of this approach is that some outcomes may have only a small number of measures associated with them.[35] We do not consider this approach is problematic and there will be scope to

[35] Only one of the proposed measures is associated with 'an airport I want to travel from that offers me a good value choice of flights' and only two are associated with 'I am confident I can get to and from the airport.'

further develop the outcomes framework over time and if appropriate introduce additional measures.

Measures

14.41 Table 14.1 below shows the measures that we are currently proposing, along with an indication of the main outcome that each is associated with and whether it is a new or existing measure. It first lists the measures that have financial rather than reputational incentives, and also distinguishes between survey-based and operational measures.

14.42 The broad rationale for the inclusion or exclusion of specific measures is discussed above. The list below covers the most important services that HAL provides directly either to consumers or to airlines, and also the main services that are important to consumers and are provided by a combination of HAL and other parties. The changes compared with the current SQRB measures include:

- the removal of the current survey-based measures for flight information display screens and departure lounge seat availability, which are now captured within the wider measure (with reputational incentives only) “an airport that meets my needs”;
- the combining of several existing operational measures with financial incentives, including the availability of lifts, escalators and travellators (which previously had separate measures for “priority” and “general” passenger sensitive equipment) and the merging of four separate measures of stand facilities (stand entry guidance systems, pre-conditioned air, fixed electrical ground power and jetties);
- the introduction of financial rather than reputational incentives for Wi-Fi performance and the helpfulness/attitude of security staff (which was previously part of a wider set of questions on security performance);
- the introduction of three new measures with financial incentives: “availability of check-in infrastructure”, “hygiene safety testing” and “timely delivery from departures baggage system”; and
- the addition of seventeen other new measures with reputational incentives only. Most of these cover services that are jointly provided by HAL and other parties.

14.43 Before our Final Proposals we will give particular consideration to, in consultation with stakeholders, a small number of possible further changes, including:

- the grouping of control posts, which HAL and airlines have continued to discuss; and
- whether a further measure of baggage performance (such as HAL’s proposed “baggage misconnect rate”) would be useful in addition to the new “timely delivery” measure which is currently supported by both HAL and airlines.

14.44 As explained above, we are not proposing any changes to the granularity (for example, monthly or annual averages) of any measures at present. But this is an important issue to consider further during H7, and HAL should ensure that suitable data are recorded and retained to allow for different options to be examined thoroughly.

Table 14.1 Proposed measures

Type of measure / incentive	Measure	Outcome	Notes
Survey-based measures with financial incentives	Cleanliness	Comfortable and secure	Existing SQRB measure
	Wayfinding	Predictable and reliable	Existing SQRB measure
	Helpfulness/attitude of security staff	Cared for and supported	Replaces more general questions on security (which had reputational incentives only)
	Wi-Fi performance	Enjoyable experience	Existing SQRB measure (though currently reputational incentive only)
Operational measures with financial incentives	Security queue time – central search	Predictable and reliable	Existing SQRB measures
	Security queue time – transfer search	Predictable and reliable	Existing SQRB measure
	Security queue time – staff search	Predictable and reliable	Existing SQRB measure
	Control post vehicle queue time	Predictable and reliable	Existing SQRB measure (groupings to be confirmed)
	Availability of lifts, escalators and travellators	Predictable and reliable	Merger of two existing SQRB measures (there were previously separate categories for “priority” and “general” passenger sensitive equipment)

Type of measure / incentive	Measure	Outcome	Notes
	Availability of check-in infrastructure	Predictable and reliable	New measure
	Availability of arrivals baggage carousels	Comfortable and secure	Existing SQRB measure
	Availability of T5 track transit system (TTS)	Predictable and reliable	Existing SQRB measure
	Availability of stands	Predictable and reliable	Existing SQRB measure
	Provision of stand facilities	Predictable and reliable	Merger of four existing SQRB measures (there were previously separate measures for the availability of stand entry guidance systems, pre-conditioned air, fixed electrical ground power and jetties)
	Pier-served stand usage	Comfortable and secure	Existing SQRB measure
	Runway operational resilience	Predictable and reliable	Existing SQRB measure (renamed, previously the aerodrome congestion term)
	Hygiene safety testing	Comfortable and secure	New measure
	Timely delivery from departures baggage system	Comfortable and secure	New measure

Type of measure / incentive	Measure	Outcome	Notes
Survey-based measures with reputational incentives	Overall satisfaction		New overarching measure
	Customer effort (ease)		New overarching measure
	Enjoy my time at the airport	Enjoyable experience	New measure
	Airport that meets my needs	Comfortable and secure	New measure, which includes previous SQRB measures on flight information display screens and departure lounge seat availability (both of which had financial incentives)
	Feel safe and secure	Comfortable and secure	New measure
	Ease of access to the airport	Can get to and from the airport	New measure
	Helpfulness/attitude of airport staff	Cared for and supported	New measure
	Being able to social distance if I want to	Comfortable and secure	New measure
	Ease of understanding Heathrow's Covid-19 safety information	Comfortable and secure	New measure
	Passengers with reduced mobility (PRS/PRM) – overall satisfaction	Cared for and supported	New measure

Type of measure / incentive	Measure	Outcome	Notes
Operational measures with reputational incentives	Departures flight punctuality - % of flights departing off stand within 15 minutes	Predictable and reliable	New measure
	Airport departures management (% of flights taking off within x minutes of standard time)	Predictable and reliable	New measure
	Airport arrivals management (wheels down to doors open)	Predictable and reliable	New measure
	% of UK population with 3 hours (and one interchange) of Heathrow by public transport	Can get to and from the airport	New measure
	Passenger injuries	Comfortable and secure	New measure (to consider expanding to cover staff when reliable data is available)
	Immigration queue times	Predictable and reliable	New measure
	Reduction in Heathrow's carbon footprint	Airport I want to fly from	New measure

Targets

14.45 As noted above, we will consider Arcadis' views on the targets in the RBP update and set out our proposed targets in the working paper that we will publish later this year. We will also engage with stakeholders before the Final Proposals, including in relation to targets that cannot be set until late 2021 or 2022 due to the need to gather sufficient baseline data.

Incentives

14.46 For the reasons discussed above, we continue to consider that "knife edge" incentives should be used to determine OBR rebates in H7. HAL will pay a simple rebate to airlines whenever it misses one or more targets for measures subject to financial incentives.

14.47 We are not proposing to change HAL's maximum potential exposure to rebates, which is currently seven per cent of airport charges revenues. In the forthcoming working paper, we will consult on our proposed approach for allocating this total between those measures subject to financial incentives. As discussed above:

- we consider that the monthly rebate should continue to be calculated as one sixth of the annual maximum, rather than one twelfth as proposed by HAL; and
- we have reservations about the allocation of rebates proposed by HAL as noted above. Instead, we consider it will be useful to take a high-level overview of the pattern of rebates, including what should change compared with the current allocation of rebates.

14.48 We also propose to maintain HAL's maximum potential bonus receipts at 1.44 per cent of airport charges revenues. We note that HAL can currently earn bonuses in relation to four measures, flight information display screens, departure lounge seat availability, cleanliness and wayfinding, but that the first two of these are not included in the proposed measures for H7. We will consider whether to add a small number of extra measures to the group for which HAL can earn bonuses where improved performance can deliver tangible consumer benefits. As with the allocation of rebates, we will consult on our proposed approach to allocating bonuses in the forthcoming working paper.

Continuous Improvement

14.49 We have previously stressed the importance of the OBR framework remaining agile and being able to evolve periodically to reflect the outcomes and quality of service that consumers expect and value. In the April 2021 Way Forward Document made some comments on HAL's proposed annual review mechanism, including agreeing that changes to OBR during H7 should not expose stakeholders to significant additional risks, clarifying that the CAA's Consumer Panel is not a decision-making body, and stating that possible changes should not be limited to those based on consumer research

14.50 We said that a 'continuous improvement' process could be used to review and revise targets during H7 to:

- introduce targets which have not been set due to the need to gather sufficient baseline data;
- reflect service improvements that are brought about through capex projects as they are delivered during H7; and
- ensure targets remain appropriate and sufficiently challenging and can take account of wider circumstances.

14.51 HAL's licence already contains a provision which allows us to modify certain parts of the SQRB scheme with immediate effect if there is written agreement between HAL and the AOC (or if there is not agreement, then either HAL or the AOC can request that CAA determines the modification).[36] While in the forthcoming working paper, we may propose a minor change to the scope of this provision, we do not intend to specify particular timescales for reviews or decisions, or to specify a particular process that must be followed for changes that are agreed between HAL and airlines. It is for the parties themselves to decide if a particular process (such as an annual review) should be adopted, and the nature and scope of any discussions. Nonetheless, if the parties cannot agree the approach to these matters we will be able to determine a way forward, and will consult the CAA Consumer Panel where appropriate.

14.52 In general, we consider it important that any continuous improvement process does not undermine the current structure of five-yearly price control reviews and should not exposure stakeholders to additional risk. When considering any proposals put to us for determination we will need to ensure that we maintain an appropriate degree of consistency with the broader price control settlement.

14.53 We also consider the current situation is unusual in terms of both the introduction of a number of significant changes to the SQRB framework and also the uncertainty created by the impact of the covid-19 pandemic. For this reason, we consider there is a strong case for a one-off mid-term review of the OBR framework during H7. This would allow us to address any problems arising with the new framework, or any issues that could not be resolved by the time the framework was finalised, without having to wait a full five years until the next review.

14.54 There are a number of possible issues that such a review could cover, and we consider it best to deal with these together at the same time rather than, for example, adopting a more piecemeal approach. As noted above, it is important to maintain an appropriate degree of consistency with the overall price control settlement, so we would expect the mid-term review to be restricted to:

[36] See conditions D1.6 to D1.10 of HAL's licence.

- any issues that could not be resolved during the current review, but which we indicated should continue to be discussed and will be reconsidered at the mid-term review. These could include issues such as the granularity of different measures (for example, monthly averages, daily averages or alternative approaches), airlines' suggestion of an 'available when required' approach for some availability measures, the inclusion of staff in the injuries measure, or measures (such as departure gate facilities or mototok/EV charging points at stands) that were not adopted at the start of H7 because provision across the airport was still limited. We will make clear in the Final Proposals which of these (or other) issues might be included in the scope of the mid-term review;
- any cases where we might decide to adopt a deliberately cautious approach for our Final Proposals (for example because of a lack of historical data for new measures, or because of uncertainty associated with the impact of the covid-19 pandemic), but indicate that we will revisit these issues at the mid-term review with a view to resetting the target (or other parameters) at that point;
- addressing any specific problems that have arisen since the start of the period, recognising that OBR includes a number of new and/or untested measures. In resolving any such problems, we would aim to do so in a way consistent with the intentions of the original policy decision;
- any issues that need to be considered, or opportunities for improvement arising, following the installation of new security scanning equipment and new queue measurement systems;
- any changes that are required because of specific investment projects or changes in the overall level of capex compared with our initial allowances. While such changes could be considered as part of the mid-term review, they could also be implemented by agreement between HAL and airlines at the same time that the investment transitions from development to core (or otherwise passes through the governance process); and
- any other changes that should be considered due to changing circumstances. This could include, for example, adjustments if covid-19 was no longer regarded as a serious threat or if there was robust evidence of a significant change in consumer preferences that could be accommodated while maintaining broad consistency with the overall price control settlement.

14.55 For the avoidance of doubt, unless there was agreement from both HAL and airlines, we would not expect this mid-term review to revisit the maximum overall level of rebates and bonuses. We expect to consult stakeholders and our Consumer Panel both before and during the review. And we would expect to implement any resulting changes through the modification provisions in section 22 of CAA12. Stakeholders would therefore have the opportunity to appeal to the Competition and Markets Authority if they disagreed with our proposals.

14.56 We do not have a firm view on the timing of the review at present. This is likely to depend on factors such as how fast traffic recovers and operating conditions stabilise, and when new security scanning equipment and queue measurement systems will be installed. We will consult stakeholders in advance of any final decision on the scope and timing of the review but consider there are benefits in undertaking the review before the half way point of the price control period so that relevant changes can be implemented in reasonable time ahead of the next price control period.

14.57 Taking these proposals in the round, for the reasons set out above, we consider that our Initial Proposals will further consumers' interests by ensuring that the services HAL provides meet their needs in terms of their range, availability, continuity and quality of the AOS that HAL provides.

14.58 Among other things, we consider that the proposed OBR framework will:

- strengthen the link between economic regulation and consumers' needs and priorities, thereby securing that consumers' reasonable demands for airport operation services are met in terms of the outcomes incentivised;
- incentivise HAL to deliver more innovative solutions and service improvements as circumstances change, so promoting economy and efficiency in the way in which those outcomes are delivered; and
- improve transparency, and encourage HAL to exercise its co-ordinating role across the airport to improve outcomes for consumers, again promoting HAL in meeting the reasonable demands of consumers and doing so efficiently.

Next steps and implementation

14.59 We welcome views of stakeholders on the approach set out above and will consider these responses carefully in formulating Final Proposals

14.60 We will also produce a working paper later this year that will provide further details of our approach and will engage with stakeholders further.

14.61 The new OBR framework will be implemented through changes to HAL's licence and Schedule 1 to the licence. The existing SQRB framework will, therefore, continue to apply at least until the licence modifications implementing the full H7 price control take effect. Before we issue our Final Proposals, we will consider whether there might be an argument for delaying the introduction of some (or all) new measures further, for example until the beginning of 2023, to allow for an orderly transition to the new arrangements.

14.62 Except for the introduction of new measures and some changes to the allocation of rebates and bonuses, we do not currently expect to change the way that rebates and bonuses are calculated and paid but will consider this further ahead of the working paper.

Chapter 15

Putting in place a price cap for HAL's 2022 charges

Introduction

15.1 This chapter discusses our views on the way forward for dealing with airport charges from 31 December 2021 (when the current price control expires) until the new price five-year control arrangements come into effect in summer 2022. In considering this issue, we have been mindful of the particularly difficult and challenging circumstances that have been created by the covid-19 pandemic and its impact on the CAA's H7 price control timetable.

15.2 It covers:

- the background to this issue, including the interaction of HAL's timetable for consulting on airport charges under the ACR2011 and the CAA's H7 price control review timetable;
- the views of HAL and airlines on the approach to setting a "holding" price cap for 2022;
- our assessment of those views;
- our proposals for the 2022 holding cap and level of airport charges; and
- next steps and implementation issues.

Background

15.3 The very significant impact of the covid-19 pandemic on the aviation sector and passenger numbers at Heathrow Airport has also had a knock-on impact on the timetable for the H7 price control review. HAL's RBP and updated RBP were delayed to ensure they were based on more up-to-date traffic projections. In addition, we have taken extra time and resources to consult stakeholders on HAL's request for a covid-19 related RAB adjustment. These developments mean that our Initial Proposals are being issued later than planned in our April 2020 timetable update.

15.4 HAL's current price control ends on 31 December 2021. For the reasons outlined above, the final decision on licence modifications for a new five-year control period for H7 will not be made until early in 2022. Consequently, without further action by the CAA, there will be no price cap applicable to HAL from 1 January 2022 until the summer of 2022, when the H7 modifications are expected to be implemented.

15.5 The absence of a price cap in the intervening period risks exposing consumers to charges that would be unduly high in 2022 and could also create or exacerbate a conflict between the interests of "present consumers" travelling during the first part of 2022 and "future consumers" travelling later in the H7 period. Present consumers could experience materially higher charges while future consumers somewhat lower charges because of the impact of any "truing up" arrangements.

15.6 We have been considering this issue with HAL and airlines since our April 2021 Way Forward Document. We have encouraged HAL and airlines to engage on the level of the charge for 2022 to see if they could agree a "holding" cap which would be trued up with the CAA's final decision to ensure that HAL was "held harmless" for any difference between the holding cap and the eventual H7 price cap. HAL and airlines both support the approach of introducing a holding cap, but have different views on the appropriate level and how it should be implemented.

15.7 The ACR2011 provides limited, largely procedural, protection to consumers, indirectly through the requirements on airports to consult airlines on the level of charges they intend to set in advance. In normal circumstances, the ACR2011 requires HAL to consult airlines at least four months before changing charge levels and to notify airlines of its decision on charges at least two months before the change takes effect. Nonetheless, there is some flexibility within the ACR2011, which allows a shorter period for consultation and notice in exceptional circumstances.

15.8 HAL wrote to us on 10 August 2021 noting that its preference was to reach an agreement with airlines on the level of the holding cap. HAL also sought clarification regarding the CAA's approach to enforcing the ACR2011 in the event that agreement could not be reached.

15.9 We published our response on 25 August 2021 explaining that:

- the CAA has an obligation to investigate complaints as to whether an airport operator is failing to comply, or has failed to comply, with an obligation imposed on it by the ACR2011;
- if we receive a complaint from a Heathrow airport user, we would have to consider all the relevant facts of the case and, therefore, could not give assurance in relation to the outcome of any particular investigation that might arise; and
- nonetheless, in carrying out any investigation we would have regard to the difficult and unprecedented circumstances that the sector currently faces.

15.10 We also set out our proposed next steps if no agreement could be reached between HAL and airlines, including that HAL should ensure that its ACR2011 consultation explains the CAA's H7 process, including our intentions to:

- publish Initial Proposals in October 2021;
- consider whether it was necessary to publish a notice consulting on a proposed licence modification to introduce a holding price cap for 2022, based on the analysis published in our Initial Proposals; and
- issue a notice making that licence modification by the end of November 2021 (subject to any representations made).

15.11 At the end of August 2021, HAL issued its consultation on airport charges for 2022, which it considered was in accordance with the requirements of the ACR2011. HAL's consultation assumes a yield of £37.60 per passenger (nominal prices) which it derived from the assumptions included in its updated RBP.

Stakeholder views

15.12 HAL has said that the level of the holding cap should be driven by financeability analysis noting the risk of a further downgrade to its credit rating. HAL considers that such a downgrade would lead to higher costs in the long run and would reduce the ability of the airport to invest in appropriate service and resilience leading to worse outcomes for passengers. HAL has also said that "FFO to net debt" is the key metric in this regard and that it needs to be able to recover a minimum revenue of £2.3bn in 2022 to avoid a breach of this metric. HAL said that this equates to a charge of £36 per passenger based on its passenger traffic forecasts (all 2018 prices).

15.13 It has also said that charges at this level would be affordable for both consumers and airlines. HAL has also informed us that a charge of £33 per passenger (2018 prices) would be the "absolute minimum" it could tolerate but this would imply sub-investment grade cover ratios in 2022 and would bring a high risk of a credit rating downgrade.

15.14 HAL has suggested that these levels of airport charges would be consistent with the consumer acceptability testing it provided alongside the updated RBP.

15.15 In recent correspondence, HAL has also expressed serious reservations about the CAA implementing a licence condition to introduce a holding cap. It considers that the CAA is not currently in a position to set an interim price for 2022 at the "correct" level, given the amount of work and consultation still to be undertaken. It observes that any interim licence modification by the CAA would, therefore, be disproportionate and could be appealed to the CMA, potentially delaying and obfuscating the final H7 decision. It considers that this would not be in the interests of consumers, HAL or airlines. HAL notes that an appeal could also lead to a significant diversion of resources for all stakeholders.

15.16 HAL has also said that, if an interim cap is required, it should be based on the level it has set out in the recent ACR2011 consultation: £37.60 per passenger. HAL notes that no changes could be made to this price without an additional consultation under the ACR2011, which it states it has no plans to undertake. HAL has also said it would be willing to make a voluntary and public commitment regarding the maximum charge level for 2022 to provide airlines and the CAA with additional assurance regarding the price, if this were required to give the CAA confidence over the charge level for 2022.

15.17 Airlines have made it clear that they need certainty on the level of airport charges to support their business planning and ticket pricing. They have also said that it would be inappropriate to delay the start of the H7 period from 1 January 2022 and that 2022 charges should not exceed the level of charges in 2021.

15.18 Airlines have said that, in their view, the CAA's Initial Proposals (rather than HAL's updated RBP) should be the basis for HAL's ACR2011 consultation by establishing the holding cap until the H7 decision has been finalised. Airlines said this would create space for a more productive consultation.

15.19 In relation to HAL's ACR2011 consultation, airlines have said they do not accept the price increases proposed or accept HAL's authority to impose these charges in 2022. Airlines have said the setting of charges at Heathrow is a matter for the CAA. Airlines have also been critical of:

- the assumptions in HAL's updated RBP, including that HAL is making overly pessimistic assumptions on opex, commercial revenues and traffic forecasts; and
- HAL's approach to the covid-19 related RAB adjustment and estimation of the WACC.

15.20 Finally, airlines have set out a number of detailed comments on HAL's overall approach including in relation to the structure of charges and its Conditions of Use.

Our views

15.21 We consider that the absence of a holding cap for 2022 exposes consumers to the risks identified in the background section above.

15.22 We agree with HAL and airlines that the interests of consumers and other stakeholders will be furthered by providing clarity on these matters as soon as possible. Such clarity will further the interests of consumers, regarding the costs of the air transport services that they use at Heathrow airport. These costs, when reflected in the charges that HAL sets, are factored by airlines into setting ticket prices. Certainty over HAL's charges for 2022, therefore, facilitates airlines in being able to set ticket prices and organise their services, which together provide significant benefits for consumers.

15.23 We recognise and welcome the efforts of HAL and airlines to find a mutually acceptable solution to charges for 2022, and it is unfortunate that this has not been possible so far. HAL and airlines have expressed general support for the principle of a holding cap, but appear to have differing views on two main issues:

- the approach to implementation; and
- the level of the cap.

The approach to implementation

15.24 HAL is opposed to a licence modification and prefers an approach that mainly relies on the protections provided by the ACR2011 which, as noted above, regulate the process for consulting on changes to charges but do not impose a binding cap on the level of charges. In contrast, airlines have a preference for a licence modification that imposes a binding cap on airport charges per passenger.

15.25 We note HAL's comments on the procedural difficulties that an interim cap introduced through a licence modification could create under ACR2011. We also accept that an appeal to the CMA at this stage of the process could be distracting for all stakeholders from the final stages of the H7 review. That said, in the context of the H7 review and impact of covid-19, we do not consider that the provisions in the ACR2011 provide an adequate level of protection for consumers with its focus on transparency and reasonable consultation processes rather than giving protection to/regulation of the overall level of airport charges.

15.26 Further, the ACR2011 was not designed to deal with the present circumstances. We also note that relying on the ACR2011 in the absence of a price control condition would also be unprecedented at Heathrow which has been regulated by a binding price cap since privatisation.

15.27 In this context, we also observe that HAL:

- continues to have substantial market power;
- currently levies the highest airport charge in the UK and one of the highest in the world; and
- is currently consulting on a substantial increase to the level of the charge, a proposal that is fiercely resisted by its airline customers.

15.28 Our understanding is that HAL's covid-19 Airport Cost Recovery Charge is typically being passed though directly to consumers through airline ticket prices. The competitive dynamics of the airline market suggest they are likely to pass further increases in airport charges directly to consumers in the form of higher airfares. This is further heightened by 2022 having the potential to be a particularly sensitive year for consumers as it is likely that they continue to face higher costs from government imposed travel restrictions (even if these have reduced from the levels experienced in 2020 and 2021). We note that the intense pressure on airline finances and that higher airport charges in 2022 could also artificially restrict airlines' ability to support the recovery in services, which would also disadvantage consumers and limit the demand for AOS.

15.29 Therefore, we consider that action by the CAA is needed to put in place a licence condition to prevent HAL unduly increasing prices for 2022 to the detriment of consumers. Given the importance of 2022 to consumers any such licence condition would need to be accompanied by a provision that compelled HAL to price to the level of the holding cap in 2022 and consult under the ACR2011 to that effect. If the licence conditions did not do this, HAL might seek to leave in effect any charging arrangements it had put in place following its consultation on its charging proposals in August 2021 and rely on the operation of the truing up of charges and/or the correction factor mechanism with the price control licence condition to address the difference. If HAL took this approach, the benefits to consumers of addressing the issues set out in paragraph 15.5 above would not be fully realised.

15.30 Nonetheless, noting the issues and process risk created by an early appeal to the CMA, should HAL and airlines agree alternative arrangements, to dealing with these unique circumstances, such as binding commitments from HAL to set charges at a reasonable level we would be open to considering these further. To accept such an approach we would need to be satisfied that the arrangements and level of charges:

- fully protected the interests of consumers and were consistent with our statutory duties; and
- were suitably enforceable.

15.31 We are open to discussing these issues further with HAL and airlines and to consider whether any alternative approach that they develop and put forward to us might be appropriate and consistent with furthering the interests of consumers. Nonetheless, we note that the timetable is very tight and in practice the approach set out above is likely to lead to a licence modification that imposes a holding price cap.

The level of the cap

15.32 There is a significant difference between HAL and airlines on what they consider the appropriate level of the cap in 2022 should be. HAL's analysis, driven by its financeability concerns, implies a price of £37.6 (nominal prices). Airlines have said they want "flat or falling" charges and have suggested no increase in real terms from 2021 levels.

15.33 Our detailed analysis of the appropriate range for HAL's H7 price control for the notional company, which should further the interests of consumers and has been developed having regard to our duties under CAA12 as a whole, is set out in the preceding chapters. We have also noted that:

- significant uncertainty remains about the appropriate level of charges for the H7 period;
- we will need to both update our analysis for Final Proposals and also include within the price control specific arrangements (such as the TRS mechanism) to help deal with uncertainty remaining at the time we make Final Proposals early in 2022.

15.34 We have set out in Chapter 11 a range for airport charges based on lower and upper quartile assumptions of operating costs and commercial revenues, and our range for allowed returns. This range reflects in part the uncertainty created by the impact of the covid-19 pandemic.[37]

15.35 This overall range reflects the best information currently available on how to further the interests of consumers and discharge our other statutory duties. While a narrow focus on present consumers' short term interests might suggest setting the holding cap at the bottom of this range, we have taken account of our duties as a whole in assessing where in the range to establish the holding cap. We recognise that there can be arguments that a price in the upper part of the range could be appropriate for 2022 in isolation as Figure 11.1 in Chapter 11 shows that an unprofiled range for the Initial Proposals would suggest airport charges for 2022 on a stand alone basis would be £38 to £51. The mid-point of this range is £44.50.

15.36 That said, as discussed in Chapter 11, we consider that profiling of charges over the H7 period is likely to be in the interests of present and future consumers and

[37] See paragraph 11.52.

consistent with HAL's financeability. So, on balance, we consider that the middle of the range for profiled airport charges of £24.50 - £34.40 per passenger would both further the interests of consumers and have appropriate regard to supporting the financeability of the notional company in 2022 and beyond (as explained in Chapter 11). Therefore, our starting point is to assume that the holding charge should be based on the mid-point of this range which we have rounded to £29.50 per passenger. We consider that this would be consistent with the notional company retaining access to investment grade finance and being able to continue to finance its activities.

15.37 It should be noted, in particular, that, as this figure is based on analysis for our Initial Proposals, our calculation of the building blocks and the precise estimates that we select within them are all subject to further comments from stakeholders and analysis by us as we prepare our Final Proposals. Other variables and assumptions might also change. As a result, the proposal for the level of the holding cap cannot, and should not, be interpreted as indicating that the CAA would necessarily take the view that the mid-point of the range is the appropriate price cap for the full H7 period when we come to make the Final Decision on the H7 price control.

15.38 As noted in the section above, we also remain open to the use of alternative arrangements proposed by HAL and airlines, should they be able to demonstrate that these fully protect the interests of consumers, are consistent with our statutory duties and suitably enforceable.

The approach to truing up

15.39 It is necessary to consider how any holding cap would be trued up against our Final Proposals. Our current view is that the Final Proposals would simply remove the holding cap from HAL's licence and the correction factor in the price control would automatically adjust revenue in the later years of the price control for any under or over recovery of revenue against the level specified for 2022 in our Final Proposals.

15.40 Our expectation is that HAL's decision on its current ACR2011 consultation should account fully for the CAA's Initial Proposals.

Our Proposals

15.41 In the light of the issues discussed above, our Proposals for HAL's charges for 2022 are as follows:

- we should put in place a licence condition to regulate HAL's prices in 2022. We are publishing a Notice of this modification in Appendix C of this document;
- the interim price cap set out in that Notice is £29.50 per passenger;
- once Final Proposals are in place, the correction factor in the price control licence condition will provide an automatic mechanism that will true up any under or over recovery of revenue against the revenues derived in accordance with the price cap set out in the Notice; and

- subject to any representations made on the proposed modification, we expect to decide on whether to implement the price cap for 2022 and publish a notice in relation to that by the end of November 2021.

Next steps and implementation

15.42 Noting that the existing price control expires on 31 December 2021 we will discuss the issues set out in this chapter as a matter of urgency with HAL and airlines.

15.43 We welcome representations on any of these issues by **17 November 2021**. We will carefully consider the evidence and views that are put to us and, as discussed above, intend to publish details of our decision on how best to proceed by the end of November 2021.