

Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP1658)

Heathrow's response

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Contents

Executive summary	3
Approach to affordability and financeability.....	5
Affordability.....	5
Financeability.....	7
Initial assessment of affordability and financeability.....	8
Evolutions to the regulatory framework.....	10
Regulatory changes.....	10
Alternative commercial and delivery arrangements.....	12
Innovation Partners.....	13
General Licence Condition.....	15
Cost of capital and incentives	16
Cost of capital.....	16
Incentives	17
Interim arrangements to apply after the end of the Q6 price control	20
Early Category C costs.....	23
Surface access.....	25
General commentary	25
Holistic approach to assessing surface access spend.....	26

Executive summary

1. Expanding Heathrow is a once in a generation opportunity. It will create new capacity in the UK market that will lead to new destinations, consumer choices and business models. The Department for Transport (DfT) estimates that expanding Heathrow will generate £68 billion¹ in benefit for consumers through lower fares driven by increased competition and choice, with more airlines operating and competing at an expanded Heathrow.
2. The CAA – and all involved in expansion – must focus on the opportunity for consumers, the aviation industry and the UK economy. The CAA needs to quantify (or at a minimum officially embrace the analysis performed by the DfT or Heathrow) the benefits that capacity expansion provides to consumers and its corollary, the costs that a delay would generate. This is essential evidence to support its future decision making.
3. Parliament's vote in support of the Airports National Policy Statement (NPS) is a major milestone in delivering this important national project. The Secretary of State (SoS) has emphasised the importance of timely delivery. It is now more important than ever that sensible decisions are made in a timely manner to support delivery for consumers.
4. The SoS articulated four important principles in expanding Heathrow.
 - a. It should be affordable – although the CAA is still to define affordability, Heathrow is committed to working towards delivering new capacity at close to 2016 charges in real terms. We have reiterated this in our recent letter to the CAA.
 - b. It must take account of the community and environment – Heathrow has proposed a package of measures for which the CAA has provided support. It is vital that support continues in a consistent and clear way.
 - c. It should be privately financed – that requires the right framework for both debt and equity investors and recognises the nature of a private commercial investment.
 - d. It should deliver an integrated hub airport that serves consumers.
5. The CAA must focus further on the work it needs to do to ensure that these principles are adequately given effect in the best interest of consumers. In particular, the CAA needs to:
 - a. Consider how its work on cost of capital enables expansion to be privately financed. In this context it is particularly important to compensate investors for the risk of expanding Heathrow.
 - b. Address the potential inconsistency that alternative delivery mechanisms (ADMs) may generate² with the SoS's principle of delivering an integrated hub airport. More broadly it needs to address regulatory innovations in a comprehensive and proportionate way.
6. We recognise and welcome progress made by the CAA on some pressing regulatory issues which help build certainty and stability for all parties while furthering consumers' interests, including:

¹ NPV of economic benefit in NPV terms 2014p, 60 years – DfT, Updated Appraisal Report Airport Capacity in the South East, October

² CAA April document (CAP1658), p 45, para 3.19

- a. Confirming a RAB based regulatory framework which, if adhered to, will help in ensuring the stability of cost effective financing.
 - b. Extending the current price control to allow a pragmatic alignment between the statutory planning process and the regulatory process and enabling up to date information to be used to make decisions.
 - c. Clarifying the treatment of Category B and early Category C costs to incentivise an efficient and focused Development Consent Order (DCO) and timely and efficient delivery of expansion while fairly compensating our community.
 - d. Consolidating the role of the Consumer Challenge Board (CCB) so that the voice of the consumer is fully integrated in the expansion process.
 - e. Recognising the need to provide longer term regulatory certainty and the enhanced risk of delivering, financing and operating expansion and the need to provide a premium to compensate it.
 - f. Developing its thinking on debt indexation and surface access.
 - g. Being open to flexible commercial arrangements with airlines being accommodated by and supplementing a regulatory model.
7. Heathrow has a breadth of private investors – both debt and equity – uniquely capable of delivering new capacity. They have consistently invested over the long-term when given incentives to do so. They have consistently said they are willing to do so for expansion on commercially viable terms. They have backed this with action by consistently promoting and developing proposals for expansion in the face of real business risk and opposition. This actual behaviour should be recognised by the CAA in its decision making.
8. The CAA should build on the strengths of the current regulatory model. At Heathrow it has delivered better service, falling prices in Q6 and fostered private investment in an integrated hub. The CAA thus needs to continue to deliver a stable, predictable regulatory framework with appropriate reward for the risk to which Heathrow will be exposed through the development, delivery and operation of an expanded airport. Strong, simple and reasonable incentives will ensure private investors will pursue every avenue to drive costs down and optimise investment.
9. Incentives and long-term certainty in a stable framework are far more effective than the introduction of additional licence conditions. It is also superior to excessive intervention in the process of *how* expansion happens or regulatory innovation as an end in itself.
10. Greater certainty is now required around the nature of the risk premium associated with the additional risks of expansion and around other elements of the regulatory jigsaw like debt indexation, ex-ante incentives, surface access policy and outcome delivery incentives. We call on the CAA to solidify its thinking in the above areas and stand ready to engage.
11. We are uncertain of when and how the CAA is planning to make these decisions. We are concerned that the CAA's commitment to a balanced package of incentives may not be deliverable as we are not yet able to ascertain how the CAA plans to piece all the elements and incentives together. We lack a sensible overall programme of work that enables these

decisions to be taken in a coherent and consistent manner, driven by analysis and data and not by emotion or apparently appealing but flawed arguments.

12. As we prepare the final airport expansion masterplan, Heathrow has invited proposals from Innovation Partners to help us maximise benefits for consumers. We are committed to a collaborative process and welcome all proposals that will align with Heathrow's strategic objectives to improve passenger experience, drive cost efficiency, grow commercial revenues and deliver sustainability targets. This process has been accelerated in response to the CAA's interest in ADMs.
13. While Heathrow is committed to progressing with Innovation Partners, we remain surprised that the CAA provides so little insight of what it is trying to address with this initiative. We are puzzled by the implicit assumption by the CAA that the Airports Commission (AC) process and an open DCO amounts to nothing when it comes to providing fair opportunities to competing schemes for delivering airport capacity in the South East. All commercial interests should have engaged in the relevant public processes and public scrutiny.
14. It is also important the CAA recognises that regulatory innovations such as ADMs are not and cannot be an end or an objective in themselves. We and the CAA need to be open to the potential benefits and drawbacks that they may generate for consumers. Nor is it the role of Heathrow to disprove the merits of every potential regulatory construct or proposal. The CAA needs to recognise the impact that exploring innovations such as these has on regulatory stability and market confidence built up over decades. There is a risk that they could undermine decisions that the CAA has made over the past 3 years regarding the regulatory framework for expansion. Furthermore, if considering significant moves away from the established regulatory framework, the CAA should consider all the possible options that may benefit consumers – for example dual or hybrid till models and alternative pricing structures.
15. Heathrow looks forward to engaging with the CAA on this response and the regulatory framework. The response is structured to follow the chapters of the CAA's consultation.

Approach to affordability and financeability

Affordability

16. Heathrow agrees with the CAA that furthering the interest of consumers is paramount. The CAA is right to say there will be cases where investment made in the consumer interest, which is evidenced by a clear business case and linked to engagement with consumers, results in higher prices. This represents protection of the consumer interest if the benefits of this investment for consumers outweigh the costs³.
17. It is important that the CAA makes a clear distinction between *what consumers value and want* and an investment programme that delivers the lowest possible airport charge. The former should drive its policy making, the latter should be discounted, as it often potentially only serves the private interest of airlines' shareholders.
18. The CAA, Heathrow and the airline community should continue focusing on providing value for money for consumers. It is not in Heathrow's commercial interest to create an unviable airport that is excessively expensive relative to the value for consumers. Creating a product

³ Are in consumers' interests if those higher prices result from costs that are less than the associated benefits for consumers

that passengers are willing to pay for will ensure that expansion is affordable for both passengers and airlines. It will also support the efficient financing of expansion.

19. Delivering expansion is the ultimate prize for consumers. Heathrow is supportive of a delivery of expansion that meets all stakeholders' needs, including the needs of consumers. In this context, we understand the steps taken by the CAA to refocus the CCB's efforts on the longer-term masterplanning and expansion process. Consumers' views will need to be integrated with the views, needs and requirements of other key stakeholders.
20. The CAA has consistently stated that "*... additional runway capacity in the south east of England will benefit air passengers and cargo owners. More aviation capacity is required to prevent future consumers experiencing higher airfares, reduced choice and lower service quality. We understand that there would be substantial costs for consumers associated with significant delays to capacity expansion*". We agree. The CAA must quantify that view and provide the implications for the airport in terms of consumer value and the value of timely delivery. The CAA has not done so. Nor has it commented on or validated the information Heathrow has submitted on the benefits that expansion generates for consumers, nor the analysis by the AC and DfT.
21. We continue to request that the CAA develops this primary analysis. It should quantify the benefits that an expanded Heathrow would generate for consumers and the costs to consumers of each year's delay. At a minimum, it should recognise the validity of the analysis developed by Heathrow or the DfT, and draw out the consumer implications. It would also be helpful to have the CAA's views on the ways to maximise this consumer surplus as airport and airlines develop plans over the next few years.
22. Absent this analysis, it is not clear to Heathrow how the CAA is fulfilling its primary duty when making policy decisions such as surface access policy, early Category C costs recovery or the appropriate risk and reward balance of the regulatory framework.
23. In addition, the CAA cannot address arguments that there is a case for delaying expansion to allow particular approaches to be explored or implemented, to alter the investment profile.
24. We call on the CAA to address this fundamental analytical gap as soon as practicably possible.
25. We have also argued that the CAA should more carefully define the notion of affordability. Heathrow's view continues to be that the CAA's approach to affordability ought to relate to passenger affordability. As previously discussed this is wider than Heathrow's airport charges and it should take into account the overall fares and APD paid by passengers at Heathrow⁴. We understand that the CAA has loosely assumed that affordability is a shorthand term to describe airport charges. This is not consistent with the CAA's primary duty.
26. Heathrow does recognise the SoS's challenge on airport charges. The CAA too has been clear that with expansion it wants to see charges remain close to 2016 levels in real terms adjusted for RPI in each year of the expansion period. Great strides have already been made in reducing costs. We will continue to work with airlines and the CAA to ensure that we meet this commitment in the coming years.

⁴ Refer to Competition and Choice 2017 report:

http://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/HAL%20-%20Frontier%20Competition%20and%20Choice.pdf

27. It is nevertheless important that airport charges are built bottom up, considering consumers' and airlines' input and efficient cost and income projections. Heathrow supports the CAA's statement that *"Airlines and consumers should expect to see no more than efficient costs reflected in airport charges"*⁵.

Financeability

28. We reiterate our long-standing position that a financeable H7 and wider expansion outcome is achieved through a stable regulatory framework that adequately recognises the risks faced by Heathrow. This requires fully integrated decisions from the CAA that account for the totality of regulatory changes, incentives and market dynamics to adjust risk and reward.
29. Financeability fundamentally cannot be decreed. Simply listing out a set of a-priori conditions or objectives does not improve financeability or financial resilience. Only the underlying economic reality of actual risks and incentives to fund those risks ensure private financing over the long-term. In fact, arbitrary conditions imposed in isolation can make financeability practically harder – by increasing risk to debt or equity, reducing incentives to provide risk financing or clashing with other incentives. Our key message to the CAA would thus be to think of financeability for expanding Heathrow in an integrated, coherent way focused on commercial economics.
30. Heathrow can pragmatically adapt to potential financing requirements. However, the potential benefits of any given licence condition may amount to nothing if the economic assessment is unrealistic. For example, inconsistent regulatory decision making could lead to, on the one hand the CAA requiring Heathrow to maintain a given credit rating while on the other imposing so many risks on equity or debt finance that they are unable to provide that level of financial stability.
31. In the absence of sensible and integrated regulatory decisions, introducing licence conditions does not meet the CAA's statutory duty of securing that its regulatees are able to finance their activities. Nor does it protect consumers from the significant challenges that financing expansion could generate.
32. Heathrow is thus concerned that the CAA is not consistently progressing work on the development of the regulatory framework, potentially resulting in inconsistent decisions. Particularly, we are concerned that work on incentives, financial resilience, financeability and the cost of capital appear not to be sufficiently integrated.
33. In recent comments on the water sector, rating agencies have expressed concerns that regulatory decisions which have challenged the notion of stable and predictable regulation, and which are considered not to be transparent or seen to be subject to substantial political influence could produce financeability challenges for regulated businesses.
34. Concerns following these changes has led to Moody's moving the outlook of 60% of the rated water companies to negative and Fitch to raising initial concerns regarding the business risk of water companies due to the changes in the regulatory framework⁶. A downgrade of this type for Heathrow would risk securing a financeable delivery of expansion. The CAA should therefore ensure that it continues to develop a regulatory framework which is both consistent

⁵ CAA April document (CAP1658), p 22, para 1.19

⁶ Fitch: What Investors Want to Know: UK Water - Price Review 19: What is the Impact on Credit Quality?

with previous decisions and is based on transparent and independent assessments. This will provide a secure base to ensure financeability.

35. Heathrow has the following more detailed comments regarding financeability:

- a. We welcome retention of the notional approach and recognition that Heathrow's financial structure is a matter for Heathrow's Directors to decide.
- b. We recognise the "twin track" approach described by the CAA as another reference point for the financeability assessment. However, the emphasis should be very clearly placed on the notional assessment.
- c. We recognise and share the CAA's expectations that Heathrow would retain access to cost efficient and efficient investment grade financing. We previously argued that the CAA should explicitly target a credit rating in its decision. We continue to hold that view. This will be instrumental for an efficient and timely delivery of expansion. As set out above, Moody's has recently put in a negative outlook for four different water companies because of changes which have undermined the predictability of the regulatory framework⁷. A similar situation following a CAA decision could jeopardise the expansion programme. It would certainly increase the cost of delivering it.
- d. We welcome recognition of the distinction between threshold and target metrics. It may be useful to perform sensitivity analysis for upside and downside scenarios to confirm that the level of risk sits in the middle of the range.
- e. Heathrow strongly believes that Debt to EBITDA should be promoted to one of the core metrics when assessing financeability. Fitch and S&P use Debt to EBITDA as one of their core metrics, including guidance on what could make the rating change.
- f. We believe that the FFO to gross debt could be demoted to a secondary metric because, as the CAA says, Moody's is likely to put more weight on FFO to net debt given the expected level of cash during the construction period.
- g. The CAA should ensure consistency between the rating targeted and the index used for debt indexation. In addition, it should also ensure consistency between the long-term nature of the project and the tenor of the index. Using a 10+ year index would be more consistent and appropriate than a 10-15-year index given the long-term nature of expansion.
- h. We recognise the CAA's intention to develop an equity financeability assessment over a long-term time horizon. We also think a qualitative assessment of debt financeability is a helpful analysis which will support the CAA meeting its duties in relation to financeability.

Initial assessment of affordability and financeability

36. Heathrow recognises the value of and effort put in by the CAA to develop the modelling analysis. The modelling exercise has been done in the specific context of the Section 16 report

⁷ Examples of such decisions are Ofwat's decision on cost of capital and its move to a more prescriptive approach to companies' capital structure. This moves away from the previous, predictable, regulatory framework and appears to be a reaction to largely political motivations and public pressure, rather than motivated by a regulator's independent assessment.

ahead of NPS designation. Heathrow recognises that the CAA's analysis is based on plausible but very preliminary information at a particular point in time. Therefore, as the CAA discusses, the results do not represent a likely outcome of H7. It cannot be ignored that actual airport charges may vary significantly from these results published by the CAA.

37. It is important also to note that the CAA's analysis should by no means set any expectations of what the outcome would be. Should that be the case, it would undermine the regulatory process being undertaken including aspects such as independent research and evidence gathering, benchmarking and the role of the CCB in H7 and expansion.
38. Heathrow believes that it is important that, going forward, the CAA is consistent with its discussion that the lowest possible airport charges may not always be in the interest of consumers. Service, resilience and capacity amongst other things will be considerations in furthering the interests of consumers. These considerations should be reflected in its future decisions which should also be informed by engagement with the CCB and the CAA's Consumer Panel.
39. Yet again, for the avoidance of doubt, Heathrow has stated that it will work in good faith toward the SoS's challenge to deliver new capacity at close to October 2016 charges in real terms adjusted for RPI in each year of the expansion period. This is a challenge we are confident we can meet and progress has already been made in reducing costs. We will continue to work with airlines and the CAA to ensure we achieve this ambition in coming years.
40. Heathrow has the following more detailed comments regarding the financeability exercise:
 - a. It appears a sensible approach and consistent with the policy steps that the CAA is taking. Heathrow would like to reiterate the principle that the CAA should also be explicit about the credit rating it expects the notional structure to achieve for its H7 determination. Target ratings should be consistent with this credit rating. The credit rating should also be consistent with the cost of debt assumptions used for determining the WACC.
 - b. We would like to better understand the rationale for increasing the gearing from 60% to 65%. Established regulatory precedent is 60%. We question how in an expansion scenario an increase in the proportion of notional debt is justifiable, given the higher risks that the airport will face.
 - c. The CAA appears to target a Regulatory asset ratio (RAB gearing) of 65%. The actual gearing in the model averages 55% for the forecast period. This would mean that the financeability test has been run based on a 55% nominal gearing. We would like to discuss this apparent inconsistency in more detail with the CAA and if need be the CAA's model will need to be updated for future financeability and affordability assessments.
 - d. The Funds from operation to net debt target are based on S&P's assessment of Heathrow's actual capital structure. Heathrow's actual capital structure includes structural enhancements that protect creditors such as: restrictions on business activities; distribution and debt restriction covenants; dedicated liquidity reserves during credit remedy periods; prudent treasury policies; and a pledge on holding and operating company shares and operating assets.

- e. These protections to debt creditors are at the expense of equity holders. Therefore, the target for this ratio should not factor the benefits of the structural enhancements to the quality of the credit as there is not recognition of the additional risk taken by equity holders.

Evolutions to the regulatory framework

Regulatory changes

- 41. The CAA has proposed exploring various potential regulatory innovations. While described as evolutions, many of them have the potential to be fundamental changes to the regulatory framework. These could have material impacts on the chances of delivering new capacity.
- 42. When considering such changes, it is vital that the CAA does not make an implicit assumption that changes to regulation, new interventions or complex structures are needed and of benefit to consumers by definition. Nor is it the case that, simply because expansion will require greater investment than in Q6, radical change is therefore needed. Such changes can be appealing from an intellectual or rhetorical point of view but may only add complexity, perverse incentives and cause delay in the real world. This has been a genuine issue in some other large UK infrastructure businesses and projects.
- 43. It is therefore imperative that the CAA defines carefully what issues – and what evidence there is for them – it is seeking to address in the current regulatory regime before leaping to structural solutions. Regulatory change of these sorts cannot be based simply on the latest assertions by one or another stakeholder or out of intellectual curiosity. We remain unclear in a number of cases of the logic and evidence the CAA has for proposed changes.
- 44. Furthermore, the CAA needs to consider the full impacts and ramifications of departures from the established framework. These include impacts on the risk and reward balance, on stability of the regulatory framework, on incentives for the airport and on timely delivery. Some of these impacts will emerge even before any such change is implemented.
- 45. It is also important to note that it is not Heathrow's role to disprove or prove the case for every possible regulatory change. The airport should rightly focus on bringing forward a business plan that achieves the objectives outlined above. Where we can see commercial or regulatory options to help do that we will propose them. Where we have access to evidence we can provide it. But we are not the regulator, nor well placed, nor frankly with the ability and capacity to test every regulatory concept that may be brought forward.
- 46. Timing is important. Airport and airlines will need to concentrate on improving the business plan and progressing the early stages of the H7 plan in the near future. Constant changes to or uncertainty in the regulatory framework will not allow this to happen. We call on the CAA to allow a pragmatic window for these discussions that does not delay progress nor require Heathrow to produce an Initial Business Plan (IBP) in the absence of a reasonably settled regulatory framework.
- 47. In that context the proposal for commercial arrangements with airlines that was advanced in 2017 is in contrast to some of the more recent proposals. Abruptly introduced proposals that appear to be driven by late representations to the CAA by third parties, leave a small window of opportunity to be addressed without significantly disrupting the progress achieved so far. We have supported – and welcome – the CAA's support for commercial deals with airlines as

a potential supplement to regulatory approaches. We would request the CAA seeks to establish a coherent set of areas to explore and avoid shifts in focus late in the policy process.

48. Arguably a more commercially driven framework between airlines and the airport is of value in itself. We remain interested in these arrangements. Heathrow continues to be open to exploring commercial arrangements with airlines with the aim of providing long-term certainty on price and service levels to consumers. We continue to discuss this with airlines.
49. However, even here, regulatory innovation should not become the prime objective and the CAA must keep working to deliver the standard regulatory framework in a timely way.
50. The regulator should also focus on clear incentives for the airport – to deliver service, capacity and efficiency for example. That gives a clear direction on *what* it wishes to achieve. Commercial incentives will then drive those outcomes without excessive further intervention. The CAA should avoid drifting into telling the airport as a private company *how* it must operate or deliver service or efficiency for example.
51. For consistency with Better Regulation principles, if the CAA does wish to explore various regulatory alternatives to meet its primary duty, it needs to consider the full range of options. In particular, we would highlight:
 - a. Dual or hybrid till frameworks. These are now near universal across European airports. They offer particular benefits in isolating the direct costs of new infrastructure. They also create positive longer-term incentives lacking from a single till model for developing commercial opportunities that expand consumer choice and can also reduce the airport charge over the longer-term.
 - b. Partial or full deregulation. New capacity in both the Heathrow and London markets for airport operation services should increase market dynamics and competitive pressures on the airport. Competition from other airports across the UK, Europe and wider afield is also increasing in the transfer and wider long-haul market. Likewise, competitive dynamics in surface transport and retail for example are creating ever stronger market disciplines on the airport. Given the rising competitive intensity, the CAA could consider evolving the regulatory framework in line with Better Regulation principles by stepping back from at least some aspects of regulation. This could potentially further incentivise commercial behaviours in the interests of consumers.
 - c. Licence backed price arrangements. In its review of the regulatory framework at Gatwick⁸ the CAA sets out that a commercial, commitments based approach with limited regulatory involvement is preferable. It states that the current framework of commitments gives more flexibility for the implementation of commercial arrangements than the previous regulatory framework, i.e. a framework such as Heathrow's. The CAA encourages this approach to protect the interests of consumers.
 - d. Alternative pricing structures. The current regulatory framework prices on a per passenger basis. In a future with new capacity there is a good case to look at other options such as per slot pricing. This could provide protection to airlines (and thus consumers) which did not seek new slot capacity and certainty on capacity to those that wish to access that capacity. It would also arguably better allocate risks – for

⁸ CAA, *Future economic regulation of Gatwick Airport Limited: initial consultation*, 29 June 2018, <http://publicapps.caa.co.uk/docs/33/CAP1684gal%20condoc%20final%20280618.pdf>,

example of passenger volumes and infrastructure costs – to the net benefit of consumers. Auction type pricing options might also become possible in this framework thus allowing more efficient allocation of capacity as it becomes available.

- e. There are other aspects of the regulatory framework that could also be debated, these are; the duration of the price control including different durations for different elements of the price control, rolling incentives for outperformance, pass-through elements of different and new cost categories related to NPS conditions.
- f. This list is not exhaustive. But it illustrates the issue with the seemingly selective and random set of regulatory evolutions so far considered by the CAA. If it wishes to explore such changes it is important that this be done in a systematic and evidenced way. We would be keen to discuss such options with CAA in the next few weeks.

Alternative commercial and delivery arrangements

52. We are committed to working with third parties to explore ways to better meet consumers' needs. We outline our Innovation Partners process that will do so below. Having said that, we would like to highlight to the CAA a number of important issues that emerge from its discussion on the section on ADMs:

- a. We are aware of the benefits competition offers consumers. Increased airport capacity is the key to unlock that competition. The average airfare at Heathrow is £650 based on IATA fares data, and the standard APD rate £90. Heathrow's charge is 3% of that amount. We have already provided good evidence that the lack of capacity is driving higher fares for consumers than they might otherwise face. This is aligned to the CAA's long-standing assertion that absent new capacity airline fares would continue to be above the market clearing price of an unconstrained market. Viewing competition in this context would be more meaningful for consumers.
- b. One of the key objectives described in the NPS is to maintain the UK's status as an international hub. The continuation of Heathrow's hub operation is instrumental for delivering the Government's objective. Therefore, Heathrow's ambition is to continue to own and operate the hub airport as a single entity. Evidence from around the world also shows this is in passengers' interests. Heathrow considers that this key principle should form part of the CAA's guidance for ADMs, for example adding to paragraph 3.18 *"It is, however, important to note that we will need assurance from all relevant parties that any approach to alternative delivery of capacity expansion will not undermine the ability for the expansion programme as a whole to be efficiently commercially financed, ~~and~~ delivered in a timely way in the interests of consumers and operated as a single hub consistent with the SoS objective of maintaining the UK's status as an international hub"*
- c. The CAA must also act far more carefully in regard to the competitive dynamics around airport infrastructure. Developments by parties which already have large holdings – say of land, facilities or activity – at Heathrow may not necessarily deliver the greatest long-term consumer benefits. There is a clear incentive for stakeholders which own or control significant airport capacity which they also then use for their own businesses, to use this for their own benefit and not in the interest of consumers. Heathrow as an integrated and sole operator has an incentive to maintain a level playing field in all respects. It also ensures a single accountable entity to be held to standards of

equivalence and fairness. These are critical to enabling the airline competition that is key for delivering consumer benefits.

- d. The assertion that Heathrow has not been involved in competitive and transparent processes is simply untrue. Our expansion scheme has been scrutinised for literally years. The AC process was open to all. Heathrow's north-west runway was selected as the best solution to provide increased airport capacity in the South East by an independent commission and subsequently supported by the Government following further review. Following the NPS designation, Heathrow will submit its DCO application. That too will be subject to open scrutiny. It is even possible for competing schemes to be submitted. The CAA must hold others to a similar standard of scrutiny and must not jeopardise the integrity of NPS or other public processes by trying to respond to stakeholder pressure. We encourage the CAA to think hard on what would be the answer in a competitive market. For example, to what extent do competing bidders share information on their respective proposals.
 - e. Likewise, in our own processes we have already had open competitions for architectural designs, logistics hubs and will be developing an open, competitive procurement strategy in collaboration with airlines over the course of 2019.
53. Heathrow will address the expectations set out in paragraph 3.26 and 3.30 of the policy document. We have addressed this separately in a recent letter to the CAA. We would nevertheless would like to highlight to the CAA that these will likely generate incremental costs. In the most part they are not intuitively part of Category B costs. We therefore would ask the CAA how it is planning to deal with the recognition and recovery of these costs. We would like to engage on this matter with the CAA.
54. In paragraph 3.26, the CAA states that "*HAL should be open minded at this stage on its approach to procurement and it should not rule out procuring terminal capacity through, for example, a design and build approach, rather than simply relying on its previous or preferred approach*". We would like to highlight to the CAA that Heathrow's previous approach has been design and build.
55. We would welcome the CAA team engaging on our procurement approach and the construction industry supply chain expertise available. We would note that the CAA is so far, the only major relevant regulator yet to engage with Project 13 organised by the ICE.

Innovation Partners

56. We always anticipated working with commercial partners to drive innovation as we expand the airport. Heathrow does not have the monopoly on good ideas, great technology or smarter ways to deliver service and efficiency. It is in our own commercial interests to embrace those good ideas that support the overall objectives of more hub capacity for consumers delivered in a timely, affordable and privately financeable way while addressing community concerns.
57. That is why we have sought to involve third parties in a proactive, timely, constructive, transparent and open-minded way. We have, for example, sought out innovation in the supply chain through open competitions for early architectural designs and potential logistics hubs across the UK. We are also developing a procurement strategy in consultation with airlines for market testing in 2019.

58. In April we launched a pitch process for Innovation Partners to build on this approach. We accelerated launching Innovation Partners in response to the CAA's guidance in CAP1658 on ADMs. We expect that Innovation Partners will bring demonstrable capabilities, knowledge, commitment and innovation to implement their proposals at Heathrow.
59. Heathrow will use Innovation Partners to explore ideas in good faith through a transparent and iterative process that treats all potential partners on a level playing field. We will engage in alternatives and constructively develop them together. It will also ensure that all potential partners are given common access to key information, and able to share their own information in a commercially confidential manner with us.
60. The Innovation Partners process will meet the criteria proposed by the CAA for exploring ADMs. Proposals must align with Heathrow's strategic objectives and regulatory and planning constraints. They should also align with the NPS and support the efficiency of a single integrated hub airport in the interests of consumers consistent with the objective of maintaining the UK's status as an international hub (i.e. Heathrow will continue to own and operate the hub airport as a single entity).
61. Failure to align with the NPS and link back to the AC risks ignoring community concerns or undermining the planning process.
62. We do not believe it is in consumers' interests to fragment the core airport operation between separate owners and operators. Heathrow has a good track record of using a range of commercial models from direct operation to long-term design and lease concessions to deliver service and value to consumers. We continue to be open-minded as to future options. However, the transformation in passenger service at Heathrow in recent years has come from running a single operating model across the airport that drives greater simplicity and standardisation. Any move to a more fragmented model puts service to passengers at risk. Evidence from elsewhere – for example in some U.S. airports – supports that lesson.
63. We published the expression of interest (EOI) for Innovation Partners on 30th May. The EOI is a simple first stage to register potential partners. We will then run at least two further phases to collaborate, share information and assess the potential and business cases for Innovation Partner proposals.
64. We have promoted Innovation Partners as widely as possible including notifying all suppliers on Heathrow's database, via the Heathrow Expansion website, proactive communications to scores of potential new partners to encourage participation and notices in the trade press. We have also requested airlines and others actively seek out potential partners and encourage their participation.
65. We have now extended the closing date for the initial EOI from 27th June to 11th July. This is in response to feedback from airlines and others asking for more time for potential partners to prepare and thus to take part. To date, over 200 organisations have registered to review the EOI documentation and over 100 people from 84 organisations attended an information session on June 14th.
66. We are encouraged by this positive response. We believe that Innovation Partners offers exciting opportunities to create a better, more efficient expanded airport. It meets the CAA's conditions in CAP1658 and can be investigated alongside the development of an integrated regulatory package meeting the interest of consumers.

General Licence Condition

67. Heathrow has consistently argued to the CAA that licence modifications should be considered carefully. That they should be used as a last resort solution, due to their blunt nature, and be consistent with a wider package of incentives. This follows the Better Regulation Principles.
68. Since the introduction of its licence, Heathrow has been fully compliant with the conditions set out, as well as reacting positively to other incentives, commercial or otherwise, set out by the CAA through the package of measures in the regulatory framework. For example, over the Q6 period, Heathrow has managed to achieve record passenger satisfaction levels, punctuality and baggage performance levels. We have, in addition, invested in line with the Q6 decision while ensuring that all business cases have airline support at Gateway 3. Moreover, Heathrow has achieved full policy support for expansion, investing in the project at its own risk. All of this has been done in the context of reducing airport charges.
69. In preparation for H7, Heathrow has also embraced CAA priorities such as the move to an outcomes based framework, responding to the challenge by the CAA and CCB to ensure business planning is based on consumer requirements. Similarly, we have addressed CAA challenges on aeronautical charges, ADMs, commercial arrangements and the like and are proposing increasing investment for the interim extension period and H7 itself.
70. Even from the above cursory review, it is clear that Heathrow is behaving in the best interests of consumers and in line with the incentives set by the CAA. There is absolutely no evidence that Heathrow lacks commercial and regulatory incentives to act in the consumers' interests nor that the CAA has lacked effective powers and incentives to drive Heathrow's actions.
71. Heathrow strongly argues therefore that the CAA's initial focus should be in developing a balanced package of positive incentives rather than prioritising work on unjustified punitive actions which seem not to take account of Heathrow's positive compliance record. The CAA needs to recognise that it cannot mandate investment or future certainty through licence conditions. On the contrary, onerous and vague regulatory intervention risks creating precisely the negative reaction the CAA is seeking to avoid.
72. The CAA recognises that the transparency and effectiveness of a general licence condition on its own would be undermined with no benefit to consumers. Nevertheless, it seems that the CAA thinks the best way to address this flaw is by introducing policy guidance to clarify what the licence condition is intended to mean.
73. As the CAA is aware, its statutory duties include a general requirement that, in carrying out its functions, the CAA must have regard to the following principles:
- a. Regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and;
 - b. Regulatory activities should be targeted only at cases in which action is needed.⁹

It is thus highly questionable if the general licence condition as being discussed is in line with the CAA's statutory duties.

⁹ <http://www.legislation.gov.uk/ukpga/2012/19/section/1/enacted>

74. The general licence condition discussed by the CAA is not targeted. This is self-evident, based on how the CAA proposes to implement it i.e. by providing guidance clarifying the intention of the condition at different times. If the CAA is concerned by any particular issue, it should act consistently with its duties and aim to find a targeted remedy.
75. We are also concerned that the implementation of this proposed guidance to clarify the licence condition could undermine Heathrow's rights to defence. Guidance is not appealable, unless the CAA includes an appeal route in the condition itself. Should this not be the case, we would consider taking further action to ensure an appeal route is available.
76. In addition, in assessing the proportionality of new licence conditions or licence modifications, the CAA is required to:
- a. Clearly define the objective it seeks to achieve.
 - b. Determine that a licence modification is appropriate for achieving that objective.
 - c. Ensure that the licence condition goes no further than necessary to achieve the objective¹⁰.
77. The CAA has not met any of the above criteria when discussing the need to introduce a general licence condition. We are therefore very concerned that the CAA is not adhering to its duties. We strongly oppose any new licence conditions or modifications which are not fully justified. We would like to discuss this with the CAA following the submission of this paper.
78. Should the CAA evidence targeted concerns about Heathrow's ability or intention to operate and maintain Heathrow to satisfy the requirements of users, we would expect the CAA to explore the full range of regulatory tools before proposing a licence modification. Should the CAA determine that a licence condition is the best way to address its concerns, we would expect the condition to be appropriately targeted and proportionate. The route to compliance should be clear for all parties and should ensure the licence condition therefore produces the intended outcomes.

Cost of capital and incentives

Cost of capital

79. Heathrow recognises the CAA's discussion regarding the need to define a balanced regulatory package and set of incentives, reflected in the WACC, that encourages a timely and efficient delivery of expansion. The balance needs to be consistent in terms of the risks Heathrow will face and the associated reward, but equally in terms of efficiency, timely delivery, financeability and affordability of the airport charge (as distinct from overall affordability).
80. In recent publications regarding both regulated energy networks and the water sector, Moody's has expressed concerns that perceived instability or large changes in regulatory frameworks could lead to companies being exposed to a higher level of risk which should be recognised in the calculation of the company's cost of capital. In its report on regulated energy

¹⁰ See Case C-121/15 *ANODE*, EU:C:2016:637, §§55, 60 and 64.

networks¹¹ Ofgem quantified the impact of this loss of “regulatory confidence” at a 10bps to 100bps upward adjustment in a company’s WACC.

81. Heathrow has the following observations regarding Moody’s work in the context of the H7 review:

- a. In assessing the level of risk to which Heathrow is exposed, in particular in the context of expansion, the CAA should take into account the impact of any changes to the regulatory framework, in H7 and beyond, on the level of risk faced by Heathrow.
- b. Absent a regulatory framework that clearly underpins a cost of capital study, such analysis will provide very little insight to the appropriate reward for H7, since the risk would not be clearly allocated and defined.

It is fundamental that the CAA defines the regulatory framework in full, in sufficient time before Heathrow puts together its IBP so that:

- a. Risk and reward can be properly assessed and;
- b. Heathrow has a clear framework against which it can develop a business plan that furthers the interests of consumers and meets the CAA’s criteria.

82. It is likewise fundamental that the CAA assesses the impact of the regulatory framework and the underlying economic and commercial dynamics before making decisions on the H7 WACC. Commercial dynamics will be particularly fluid for an expanding airport in a changing business environment. The scale of regulatory change being explored by the CAA also increases the factors to consider in the WACC. The work done by PwC in 2017 was both premature and inadequate in addressing these issues as well as technically problematic.

83. Heathrow wants to engage with the CAA on a programme of work that ensures an effective delivery of a balanced regulatory package. This, as a first stage, should encompass clearly defined milestones, enabling a cost of capital determination that fully reflects any regulatory innovations such as capital efficiency incentives and the risk profile of an expanded Heathrow.

84. We will provide detailed responses regarding cost of capital in our response to the CAA’s working paper CAP1674.

Incentives

85. We recognise that, in carrying out its duties, the CAA should investigate different regulatory arrangements to best protect the interests of consumers. We understand that the CAA’s thinking on capital investment incentives is at an early stage. In this context, we recognise that the CAA has developed a range of scenarios to better understand the potential financial implications that a move to a more ex-ante based incentive regime could have.

86. Investigating options does not however imply a need to change incentives. Heathrow is concerned that the CAA has done very little work to understand the potential drawbacks of moving away from the current Development and Core approach. The current framework incentivises Heathrow to efficiently deliver capital investment. It drives Heathrow decision making to achieve timely and efficient investment that responds to airline and consumer needs. IFS review and extensive benchmarking support this conclusion. The approach was

¹¹ Moody’s Sector comment, *Risks are rising but regulatory fundamentals still intact*, 29 May 2018

introduced only in Q6 to address issues with previous incentives - which it has successfully done.

87. Other approaches, including a greater weighting of 'ex-ante' incentives seen in other regulatory sectors such as water, or energy are now being questioned in regard to the effectiveness of these incentives in protecting consumers' interests, and suitability these incentives in the context of a future that is not "steady state"¹². The CAA needs to avoid a simplistic assumption that different incentives are by definition better, or that ex-ante incentives somehow always create lower cost, more certainty and better outcomes. Heathrow, at this stage, is uncertain and does not recognise the problem the CAA is trying to address with ex-ante incentives.
88. A sophisticated approach to any shift towards ex-ante incentives will acknowledge and investigate the real-world trade-offs between certainty, flexibility, time, cost and risk that different incentive mixes will bring. It would also bring an evidence based view to proposals for change. We are open to this discussion with the CAA but urge it to engage early with appropriate expert knowledge to develop its thinking rather than settle a-priori on particular incentive approaches.
89. Equally, Heathrow is concerned with the CAA's approach in defining the different scenarios and the financial analysis performed. The CAA does not outline how it envisages that the work on capital incentives will be integrated with the wider design of the regulatory framework, including estimating the WACC. Such integration is required if the CAA's ambition of an integrated package is going to be delivered effectively. We expand on our concerns below.
90. Regarding the *problem* and *need* to introduce ex-ante incentives:
- a. The CAA has not provided any information or analysis that addresses any concerns regarding the validity of the current framework. The CAA has not, for example tapped into the IFS work or analysed the different benchmarking reports developed by the IFS.
 - b. Following Better Regulation principles, we would have expected the CAA to clearly articulate the drawbacks of the current framework so that a targeted and proportionate regulatory response could take place.
 - c. We would also expect a coherent discussion of the different trade-offs and impacts of particular incentives based on evidence from other industries and the UK market.
91. Regarding the scenario definitions, Heathrow is concerned that:
- a. The scenarios are simplistic and only suitable for a high level financial analysis. The scenarios do not provide any insight into the instrumental features that would enable them to work. For example, the scenarios are mute regarding the role the CAA will play, the associated governance, and the suitability of different capital investment projects to be subject to ex-ante incentives.
 - b. It is therefore impossible to derive any meaningful insight into the incentives that each scenario generates for each stakeholder.

¹² https://www.ofgem.gov.uk/system/files/docs/2017/11/ensuring_fair_returns_workshop.pdf

92. In relation to the financial analysis:

- a. The CAA's work does not incorporate any thinking on the link between different forms ex-ante incentives (and thus risks) and the allowed returns. For completeness and regulatory consistency, it is important that the CAA develops the RORE analysis in tandem with the impact on risk and therefore reward. In addition, the analysis should quantify the impact on airport charges, so that the CAA can assess the impact on aeronautical charges "affordability" of an ex-ante framework. We note that in other examples, ex-ante incentives tend to increase total cost even as they increase the certainty of what the total cost will be¹³.
- b. Caution must be applied when interpreting the RORE ranges results on the basis that it is a complete analysis, for the following reasons:
 - i. The comparison of the RORE range for ex-ante incentives with those from other price controls does not compare like with like. The range for other industries relates to totex and therefore includes risk from operating costs as well as capex. For Heathrow, the RORE range for opex variations is likely to be greater than 3% given previous performance against targets. Given that operating cost performance is likely to be independent of the capex risk from expansion, the comparative RORE range for a 25% capex incentive would therefore be around 8%, twice the typical level of risk for other regulated industries.
 - ii. It is important to note that because the regulatory regime allows a real cost of debt, actual cash interest payments are higher than the real debt allowance, and therefore a significant element of the cash return nominally intended for equity is required to cover interest payments. Consequently, low levels of RORE can lead to significant financeability challenges as cashflows are insufficient to cover cash interest costs.
- c. Given this, an 8% RORE range for cost risk (significantly skewed to the downside) could foreseeably lead to financial distress. Moreover, Heathrow faces significantly higher revenue risk than energy or water companies both because of the volatility of passenger volumes, the commercial market dynamics (e.g. online retail, the rise of ride sharing, digitisation etc) affecting non-aeronautical revenues. Higher revenue risk of Heathrow compounds this risk. This suggests RORE ranges for Heathrow should be narrower than other industries for the same level of financial risk.

93. In relation to developing any ex-ante analysis, therefore:

- a. The CAA needs to outline with clarity its proposed next steps for investigating this policy. The CAA needs to describe a planned approach for ex-ante incentives and how it plans to integrate any decision on this area with the rest of the framework. Heathrow is concerned that this remains vague.
- b. The CAA needs to acknowledge that a high-level RORE analysis does not demonstrate that the CAA is providing a balanced regulatory package. It needs to

¹³ Refer to Review of past experience on ex ante incentives section, Ex-ante incentives report, CAA-H7-135

commission an informed review, based on observed industry experience, of the risk impacts of different ex-ante incentives.

94. We are keen to ensure that the regulatory framework enables the delivery of an efficient and timely operation and expansion programme. We would therefore like to work with the CAA going forward, on capital investment incentives with an open mind towards finding the regulatory regime for capital investment that furthers the interest of consumers. We believe that the following principles would provide helpful guidance:

- a. Any framework needs to be supported by detailed analysis. For example, if a given framework would require more regulatory scrutiny and therefore generate incremental costs compared to the existing approach, this needs to be considered as part of the “business case” for change.
- b. The regulatory framework needs to preserve flexibility reflecting the reality of Heathrow. It needs to be able to deal with unforeseen circumstances.
- c. The regulatory framework needs to recognise the characteristics and nature of different business cases.
- d. The regulatory framework needs to provide value for money, and find the right balance between the cost, time and quality.
- e. The regulatory framework for capital investment needs to be consistent with the whole regulatory framework, and integrated package of incentives. Therefore, risk and reward need to be assessed in tandem and reflected into the financeability and affordability model developed by the CAA.
- f. The regulatory framework needs to enable timely decision making to develop investment at pace, it cannot slow down the delivery of projects or add to the already extensive governance process.
- g. Governance arrangements need to be optimal and focused on the areas that provide more value for consumers. A review of the capital investment framework and incentives is an opportunity for example to streamline the governance process for ‘routine’ investment areas or areas that require more nimble decision making.

95. Heathrow would like to reassure the CAA that we are working with the airline community on how best to integrate or otherwise the recommendations, made by CEPA, into the current framework. This is being done through the established governance forums. Those recommendations where Heathrow and the airline community are in agreement are being, and will be, implemented throughout the remainder of the Q6 and iH7 extension.

Interim arrangements to apply after the end of the Q6 price control

96. We recognise the CAA’s decision to implement a further year’s extension to Q6, referred to as iH7+2 in the document. We accept there will never be perfect alignment between the regulatory and planning consent timelines. However, this further extension does enable greater alignment allowing the business planning process to run alongside the planning process, including the development of Heathrow’s masterplan. This timing is now reinforced given the NPS has been formally designated in June 2018.

97. We remain concerned that the CAA continues to insert caveats to its decision - stating that the timetable for H7 could be further extended, or even brought forward, should there be “very significant changes to the forward work programme”¹⁴ linked to NPS designation. Certainty is helpful for all parties to the process, and now the NPS is designated, we ask the CAA to plan on a clear timetable. We think that the proposed iH7+2 timetable is sufficiently resilient to prepare for a January 2022 H7 start - unless there are major new events in the expansion timeline.
98. We agree with the CAA that a top down, pragmatic and targeted reset of the key building blocks is required for a price control extension of this length. We have worked with the CAA to provide initial assumptions for calculating the revenue requirement. We will of course continue to work with the CAA and stakeholders through the implementation process. Given the far more complex issues around the H7 settlement itself and developing plans for expansion, we urge the CAA to focus on as simple, efficient and targeted a process as possible.
99. We can also see the logic in the CAA’s proposed approach for the extension years to have an overall price path consistent with Q6, and then allow any over or under recovery to be passed through to consumers in future price controls.
100. However, while we are largely supportive of the iH7 approach, we still believe that the CAA should reconsider four key aspects of its proposed policy for implementing the extension:
- a. The methodology for clawing back over recovery.
 - b. The proposed adjustment for cost of new debt.
 - c. The proposed timing of the Heathrow Business Plan.
 - d. The length of the proposed process to define the underlying revenue requirement for iH7.

Our position is discussed below.

101. Revenue clawback. The CAA proposes making an adjustment to the RAB via increased depreciation in H7 to adjust the difference between the revenue associated with the price path and the underlying revenue requirement as determined in due course by the CAA. In our response to the CAA’s December document, CAP1610, we set out our view that this difference would be better recovered through a revenue adjustment. The key arguments for that view are:
- a. A revenue adjustment would more immediately and effectively protect consumer interests. It allows for a quicker recovery of the adjustment. Any over recovery would be clawed back to passengers over the duration of H7 (or potentially even a shorter period) rather than over the average life of the RAB (c.25 years).
 - b. A revenue adjustment is more effective in reducing pressure on aeronautical charges for H7. It will be able to concentrate any impact on the peak years of pricing pressure. This is most useful in supporting the SoS’s challenge on aeronautical charges.

¹⁴ CAA April document (CAP1658), p 70, para 5.16

- c. Making an overnight adjustment to Heathrow's RAB leads to an unnecessary increase of financing risk. It would affect Heathrow's gearing and by implication it could affect the cost of debt. In addition, in general RAB adjustments are not welcomed by the rating agencies and the credit community.
- d. The revenue adjustment that the CAA implemented between Q4 and Q5 to smooth out the impact of Terminal 5 on aeronautical charges provides a very relevant regulatory precedent. We are proposing an analogous adjustment. In this case, over recovery of revenue throughout the extension period (Q4 in the precedent) is adjusted by reducing H7 revenue requirement (Q5 in the precedent). This can be implemented with the same value impact as a RAB adjustment.
- e. The CAA's justification for the retention of a depreciation adjustment in CAP1658 is weak. It states only that it was the "simplest method" with no rationale on why this method would be in the interests of consumers. Given that the alternative is likely better for consumers, for intertemporal fairness and cheaper financing, we urge the CAA to shift its view.

102. Cost of new debt. The CAA has confirmed its intention to reopen the cost of new debt and corporation tax elements of the WACC for 2020 and 2021. It states that these can be directly observed and so updated in a simple way. As stated in our response to CAP1610, we remain concerned that an adjustment of the WACC is not appropriate for the following reasons:

- a. An adjustment made without carrying out a sufficiently detailed process, could have a large impact on Heathrow's financeability. Although we recognise that the corporation tax rate could be seen as a directly observable element, the cost of new debt is more complicated. Any reset of the cost of new debt should also consider the impact of the significant investment planned for 2020 and 2021 which the CAA highlights in CAP1658. This shift in investment outlook will impact the cost of new debt for Heathrow.
- b. We are concerned that implementing this adjustment without an impact on financeability will at best introduce lots of complexity. At worst it will add uncertainty and cost to financing. It will also have limited value for consumers which would not be captured in a proper reassessment for H7. This does not meet the CAA's criteria set out in CAP1610 of pragmatism, alignment with the expansion process, stability and proportionality. We therefore believe the cost of new debt should not be reopened for the purpose of the interim price control.

103. Business Plan. The CAA sets out its proposed, updated, timetable for the submission of Heathrow's business plans for H7 given the further extension to the current price control. The CAA proposes two potential timelines, expressing a preference for a July IBP and asks for views. We believe a December IBP is the better option.

104. Two factors drive that preference. Firstly, the CAA's preferred timeline does not take full advantage of the price control extension by maximising alignment to the statutory process or providing maximum resilience to procedural challenges. Secondly, the CAA's preferred timeline does not align with the CAA's proposed timeline for implementing the conditions of the interim price control. These concerns are explained below:

- a. The preferred timeline does not allow for any headroom should there be any slippage in the statutory planning process. The NPS is now designated which helps certainty but potential Judicial Reviews, any slippage to Consultation 2 and or factors such as the Innovation Partners process could easily add a few months movement either way. We urge the CAA to use the full flexibility of the time created to provide resilience.
 - b. An IBP submission in July 2019 leaves very limited, if any, time to fully integrate Consultation 2 feedback or reflect a preferred DCO strategy into the IBP. In contrast, taking full advantage of the extension with a submission in December 2019 would provide this additional headroom and allow for a business plan submission alongside submission of our final scheme for DCO approval.
 - c. The preferred timeline is also inconsistent with the CAA's timetable for implementing the interim price control. Under its preferred option, the CAA would be requesting Heathrow to submit an IBP in advance of the conditions for the interim price control being finalised in Q3 of 2019. This would not allow Heathrow to take account of the proposals for the 2020 and 2021 period in its H7 business plan, which would be inconsistent.
 - d. Furthermore, the CAA's preferred timeline includes Heathrow submitting its Final Business Plan (FBP) in January 2020, one month after the planned submission of the DCO. This does not allow for any headroom should there be any slippage in the statutory planning process. An August 2020 FBP submission will provide appropriate resilience.
105. Given the above issues we believe that the CAA should implement timetable option 1 for the H7 process. We would like to discuss this matter further with the CAA.
106. True up process. The CAA outlines a series of key dates for defining the underlying revenue requirement for iH7. This amounts to more than a year to define the revenue requirement of an interim two-year period. We would like to explore the option with the CAA of shortening this process, to better align with the CAA's stated principles of proportionality and pragmatism, for the Q6 extension decision making process.

Early Category C costs

107. It is in the best interest of consumers that the CAA promotes the timely development of new capacity, especially now the opportunity is imminent. Timely and sensible decision-making that creates regulatory certainty is key for promoting a timely delivery of expansion.
108. We have called for regulatory guidance regarding early Category C costs over the last 18 months. We recognise the CAA's progress in developing the regulatory framework for the treatment of these costs – appropriate governance and regulatory treatment of a) compensation for large commercial/other projects and b) compensation for residential, small commercial and others.
109. Though significant progress has been made, the CAA has not yet fully developed the regulatory framework for all early Category C costs. Therefore, there is still a residual risk of unduly delaying the scheme due to concerns over the funding and recoverability of these costs.

110. We specifically refer to the regulatory treatment of early expenditure on other enabling costs. The CAA indicated in CAP1658 that the processes outlined for compensation for residential, small commercial and others could also be used for early enabling costs. But it also notes that given the scale of these costs, they could be subject to the CAA's broader approach to cost incentives, for example ex-ante incentives.
111. This is most concerning to Heathrow, not least because the CAA has outlined very little of its thinking regarding ex-ante incentives (discussed in more detail elsewhere in this response). However, the CAA has indicated a number of times that its work on incentives is at early stages, and that it will form part of balanced package of incentives for H7. This would imply that it will make a formal decision on incentives for the H7 price control.
112. Enabling works costs are expected to be close to £400m before consent is granted and thus likely to be largely incurred ahead of the start of H7. These costs are vital to maintaining an efficient and cost-effective schedule, and a schedule capable of delivering capacity in a timely way to consumers and in line with the NPS timetable. In the scenario where the CAA's policy on incentives gets implemented at the beginning of H7, there would appear to be a policy vacuum regarding costs of up to £400m. A policy vacuum of this magnitude undermines the progress made by the CAA on early Category C. Continuing uncertainty on this item may well hinder a timely delivery. This would run counter the CAA's primary duty of furthering the interest of consumers by promoting a timely delivery of expansion.
113. We therefore ask the CAA, at the earliest opportunity, to simplify and clarify this area. Given the more traditional construction nature of these costs, we consider that the established Development and Core framework is appropriate to regulate these costs. In addition, the approach defined for cost and efficiency discipline applying to all early Category C costs could also be extended, namely:
- a. Heathrow must demonstrate that the expenditure is in the interests of consumers and will be efficiently incurred. If so, expenditure should be recoverable through the RAB.
 - b. Using the existing capex governance process to provide a complete business case, engage with airlines on cost efficiency and address airline concerns. Any disputes arising from this process would be referred to the CAA for determination in line with the established process.
 - c. Extend the IPCR role to review these costs.
114. We note the CAA's statement that recovery of Category C costs is and should be consistent with the overall objective of affordability and financeability. We understand this to also lead to the CAA proposing that any approved early Category C expenditure will be remunerated at Heathrow's cost of capital until it is recovered but that recovery is assumed to be delayed until H7 or later. We have reservations with an approach like this for the following reasons:
- a. At a principle level the CAA does not outline when and how it is planning to decide whether any affordability or financeability criteria are or are not met. Airlines and Heathrow's understanding and practical ability to recover costs is constrained by the test of affordability that, as we have argued elsewhere in this response, is not properly defined.

- b. At a practical level, delaying recovery of early Category C costs in Q6 as a special category of RAB expenditure puts significant pressure on H7 charges. This comes on top of the impact of Category B costs recovery which is also subject to a similar policy. Unlike with Category B costs, there is no obvious incentive for Heathrow in this approach – in fact arguably the incentive, of uncertainty leading to delay, is a counterproductive one. It would seem to us to be sensible to adopt the standard Q6 approach to recovery for these costs and smooth charges for at least the next few years, even if there is additional smoothing applied in H7 itself.

115. Finally, we would like to reassure the CAA that we are developing work with the airline community to implement the CAA's policy on early Category C costs. Heathrow's intention is to update the Capital Investment Protocol with the CAA's latest policy decisions.

Surface access

General commentary

116. Ensuring Heathrow has the appropriate surface access provision is vitally important to the delivery of expansion. Implementing the right mix of surface access interventions in a timely manner ensures:

- a. Heathrow can meet the targets set out by Government in the NPS to expand sustainably.
- b. Passengers are provided with reliable and convenient options to access the airport in the way that best meets their needs.
- c. Heathrow's catchment grows, increasing the number of consumers who can access the airport and improving growth potential and economics of airlines and the airport.
- d. Heathrow enhances its role as a hub, maximising its contribution to the economy by ensuring that goods and people can arrive on time across the country.

117. We therefore welcome the approach taken by the CAA to surface access policy in its document. It acknowledges the importance of surface access to the delivery of expansion at Heathrow and to the delivery consumer benefits.

118. We will support and engage with surface access schemes that further Heathrow's aims. We acknowledge this historically has, and in future may again, involve contributions from airport users. However, for the avoidance of doubt, Heathrow does not intend to promote or implement complex transport schemes not directly linked to the airport. We are conscious of the risks of drift in our core focus on the airport. They include risks of fairness to aviation consumers, risks to meeting aspirations on charges and risks to the airport's investment programme. In this context, clarity on CAA policy that is aligned with wider public policy has an important role to play in protecting consumers.

119. We welcome the CAA's statement that the main principles of its current surface access policy and its focus on user pays remain appropriate. We believe that this policy, and its associated principles, are fit for purpose. They provide a clear starting point for the assessment of surface access schemes that includes consumer protection, efficient delivery and recovery of investment.

120. We also agree that there are some gaps in surface access policy to be worked through. More work needs to be done on the detail of how the cost benefit analysis elements of the policy are applied in practice and how to best take account of the wide package of surface access measures required to deliver expansion in line with the NPS.
121. In developing the outstanding elements of its policy, the CAA should seek to provide sufficient assurance to stakeholders to allow for confident and timely investment in the required surface access schemes by:
- a. Having regard to the Better Regulation Principles and its statutory duties. This is especially with regard to the principle of consistency to ensure its surface access policy is consistent with the approaches it has taken to similar policy areas, such as Category C costs.
 - b. Setting out how – and on what timelines – the CAA will review Heathrow’s surface access policy to ensure that the package of schemes proposed meet statutory, planning and consumer requirements.
 - c. Setting out how it practically plans to assess efficiency in the delivery of surface access investments.
 - d. Providing assurance that if these tests are met, the costs of these schemes will be recoverable by Heathrow.
122. We note the clarifications made by the CAA in its May working paper regarding different types of spend within the surface access strategy. We consider that in these¹⁵ cases no assessment of the capital spend would be required under the surface access framework and that the investment would be reviewed only through the usual efficiency processes, i.e. with the use of an independent reviewer, with efficient costs recoverable through the RAB.

Holistic approach to assessing surface access spend

123. The CAA sets out that it will need to develop its policy to address how surface access schemes might be expected to help address wider legal or planning obligations around air quality or congestion. It sets out that this is likely to include a holistic review of the costs and benefits of Heathrow’s overall surface access strategy.
124. We have shared our emerging surface access strategy with the CAA. It takes a holistic approach to the assessment of the costs and benefits of surface access schemes to support expansion. The key characteristics of our surface access strategy are that it:
- a. Allows us to meet our public transport modal shift and air quality requirements.
 - b. Includes a range of possible interventions to assess, not just capital investment schemes. Thus, it also includes behavioural nudge techniques, measures to

¹⁵ Where a highways diversion is required only for the purposes of allowing for the physical development of airport infrastructure and does not improve access to the airport, it would not have the characteristics of a surface access scheme.”; and

Where there may be licence conditions or statutory guidance relating to the surface access network which is impacted by the expansion project, as is the case for Highways England, and there is clear and compelling analysis that demonstrates that the required works are necessary and appropriate.

incentivise efficient use of infrastructure and increased working with surface access partners to deliver a rounded package of interventions.

- c. Is underpinned by robust modelling to evidence how our strategy will provide the required NPS requirements. It is also designed to assess the relative capital and operational costs and implementation complexity of each potential package of measures.
 - d. Includes a clear methodology to assess the impact of each potential surface access intervention on NPS targets. This allows us to build a package of measures incrementally to meet these targets in an efficient and cost-effective manner.
 - e. Builds on consumer preferences, gathered through our programme of consumer research and engagement. This helps to ensure that our surface access strategy provides convenient, attractive and value for money options to consumers. We have begun engagement with the CCB on how we have used, and plan to use, consumer insight to inform our surface access strategy. We are responding to their challenges to improve the breadth of our insights base.
125. CAA assessment of this work should serve to satisfy its holistic review of Heathrow's surface access strategy. By reviewing our methodology for producing the most efficient and cost-effective package of surface access measures to deliver expansion, the CAA would provide itself with the assurance that our strategy meets relevant legal and planning obligations and is ultimately to the benefit of consumers.
126. We would propose this holistic review as the first step in a two-step process. After the holistic review, once the CAA was comfortable that the methodology is transparent, robust and applicable, the CAA should then be able to provide us with assurance that the efficient costs of the schemes within the package can be recoverable through the RAB.
127. This approach would allow sufficient confidence to enable timely investment in surface access and support on-time delivery of expansion. Given DCO requirements and statutory stakeholder engagement it will be helpful to have this clarity by the first half of 2019, noting however the expedited timeline of the Western Rail project, our approach to which is set out below. This would also be consistent with the CAA's previous policy decisions on Category C costs.
128. We agree with the CAA that the costs of these schemes should also be efficient. We also agree that that costs should first be distributed on a user pays basis, with any residual costs divided between airport and non-airport users.
129. To support these two principles, we propose a second step in the process following on from the holistic assessment. We suggest the CAA should then review the efficiency of the proposed surface access interventions, wherever there is a capital contribution or investment required from Heathrow, to ensure they are efficient and meet the principles of the CAA's surface access policy.
130. The efficiency of overall schemes and investments should be tested using the same process as other expansion related capital investment projects to ensure consistency of treatment across expansion related projects. We would expect this process to use an independent third-party reviewer. We would expect to engage the airline community using existing governance processes.

131. Where capital contributions to surface access projects are required they should be assessed under the CAA's surface access policy, ensuring the contribution is commensurate with the benefits accruing to airport users. The analysis used to determine this contribution should be independently reviewed.
132. Regarding the calculation of airport user benefits, we agree with the CAA's position that the benefits to consumers are wider than just the direct benefits arising from easier access to the airport, and that these benefits also extend to staff journeys and mitigating required environmental impacts.
133. We also note the CAA's view on the attribution of residual costs and that it may not always be appropriate to recover these costs based on the proportion of benefits accruing to airport versus non-airport users. We would welcome further discussions with the CAA regarding this as part of the wider conversation on benefits modelling.
134. We agree with the CAA that more work is required to ensure there is a joined-up approach to modelling these benefits across all stakeholders. We have already engaged with parties, such as DfT, with regards to our modelling approach. We would be keen to continue to work with the CAA and surface access stakeholders to agree a common process and develop agreed modelling.
135. In line with the above, we are working jointly with the CAA and DfT and engaging with airlines to agree the correct level of airport contribution to the Western Rail Link project. Modelling for our surface access strategy shows the Western Rail Link project could play an important role in helping us meet our NPS targets. We are therefore working through the detail, in line with the CAA's principles, to calculate the appropriate amount of any required contribution. That contribution would be commensurate with the benefits received by airport users and adhere to the user pays principle. This work will progress through 2018 to ensure there is no delay to the project timeline.