

Consultation Response on the CAA's *Strategic themes for the review of Heathrow Airport Limited's charges ('H7')*
Heathrow Airport Limited

Date: 28 April 2016

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Status: Not confidential

Contents

Executive Summary	3
Introduction.....	4
Empowering Consumers.....	6
Incentivising Outcomes.....	8
Increasing Airport Operational Resilience	9
Promoting Cost Efficiency and Financeability	11
Constructive Engagement.....	15
H7 Timetable	17
Sustainability Leadership	19
Airport expansion.....	21
Annexe 1 - Answers to CAA's Specific Questions.....	22

Executive Summary

1. Heathrow Airport Limited's ("Heathrow") vision is to give passengers the best airport service in the world and we will continue to deliver improving service and reducing prices throughout Q6.
2. The Civil Aviation Authority's ("CAA") discussion document on the strategic themes for H7 is an important milestone. It is the first opportunity for all parties to gain a clearer understanding of the proposed process and the CAA's priorities for H7. As the CAA has noted, this is a major programme of work.
3. **We welcome the overall direction of travel towards a consumer focus and outcome-based approach to regulation.** This is in the interests of passengers, cargo users and airlines, Heathrow's vision and the CAA's statutory duties.
4. **Increasing operational resilience is critical to success both today and during H7.** However, this should be achieved through collaboration and investment with limited regulatory intervention.
5. **We welcome discussions that support cost efficiency and financeability.** It is important that these are given due consideration and implemented effectively such that investment is fostered through a predictable return.
6. Heathrow agrees that **flexibility with regard to expansion is critical** and believe an extension to Q6 may be the most appropriate tool. **The CAA's proposed timeline would benefit from some adjustment to optimise the H7 process,** whether expansion takes place or not.
7. It is our desire to shift towards a more commercial relationship with airlines. As part of this, **we support a reformed Constructive Engagement process** that builds on the successes of Q6 with a more focused, higher level, shorter engagement.
8. We would be pleased to continue our engagement with the CAA to discuss the feedback provided in the remainder of this submission and discuss how the H7 process can best serve all parties.

Introduction

9. Heathrow is grateful for the opportunity to comment on the CAA's *Strategic themes for the review of Heathrow Airport Limited's charges ("H7")*.
10. As noted in the executive summary above, Heathrow welcomes the broad approach taken by the CAA. We believe there are opportunities to improve the process further.
11. In this introduction we set the context for the H7 review. We discuss Heathrow's priorities for H7 and how they compare to those of the CAA.

Context for the review

12. Our vision is to give passengers the best airport service in the world. We believe this aligns us with passengers and is thus common ground with our airline customers.
13. The CAA set a significant challenge to Heathrow in its Q6 determination in terms of efficiency - reducing our operational cost base and improving on already outstanding non-aeronautical revenue generation. With focused management, Heathrow is set to perform in line with the CAA determination.
14. Passenger charges are reducing throughout the Q6 period - a reduction of 7.4% in real terms since the beginning of Q6. Meanwhile service quality is increasing on almost every aspect of our performance. We are now the best performing European hub airport according to the Airport Service Quality (ASQ) survey and have won multiple awards from passengers including the Skytrax 'Best Airport in Western Europe 2015' award and ACI's '2015 Europe's Best Airport (over 25 million)'
15. Even with falling prices, Heathrow remains committed to investment – demonstrated by the significant development throughout Q4, Q5 and Q6. In a decade, we have invested £11bn to open two new terminals, new baggage systems and add capacity and new transport links to the airport. We stand ready to continue investing under the right framework.
16. Our airline customers are growing their traffic while achieving stable financial results.

Priorities

17. It is important that regulation enables us to continue to improve our airport service. Understanding consumers' views and integrating them into our business plan outcomes is vital to our success. We agree this is a key priority for H7.
18. Investment in the airport will be required to continue improving service. Regulation in H7 will need to foster this investment by providing a fair, predictable return to shareholders. Due consideration should be given to opportunities to promote cost efficiency and financeability.
19. Regulation should encourage continual improvement without creating a burdensome regime. New regulation can sometimes build on old regulation, creating a more and more complex set of requirements, pressures and commitments for the airport and indeed airlines. This needs to be avoided in H7. This drives our desire for a reformed Constructive Engagement process, an adjusted timeline and continued flexibility regarding expansion.

20. We feel that a key priority for H7 should be the sustainability and community agenda. Airports and aviation can only thrive with the support of local people. The agenda is thus of significance to all airport users and local communities. Its omission from the discussion is surprising given recent CAA statements on its importance, including in their five-year strategic plan.
21. Finally, we consider that a shift towards a more commercial relationship with airlines would benefit all parties. It would likely help to achieve all of the points above by serving passengers, fostering investment and reducing the burden of regulation.
22. We believe that our priorities are broadly aligned with those of the CAA, although there are some clear differences which we address in detail later in this response.
23. The document provides feedback to the CAA's paper and is structured around the four strategic themes. Further consideration is then given to Constructive Engagement, the CAA's proposed timetable – all including the technical appendices. We discuss the sustainability and community agenda in more detail and, separately, consider issues concerned with expansion. Finally, we respond to the CAA's twelve specific questions.

Empowering Consumers

24. Our vision to give passengers the best airport service in the world is best served by high levels of consumer engagement to further understand their needs and wants and ensure they are reflected in our plans.
25. Whilst Heathrow already has high levels of engagement with passengers we agree with the CAA that passenger participation in the regulatory process can be enhanced.
26. We are supportive of the creation of a group that represents consumer interests and involving the CAA's Consumer Panel more than they were in Q6. Further visibility of the CAA's proposals for the Consumer Panel would be welcome.
27. We are also supportive of UKRN's 4 principles for consumer engagement¹. In particular, we believe that a tailored approach is important when designing overall timescales for the H7 process.
28. Cargo is a major activity at Heathrow and we are committed to providing an excellent level of service to cargo operators. We welcome the CAA's intent to better understand the perspective of cargo owners for H7.
29. The CAA states that "given that over 95% of cargo at Heathrow travels in the belly hold of passenger aircraft, we consider that the interests of cargo owners will in many ways be aligned with those of passengers". Heathrow believes more work is required to review this assertion, including getting a closer understanding of the cargo owners' perspectives. Heathrow would encourage the CAA to engage with all parties on this topic.
30. We agree with the CAA that airlines are not always well incentivised to represent consumer interests due to the economic scarcity rent they are able to extract from Heathrow. We feel that a consumer group will ensure these interests are better represented.

Consumer group

31. We agree with the CAA that the establishment of a group to represent consumer interests for the H7 Review is an important recent regulatory innovation. We acknowledge it is increasingly seen as good practice across regulated industries. We have explored examples in other regulated industries to inform our thinking.
32. Heathrow will inaugurate such a group, that we propose calling the Heathrow Consumer Challenge Board (CCB).
33. The primary objective of the CCB is to be a "critical friend" to Heathrow Airport and promote the interests of consumers, in a similar way that the Consumer Panel do for the CAA. The CCB will largely focus on the following key activities:

1. (UKRN state that consumer engagement strategies should be: tailored, inclusive, transparent and developing),

- a. Challenging Heathrow to provide evidence that the interests of consumers are fully accounted for in our H7 business plans.
 - b. Using existing airline and airport research, and gathering intelligence, to understand past consumer experience and inform the right outcomes for future consumers.
 - c. Assuring the CAA from a consumer perspective on the quality of Heathrow's stakeholder engagement activities in developing a high quality business plan.
34. Critical to the CCB being seen as credible by the CAA and the airlines is that they are seen as operating at arm's length from Heathrow Airport. This means it must have the ability to operate transparently with no influence.
35. There are a number of ways to secure that independence. Our proposal is that Heathrow appoints an executive search company to identify a shortlist of suitable candidates for the position of Chair. A Heathrow independent non-executive director would appoint the Chair from this shortlist, supported by an interview panel made up of a senior executive member from the CAA and a senior representative from the airline community.
36. The Chair would be responsible for appointing members to the Board (up to five members), with Heathrow providing HR support. In order to help the Chair appoint members with the appropriate range of skills and experience we will provide guidance in the form of draft terms of reference which will have been reviewed by the CAA and airlines. No employees of the CAA, Heathrow Airport or airline representatives could be a member of the board. We agree with the CAA that it may be appropriate for a member of the Consumer Panel to sit on the CCB.

Conclusion

37. Heathrow welcomes the overall direction of travel towards enhanced consumer focus throughout the regulatory process. This is in the interests of passengers, airline businesses, Heathrow's vision and the CAA's statutory duties. We will establish a CCB and work closely with the CAA to ensure it fulfils its objectives. We will also ensure we further understand the needs of cargo owners and incorporate their views into our business plan.

Incentivising Outcomes

38. Heathrow believes that incentivising the right consumer outcomes is a positive step in airport regulation. Outcomes will better represent what passengers actually want than an overly prescriptive management of inputs.
39. The current Service Quality Rebate and Bonus (“SQRB”) scheme was introduced at a time when service levels were lower and we feel that the concept no longer stands up in the current environment of improved customer satisfaction. Some of the measures are low-level with arbitrary targets that have little bearing on customer preferences. Further, the current scheme has heavily asymmetric penalties and bonuses.
40. We believe the role of the CCB will be vital in helping to create and assure the right set of outcomes, measures and targets.
41. Lots of high quality passenger insight exists already and more is emerging with new consumer tools. We expect the CCB to support the development of further research methods and data creation.
42. It is important that outcome-based regulation is not seen as an ‘add-on’ to the SQRB scheme. Rather, given its merits, we feel it should serve as a replacement for the SQRB scheme. To do otherwise, would lead to less clarity, increased regulatory burden and would not be in the interest of passengers, airlines or the airport.
43. Significant amounts of work are required to set appropriate outcomes and measures and it is important, therefore, that sufficient time is available for:
 - a. The CCB to input into design
 - b. The CAA to describe the mix of research methods it considers valid
 - c. The CAA to determine how much passenger research they expect
 - d. Sufficient research and trials to be undertaken
 - e. Outcomes and measures to be created and agreed.

Conclusion

44. An appropriate set of outcome targets and measures that penalise and reward performance symmetrically and effectively can improve on the current SQRB scheme and provide a more transparent system for consumers. Whilst Heathrow agrees with the CAA that moving to outcome-based regulation will bring benefits, it is imperative that the CAA provide sufficient time to make the change. It is also critical that outcomes are not seen as an ‘add-on’ to the SQRB scheme.

Increasing Airport Operational Resilience

45. Operational resilience is important but needs collaboration and investment, with limited regulatory intervention on airports or airlines.
46. The CAA is right to note that operational resilience is critical to the success of the airport and all stakeholders. Resilience at Heathrow continues to improve thanks to collaborative working on initiatives including APOC, A-CDM, winter resilience, Time Based Separation (a world first), enhanced ILS (a UK first), baggage resilience review and airspace and airfield redesign. This can be evidenced through the number of days where Command and Control functions have been stood-up – reducing from 26 to 10 between 2012 and 2015.
47. Many factors can cause disruption and the impacts vary greatly depending on the type of disruption, the level of interruption and the speed of recovery. Significant work has taken place, with previous recommendations implemented to positive effect.
48. The CAA currently suggests that resilience could be increased through the imposition of licence conditions, revised charging structures or restrictions on airlines' slots through a reduced movement cap. Heathrow does not believe that these approaches are necessary or likely to be particularly effective in increasing operational resilience.
49. These proposed measures are also unlikely to be in the interest of passengers as they could reduce choice and lead to an increase in prices as a result of increased scarcity.
50. It is our belief that airspace redesign is critical to drive significant impact on resilience and we encourage the CAA to pursue this as a priority.
51. There are several other areas that we are already working on and investment will be required during H7 on initiatives including:
 - a. Independent Parallel approach (IPA) which will require investment by NATS/HAL/and airlines plus airspace change, this is underway in Q6 but likely will not complete until H7.
 - b. Target Time of Arrival – we are investing in technology, people and processes to improve demand/capacity balancing in Q6. Key will be for the industry to work collaboratively to improve arrival time performance. This will require a step change in aviation culture supported and promoted by the regulator.
 - c. Airspace Capacity – already in Q6 we are starting to see the effect of limited capacity across the London Terminal Control Area, UK and European ATM network. This is a growing concern for us and our airline customers and is a key risk to resilience and improving performance. The CAA need to drive efforts to improve data sharing amongst stakeholders to support seasonal and in-season planning of airspace to better match demand vs. capacity, particularly in the south east of the UK – this should result in better alignment of plans across NATS, airports, airlines and the European Network Manager.
52. The CAA should review the incentives/licence arrangements of all stakeholders (airlines, handlers, NATS, airports) to improve alignment with the overall resilience objective.

53. Procedure design or procedure change in any guise be it new airspace or current airspace ensures that the capability of the modern aircraft can be fully utilised to improve efficiency

Conclusion

54. Operational resilience is important but regulatory intervention is unlikely to drive significant change in levels of resilience. Airspace redesign is the key tool that will make a significant difference and Heathrow therefore urges the CAA to reconsider its approach.

Promoting Cost Efficiency and Financeability

55. Heathrow agrees with the CAA that RAB-based regulation is likely to be the most appropriate approach to economic regulation for the airport.
56. Heathrow considers that there are opportunities to learn from other regulated sectors on appropriate ways to promote cost efficiency and financeability. However, these must be given very careful consideration and implemented only when their impacts are fully understood and acceptable to investors and passengers.
57. Benchmarking will be a key tool in the H7 process and we believe there are significant lessons to be learnt from Q6. We encourage the CAA to consult on methodological improvements to benchmarking and welcome the early completion of studies to best inform the business planning process.
58. We agree with the CAA that an opportunity also exists to sign off a high quality business plan using a form of 'fast-tracking'. We encourage the CAA to engage further on how this process might work, especially being mindful of the difficulties associated with 'accepting' parts of a business plan but not others. The concept of providing up front guidance is helpful to this aim and Heathrow welcomes the opportunity to discuss the guidance with the CAA. It is important, however, that the CAA strikes the right balance with regulating on outcomes, rather than inputs.
59. We would encourage the CAA to extend this guidance to providing an early view of allowed returns such that investors can be confident that their investment risk will be appropriately rewarded.
60. We agree with the CAA's comments that totex is unlikely to be appropriate for airport regulation, given the lack of capex bias at Heathrow. We understand the benefits in other sectors and also agree that the implementation of an untested approach in the event of expansion would introduce undue risk.
61. Heathrow is not at all clear on the perceived benefits of pain and gain share mechanisms to consumers. Again, there may be some benefit in other regulated sectors but it is not clear that this applies to airports. We do, however, fully support a move to more commercial arrangements with airlines as previously mentioned.
62. We support the CAA's thoughts on exploring opportunities to fund innovative projects. We believe this may be particularly appropriate for environmental and community projects, where there is clear consumer benefit but where it may not be possible to secure airline support – especially given that the project may have impacts on their operation and provide no additional revenue. The airport will, in most circumstances, find itself in the same position. However, these projects are often the right thing to do for both current and future consumers. Given the long-term nature of such projects, it is possible that some form of innovation fund or rolling incentive mechanism could provide the required motivation to proceed where otherwise the project might falter.
63. The CAA has a duty to have regard to Heathrow's ability to finance the operation and development of the airport. This is a critical component of the CAA's primary duty to further the interests of present and future passengers.

64. This means that the H7 price cap (in terms of both the level, the financial mechanisms that underlie it, and the allocation of risk²) must provide Heathrow with the ability to raise debt and equity finance. As in Q6, the CAA will need to ensure that Heathrow can maintain an investment grade credit rating, robust to reasonable downside shocks, whilst also providing sufficient incentive for equity investors given the level of risk that they face.
65. This last element – the incentive for equity investors given the level of risk – was lacking in the Q6 settlement. It will need to be carefully considered for H7. We have no objection to the overall framework that the CAA use to determine Heathrow’s WACC but we do have concerns that the way the CAA calibrates the inputs into WACC do not capture the true nature and risks faced by Heathrow. Whilst the purpose of this consultation is not to get into details of the WACC calculation, we do need to clearly trail the importance of ensuring the H7 WACC is set at the right level.
66. The CAA raise a number of important issues in this chapter of the Consultation Document, most notably whether to switch to a CPI inflation measure, and treatment of the cost of debt. We address these below.

CPI inflation

67. The RPI ceased to be a national statistic in 2013 and was replaced as the primary UK inflation measure by the CPI which is now used for inflation targeting by the Bank of England. The RPI is still published by the ONS and remains the basis for calculating capital growth and coupons on all UK government index linked gilts. The UK’s Debt Management Office (DMO) has no current plans to issue CPI linked gilts.
68. Within Heathrow’s regulatory settlement, the RPI is used in two ways:
 - a. First, it is used to express operational costs and commercial revenues in real terms, and features in the “RPI-X” price cap formula. Since operational cost and revenue forecasts should be made on the basis of the true underlying cost drivers it makes no difference whether they are subsequently expressed in either RPI or CPI terms, provided that the resultant “X” value is also calculated consistently against either RPI or CPI. This is what the CAA has already done in relation to the NATS price control;
 - b. Secondly, the RPI is used to revalue the RAB, and (consistently with this) as the basis against which the WACC is calculated in real terms. The choice of RPI or CPI will have serious implications for the RAB and WACC. Moving to CPI indexation for the RAB will reduce the long term growth in capital value. Counterbalancing this, the CPI based real WACC will be higher than the RPI based real WACC. There will almost certainly need to be an immediate upward P0 adjustment to prices to correct for the higher WACC.

2. Such as adjustments to the price cap formulae, indexation of the RAB, and any risk sharing mechanisms.

69. An immediate transition from RPI to CPI will have two problems:
- a. First, a substantial P0 adjustment will be required. The CAA should consider very carefully whether it would be in passenger interests to move immediately to CPI indexation if the consequence of this would be an immediate increase in prices;
 - b. Second, Heathrow would have a mismatch between a CPI based RAB, and an RPI based bond and derivative portfolio. As discussed above, the UK's DMO at present has no plans to issue CPI, and until this happens a liquid market in CPI based bonds and derivatives will not develop.
70. We propose that the CAA should refrain from making any changes to RAB indexation until the DMO states a definite plan for the issuing of CPI indexed gilts. This will ensure that there is a liquid market into which Heathrow can issue new CPI indexed financial instruments.
71. In the interim the CAA can adopt the same approach as used for NATS whereby revenue and opex projections are made relative to CPI, and the price cap expressed in terms of CPI-X, but RPI is retained for RAB indexation. If and when the DMO publishes plans to issue CPI indexed debt, consideration can be given to begin to index the RAB by CPI in respect of new capex (with a corresponding CPI based WACC for this element of the RAB).

Cost of debt

72. The Consultation Document suggests that in light of the potential for Heathrow to incur significant amounts of new debt in the coming years, it will be appropriate to re-examine mechanisms that match revenue to actual cost of debt as it is incurred.
73. In previous quinquennia the real cost of debt has been determined at a fixed amount within the regulatory settlement, set at a weighted average of the cost of embedded debt, and the expected cost of new debt over the forthcoming period. In Q6 this weighting was 70:30 respectively. We see no reason to alter this provided that new debt remains at around 30% of total debt (since it is only new debt that exposes the company to risk).
74. Ofgem (in the context of an 8-year price control) has linked the cost of debt for energy distribution and transmission companies to an index derived from iBoxx indices and "break-even" inflation expectation derived from index linked and nominal gilt yields. Unfortunately, analysis of historical returns shows that this index does not fit well to Heathrow corporate debt yields, especially around 2009 when the company was in negotiation with the DfT around potential special administration license clauses (See Figure 1). It is easy to imagine analogous situations arising during discussion on Heathrow expansion when, for a considerable period of time, Heathrow's debt yields disconnect from market indices.

WACC guide ranges

75. The Consultation Document suggests that the details of Heathrow's WACC will be set out at a later stage in the H7 process. Although we understand that the final WACC will not be determined until later in the process, we see material benefit in the CAA providing guidance on the possible range for WACC at an earlier stage. This will greatly assist discussion (including Constructive Engagement with airlines, and review by the Consumer Challenge Board) on other building block elements – especially the capex programme. The ability of the airport to invest, and the appetite of the airlines to support investment, will depend on the range within which WACC is likely to be determined.

Conclusion

76. Investment is required to continue improving service. Regulation in H7 will need to foster this investment by providing a fair, predictable return to shareholders. Heathrow does need to reduce costs and drive efficiency. We also need to take opportunities to improve financeability. We encourage the CAA to provide upfront guidance on allowed returns (or key parts of the WACC calculation) so that investors can plan appropriately for the level of risk being rewarded. We are keen to discuss suitable risk allocation mechanisms with the CAA and airlines. We believe the price cap can be expressed as a CPI-X cap from the beginning of H7 subject to the CAA adopting an appropriate solution. As and when the government makes a decision in favour of Heathrow expansion, we will need to explore an appropriate cost of debt mechanism with the CAA.

Constructive Engagement

77. Constructive Engagement (CE) during the Q6 process worked well in some areas. We are keen to see it evolve to be of even greater value in H7. We felt that engagement on areas including a joint airport vision, capex and demand forecasting worked extremely well in creating common understanding and an opportunity to share ideas on strategic improvements. In these work streams the conversations were focused on key topics, with work completed between periodic review meetings over a relatively short total duration.
78. We consider that if all areas of CE followed a similar process then it could generate significant value. Our desire is for a more focused, higher level, shorter engagement. We envisage an Executive Committee level kick-off and periodic reviews with short working periods in between. The whole process could be completed in three to four months. This should leave real time for formal airline community consultation. It will reduce the process burden for Heathrow and airlines while sharpening decision making and thus accountability.
79. Engagement on Capital with the airline community is an ongoing, business-as-usual process. There are still a number of areas in Q6 where the exact solutions are to be determined. It is natural to develop a continual stream of projects rather than cut them into 5-year blocks. As such, we feel the initial business plan may be too early to specify a detailed capital plan made up entirely of specific business cases. We propose to describe the investment by strategic programmes and benefit categories.
80. We feel that it is important to include consumers in this process. It is also critical that the CCB remain independent and must not be tied to the output of CE. As such, whilst the CCB would probably not have a direct role in the CE process, we imagine that they would observe, contribute where necessary and submit a report on its effectiveness.
81. The CAA's operating principles³ for CE in H7 are appropriate and provide a firm basis on which to undertake CE.
82. With regard to the CAA's proposed options to strengthen CE, we have the following observations:
 - a. Clarity around the timescale for CE is critical and, as discussed, we believe there is an opportunity to improve the process by significantly shortening it to increase effectiveness. We discuss the proposed timetable in more detail in the following section.
 - b. There is potential value in reducing the scope of CE and we remain open to discussions on this point. In either case, we believe it is important to make CE more strategic and focused than it was in Q6.

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3. The CAA's operating principles are: Consumer-focused; Accountability; Transparency; Collaboration; No surprises; Dispute resolution

- c. We believe that integration of different work streams is key to success and that our proposal will help to achieve this by bringing regular Executive level scrutiny to the process.
- d. We do not see any value in terminal level CE. Whilst each terminal is different, the requirement for airlines to switch between terminals as required makes this idea ineffective. It is entirely possible that a given airline would be heavily involved in CE in one terminal, only to have reason to require a terminal move before or during H7.
- e. New runway capacity will certainly need significant separate negotiation. We do not consider this to be part of standard H7 CE and would expect the entire process to require a change in scope, size, timing and direction if the government decision supports Heathrow expansion.
- f. We feel that, similar to the CCB, the CAA would best serve the process in an observing role with contributions as necessary.
- g. As discussed previously, we see value in commercial negotiations and will be encouraging airlines to engage with us on a bilateral or multilateral basis.

Conclusion

83. Constructive Engagement should have an important role in the H7 process. We believe that it should be shorter, more focused and engage at a higher level than it has previously to have the greatest impact. We believe that both consumers and the CAA should be involved in the process; primarily in an observing role but with the remit to input as required. Particularly in the case of consumers, it is important that the CCB remain independent and able to comment freely after the event.

H7 Timetable

84. Setting the correct timetable for the H7 process will be critical to ensuring the process runs effectively and successfully. The most critical factor relating to the timetable is flexibility with regard to expansion. Whilst it is unclear when a government decision will emerge and the outcome is uncertain, a decision in favour of Heathrow expansion is likely to require significant changes to the proposed timeline. We believe it is unlikely that we could progress with a business plan of appropriate quality for a three-runway scenario within the timings required to allow a 10-month CAA-led delivery phase. We therefore welcome the CAA's suggestion that an extension to Q6 might seem the most appropriate way to deal with a capacity decision. Any extension will clearly require significant consultation in and of itself. We would expect the extension process to be relatively light-touch, allowing all parties to focus fully on the work required towards successfully gaining planning consent and designing the associated regulatory architecture.
85. In a two-runway scenario, Heathrow believes that there are significant opportunities to improve the proposed timetable. Further, we feel that some change is necessary to provide sufficient opportunity to fulfil the objectives of consumer engagement, allow publication of a high quality business plan and run an effective constructive engagement process.
86. We support the overall order of events, namely:
 - a. Seminars, benchmarking and consumer engagement
 - b. Publication of our first business plan
 - c. Constructive Engagement
 - d. Publication of our second business plan
 - e. CAA delivery
87. Heathrow is supportive of the CAA running seminars to help all parties better understand the CAA's current thinking and vice versa to support the CAA's policy update. Equally, benchmarking is a critical input to business planning and consumer engagement. It is therefore important that the CCB and the airport have sufficient time to take account of the outputs of the CAA's new policy and the benchmarking work (currently expected in October 2016) in our business plan.
88. Furthermore, and given the importance of their role, we believe it is vital that the CCB have enough time to influence our passenger research and associated consumer-focused outcomes. The CCB is unlikely to be established before the summer of 2016. It may also take some time to get to grips with the various airport issues.
89. As such, we believe that the quality of our first business plan will be compromised if the CAA require submission in January 2017. Rather, we recommend delaying publication of the first business plan to June 2017.
90. This would be followed by a formal Constructive Engagement of three to four months to allow airlines to scrutinise and challenge the business plan. At the end of this process,

we would have three months to revise our plan, taking into account feedback from CE and gaining assurance from the CCB that our new plan is developed appropriately according to consumer interest.

91. This would allow the CAA-led delivery phase to begin in November 2017, leading to final proposals in June 2018 and statutory notice published in September 2018.

Conclusion

92. Heathrow believes that flexibility with regard to expansion is critical and that an extension to Q6 may be the most appropriate way to deal with a decision in Heathrow's favour. We also believe there are opportunities to improve on the CAA's proposal in a two-runway scenario, including delaying the first business plan to June 2017, shortening constructive engagement and leaving time for a second business plan and the CAA-led delivery.

Sustainability Leadership

93. The CAA has a clear environmental strategy which aligns well with Heathrow's own sustainability vision. The CAA's strategy is focussed on the impacts from aircraft but also acknowledges the environmental impacts associated with airport operations.
94. Heathrow has developed a sustainability vision which will see the company take a leadership position on all aspects of sustainability; across the environmental, the social and the economic aspects of the business.
95. The overarching sustainability vision is centred on delivering better quality of life for our communities. We are very aware of our place in the community and our ability to achieve and influence more sustainable operations. As a company we intend to convert our strong Q5 and Q6 track record in addressing the environmental, social and economic aspects of Heathrow into a leadership position.
96. The detailed plan underpinning the vision is currently in development but will become finalised later in 2016. The working draft presents four outcomes that the Sustainability vision will drive over the coming years. These are ensuring Heathrow is:
 - a. A Great place to live
 - b. A Great place to work
 - c. Supporting economic prosperity
 - d. Making flight sustainable
97. Sitting beneath the outcomes are a number of specific goals that we will pursue throughout our business and with relevant partner organisations.
98. We have identified many aspects of this sustainability vision that will touch passengers and we are aware of the potential to further improve the passenger experience. We know our passengers increasingly expect businesses to operate more sustainably and by taking a leadership position we will be able to reassure passengers that the impacts of their journey are being mitigated.
99. Realising this ambition through H7 and beyond will require partnerships with stakeholders across the airport the surrounding communities and beyond. We will also need support from the CAA and our airlines to make the vision a reality.
100. The sustainability strategy will need to be aligned with and supported by the regulatory framework to ensure that the investment required to achieve the outcomes is available to Heathrow. The regulatory framework will need to consider how to incentivise investments in H7 that would primarily generate environmental benefits. It is also possible that not all benefits materialise in H7.

Conclusion

101. We think that a number of the CAA's initiatives could be explored to support Heathrow's sustainability ambition, including outcome based regulation, innovation or the introduction of the CCB. We look forward to sharing the finalised sustainability plan for

Heathrow and working with the CAA, our airlines and passengers to ensure Heathrow can become a respected sustainability leader.

Airport expansion

102. Airport expansion will raise a number of new economic regulation issues for the CAA to consider generally associated with the length of the control period and risk allocation.

Duration of the price control

103. The CAA's Consultation Document correctly notes that the Aviation Act 2012 allows for flexibility in determining the length of price control periods and these may change from one settlement period to another. The duration of the price control is likely to be a particularly important issue if Heathrow is selected by the government for runway capacity expansion.

104. In the event of airport expansion, we suggest that the CAA allows certain elements of the H7 price control (particularly the mechanisms for determining the costs of equity and debt within the WACC calculation) to be set for longer periods of time consistent with the longer lead times for airport expansion investment. This also increases predictability for airlines. The details of how such mechanisms would work can be discussed when more information is available concerning the likelihood and timelines for Heathrow expansion. However, we do not necessarily advocate extension of the overall price control period – fixing the absolute price cap for a period of longer than 5 years could introduce significant risk.

Risk allocation mechanisms

105. In the event that Heathrow is chosen for expansion, the risk profile to investors will change dramatically. In particular, new sources of risk will be outside the control of the airport, most noticeably demand risk and political risk of withdrawal of government support.

106. In the event of airport expansion, we are keen to discuss suitable risk allocation mechanisms with the CAA and airlines (including how each party is compensated for taking on risk), in order to develop an optimal solution that incentivises efficient use of any new capacity, and allocates risk to those that are best able to manage that risk.

107. In addition, a change of approach could also be considered to the treatment of the cost of debt, if the implication of expansion were that new debt were expected to rise to exceed 50% of total debt – and especially if the period for setting WACC were to be extended. In this case it will be necessary to explore possibilities for a dynamic mechanism for setting the cost of debt. However, for reasons stated in the 'Cost of Debt' section, we believe that a pure indexing approach will not capture the specific risks of Heathrow's actual cost of debt. As and when the government makes a decision in favour of Heathrow expansion, we will need to explore an appropriate cost of debt mechanism with the CAA.

Annexe 1 - Answers to CAA's Specific Questions

108. Our high level answers to the following questions should be considered in conjunction with our full response document.

1. Do you agree that there has not been, or likely to be, a material change of circumstances to require a new MPD for Heathrow before January 2019?
 - a. Whilst there has not been a material change of circumstances recently, we believe the previous MPD had serious shortcomings. The CAA's latest MPD guidelines are significantly lacking and we have responded to the associated consultation accordingly.
 - b. We might expect any expansion decision to create a material change in circumstances.
2. How best can the CAA proceed with the H7 programme given the uncertainty about new runway capacity?
 - a. The H7 programme should proceed as planned (subject to our recommendations on overall timeline) and remain flexible with regard to expansion. We believe an extension to Q6 is likely to provide the greatest opportunity for flexibility.
3. Is there a case for the CAA to consider extending the current Q6 arrangements until there is a higher level of certainty over the runway developments?
 - a. Assuming that the CAA adopt a similar approach to the one taken for the Q5 extension there could be significant value in creating greater certainty. However, there would be no benefit in an extension if it led to a complete re-working of the major building blocks - we would expect the process to be relatively light-touch, allowing all parties to focus fully on the work required towards successfully gaining planning consent and designing the associated regulatory architecture for expansion.
4. Do you agree with the proposed strategic themes for H7?
 - a. We agree with the overall sentiment of the strategic themes. All are important objectives for H7. We do not agree with some of the detail within certain themes (e.g. licence conditions to improve resilience)
 - b. We believe the CAA should go further in some of its objectives (e.g. consumer focus) and we would encourage the CAA to ensure that regulation serves passengers, airlines and the airport – not the other way round.
 - c. We believe it is important to foster investment with a predictable return and would like to see the CAA making it a priority to reduce the burden of the regulatory process to all parties.
5. How can consumer engagement throughout the H7 process be improved?
 - a. A Consumer Challenge Board (CCB) will support the development of consumer-focused outcomes by scrutinising and challenging the business plan. The CCB should be involved in Constructive Engagement and beyond to assure delivery of our plans.
 - b. There is also scope to include the extensive and increasingly innovative sources of passenger insight used by airlines, Heathrow and others.

6. Are the CAA's proposed steps (see Box 2) sufficient to ensure that consumers' interests are at the heart of the H7 programme?
 - a. We believe the CAA could go much further in developing the role of consumers, as described above.

7. Do you agree in principle that the CAA should look to move toward more outcomes-based regulation and to what extent should this complement or replace the existing SQRB scheme?
 - a. Yes, we agree that outcomes will better represent what passengers actually want and that the CCB and airlines will provide assurance that we have the right outcomes. We consider that outcomes should lead to a wholesale replacement of the SQRB scheme – although there may be some similarities. Simplification is the key to successful introduction of outcomes.

8. How can the licence regime improve airport operational resilience and mitigate disruption?
 - a. Increasing operational resilience is important but needs collaboration and investment, not more regulatory intervention. Resilience continues to improve thanks to collaborative working on initiatives including; APOC, A-CDM, winter resilience, baggage resilience review, Demand & Capacity Cell, airspace and airfield redesign.
 - b. This should not be done through licence conditions or restrictions on airlines' slots through a reduced movement cap.
 - c. Airspace change is the biggest opportunity for reliability and resilience and it needs CAA focus and leadership.

9. Do you support our broad approach to promoting efficiency and financeability and do you agree that the specific issues raised (CPI v RPI, debt indexation, etc.) are relevant for this review?
 - a. Cost efficiency and financeability are critical to H7 success. We believe it is important to foster investment with a predictable return. Investment has driven major improvements for passengers but our view is that the regulated WACC of 5.35% in Q6 does not reflect the actual level of risk taken by the shareholders.
 - b. It is important that benchmarking is timely, appropriate and accurate
 - c. The RAB / WACC model works well.
 - d. We see merit in discussing specific issues in cost of debt and CPI.

10. Do you agree in principle with the continued use of Constructive Engagement and do you have any observations on how the process might be improved?
 - a. CE worked well in Q6 for topics including Capex and Forecasting, whilst some other areas were too detailed, too long and too combative. We would welcome a more focused, higher level, shorter engagement. We could envisage Exec level kick-off and periodic review, short working periods for 3 or 4 months' total duration.
 - b. Consumers should be involved to ensure representation throughout the H7 process.

11. Do you agree with the proposed timetable for the review?
 - a. We believe the timetable can be improved by giving more time for benchmarking and consumer input to the business plan.

- b. We want to deliver a high quality business plan first time which means that the timetable may need some adjustment to optimise the process. Flexibility with regard to expansion is critical.
- c. We feel a shorter Constructive Engagement process would ensure higher quality, more focused discussions.

12. Are there any other issues you consider material to the H7 review?

- a. We consider Environment and Community to be a key objective for H7 – the lack of any mention by the CAA is surprising.
- b. It is critical that the CAA focus on ensuring that regulation serves passengers, airlines and the airport – not the other way round.
- c. We believe it is important to foster investment with a predictable return.
- d. We would like to see the CAA prioritising reducing the burden of the regulatory process to all parties.
- e. We believe there are sufficient incentives on delivery and performance without introducing pain/gain share mechanisms.
- f. In 2018 Crossrail will commence service to Heathrow Airport. The commencement of this service places certain obligations on Heathrow. The ORR is reviewing Heathrow's proposals and we hope to have a definitive view about the level and structure of the TAC in summer 2016. As we have already discussed with the CAA and airlines, we are proposing that any resulting TAC would be another income stream into the single till for the H7 price determination.