

# Economic regulation of capacity expansion at Heathrow: policy update and consultation - CAP1782

## Heathrow's response

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# Contents

Executive summary .....	3
Reducing regulatory uncertainty to deliver expansion.....	5
Approach to Financeability .....	9
Incorporating financeability throughout the price control .....	9
Capital structure and gearing .....	11
Financeability testing .....	12
Financeability adjustments.....	14
Incentives for capital expenditure efficiency.....	15
Promoting economy and efficiency .....	21
The need for an efficiency condition.....	21
The drafting of a condition .....	22
The implementation of the condition .....	25
Alternative delivery arrangements .....	25
Appendix 1: Longer term regulatory certainty .....	29
Appendix 2: Proposed text of an economy and efficiency condition.....	32

## Executive summary

1. Expanding Heathrow is a once in a generation opportunity for consumers and the UK. The Department for Transport (DfT) estimates that expanding Heathrow will generate £68 billion<sup>1</sup> in benefit for consumers through lower fares driven by increased competition and choice as existing and new airlines can grow their operations at an expanded Heathrow. Latest analysis shows this could reduce consumer ticket prices by £34 for short haul return flights and £217 for long haul return flights<sup>2</sup>. An opportunity such as that demands commitment and timely action from all those involved in aviation.
2. We cannot underestimate the complexities of delivery. Heathrow is being challenged by the Secretary of State (SoS) to bring in a new runway by 2026, with consent achieved by 2021, while maintaining airport charges close to 2016 levels in real terms. All of that is to be fully privately funded. As with any major infrastructure project, this requires extensive planning, iteration and engagement. Heathrow is working to deliver one of the most complex planning applications and construction programmes in the UK. We are doing this while operating the busiest hub airport in Europe with record numbers of passengers who are reporting an unprecedented level of satisfaction.
3. Heathrow is working towards meeting the SoS challenges in terms of delivering a timely, affordable and financeable expansion. But we cannot do this alone. Gaps in the basic elements of the regulatory framework for expansion help no one, particularly consumers. The CAA also needs to consider all the risks that come with a complex, multi-decade infrastructure programme and provide the regulatory certainty required to deliver expansion. Recent UK experience shows that too many complex constraints, locked in too early or failing to make decisions conscious of the need for long term financing, can lead to costs, delays and poor results in years to come.
4. While the CAP1782 consultation advances the CAA's thinking on the economic regulation of capacity expansion at Heathrow, much remains to be done. We are concerned about slippage in the CAA's timetable for developing the regulatory framework. Throughout the remainder of 2019, and ahead of the submission of Heathrow's Initial H7 Business Plan, the CAA should focus on providing regulatory certainty by confirming the fundamental elements of the regulatory framework for Heathrow expansion. This does not need detailed numbers with false precision. Nor does it need high-level general concepts. It needs a pragmatic, coherent and comprehensive framework in sufficient, well-considered depth to provide clarity for all involved including, consumers, airlines and investors.
5. To be specific we are asking the CAA to resolve the most pressing issues to provide a clear line of sight of where the regulatory framework for Heathrow expansion is heading. This includes further clarity and decisions on:
  - a. Quantifying the benefits to consumers of Heathrow Expansion
  - b. A policy determination for Category B costs above £265m and pre-DCO Category C costs
  - c. A policy determination for surface access contributions

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

<sup>2</sup> Annex 1: Estimating the congestion premium at Heathrow, Frontier Economics

- d. Providing longer term regulatory certainty and the methodology to assess the risk premium associated with expansion
  - e. Providing clarity on process for H7, including confirming the detailed timetable for the H7 review
  - f. Undertaking a thorough analysis of the implications of different capital expenditure efficiency incentives on affordability, financeability and deliverability
  - g. Exploring some further opportunities for regulatory changes to advance consumer interests and drive affordability, such as commercial models for property developments
6. Financeability cannot be taken for granted. The starting point for financeability is recognising the nature and scale of Heathrow expansion. The CAA should set an A- credit rating for H7. The CAA must also urgently seek genuine market participant advice on what private financing on the scale needed will require. We welcome that the CAA is intending to take a holistic approach that takes into account how incentives in the regulatory framework affect financing.
  7. Changes to the incentives framework including the introduction of ex-ante incentives makes for a riskier regulatory framework against the background of a fundamentally riskier investment. The CAA needs to consider how to reflect this increased risk in the WACC and, consequently, how this will impact affordability and Heathrow's ability to meet the SoS's challenges. Heathrow has significant concerns regarding the analysis carried out by the CAA's consultant's, CEPA. Much of it is naïve and conceptual. The CAA needs to assess the value of the existing incentives framework against the scenarios developed by CEPA. Again, it also needs to avail itself of experienced advice from across the construction industry.
  8. The CAA has still not demonstrated the need for a general licence condition to promote economy and efficiency. Nor does it explain why the flexibility within the current licence is not sufficient for the CAA to fulfil its primary duty to consumers. Although further work is required by the CAA to demonstrate whether a general licence condition is required, Heathrow will work with the CAA on the drafting of a potential licence condition should it be implemented.
  9. The CAA notes that the DfT considers that Heathrow is the only credible promoter of Heathrow expansion. We therefore invite the CAA to formally recognise Heathrow as the only credible promoter and to focus all its efforts and resources on Heathrow's H7 regulatory framework for the benefit of consumers.
  10. Heathrow's response is structured around the CAP1782 chapters. We are happy to engage with the CAA on any areas contained within this response.

## Reducing regulatory uncertainty to deliver expansion

11. The complexity of delivering Heathrow expansion cannot be underestimated. Heathrow is working to deliver one of the most complex planning applications and construction programmes in the UK. Heathrow has been given a clear challenge by the SoS to open the runway in 2026, to submit a development consent order (DCO) in 2021, to open the runway for £14 billion (2014 prices), and to aim for close to 2016 charges in real terms. As with any major infrastructure project, this requires extensive planning, iteration and engagement.
12. Heathrow has achieved significant progress on the challenges that we have been set since the CAA reported to the DfT in September 2018, including:
  - a. Completing the M3c gateway. The M3c gateway gave us the first masterplan tested for National Policy Statement (NPS) compliance and DCO consent. M3c presented a capital expenditure challenge. We responded to that ahead of M4 entry by exploring and challenging all levers, to ensure runway opening can be delivered for £14 billion by 2026 (2014 prices).
  - b. Agreeing a draft preferred masterplan at M4. At M4 entry in February 2019 our draft preferred masterplan achieves runway opening for £14 billion (2014 prices) in 2026 and balances the, sometimes competing, requirements of stakeholders in a way that we believe would meet the requirements of the NPS against which our DCO application will be assessed.
  - c. Developing capital estimates for the draft preferred masterplan using robust methodology and benchmarks assured by the Independent Fund Surveyor (IFS). The IFS has also undertaken a detailed review and 'stress test' of the estimate produced. The IFS has concluded that the estimates produced appropriately reflect the scope of the scheme and the budget is realistic.
13. We are also focused on achieving planning consent in 2021 and delivering runway opening by 2026 to ensure that benefits to consumers are delivered as soon as practicably possible.
  - a. Heathrow and the airlines have invested considerable resources in the evaluation process and engagement from M3c to M4 entry.
  - b. M4 entry was the pivotal point where we established a draft preferred masterplan which could be evaluated and scrutinised by airlines leading onto M4 exit. This becomes the basis for a preferred masterplan for the statutory Airport Expansion consultation in June 2019.
  - c. Following that, we will have a further masterplan gateway (M5) ahead of a DCO submission.
  - d. Our Initial Business Plan will be the first opportunity to bring together the financial impacts of the programme in a more holistic way, based on the draft preferred masterplan emerging at M4.
14. Heathrow is making progress, but we won't be able to continue to progress with expansion at pace in isolation. We need CAA policy to enable us to deliver an expansion plan that meets the SoS' challenge. The CAA's support involves providing certainty on the following instrumental parts of the regulatory framework:

**a. Quantifying the benefits to consumers of Heathrow expansion**

- i. Heathrow has consistently argued that the CAA's decisions should be supported by a robust set of evidence and analysis. The CAA needs a quantified understanding of the consumer benefits of expansion. Without such an understanding it cannot be definitive on the boundaries of affordability, nor address questions such as the value of when new capacity is delivered. This understanding is key to inform its decision making, making sure that it is consistent with its primary duty to consumers.
- ii. The real prize of expansion is generating the much-needed capacity that will remove the current costs borne by consumers, caused by capacity constraints. Expansion will allow airlines to compete away these costs with new services and lower fares in an unconstrained market.
- iii. Heathrow is submitting further evidence from Frontier Economics to the CAA on the benefits to consumers of Heathrow expansion. These also address the findings and recommendations from the FTI Consulting review of previous evidence<sup>3</sup>. The analysis uses a range of approaches in addition to econometric analysis to assess the current 'congestion premium' that is paid by consumers. The report shows that there is clear evidence that the congestion premium in 2018 was in the order of £2 billion, equivalent to an average premium on tickets of 25%<sup>4</sup>.
- iv. Heathrow urges the CAA to provide a formal policy position in this area. This would support the CAA's work on developing a regulatory framework for expansion that allows the main consumer benefits of expansion to be fully delivered. The CAA should build on the work developed by FTI and the paper that we are submitting developed by Frontier Economics. We stand ready to engage with the CAA on this.

**b. A policy determination for Category B costs above £265m and pre-DCO Category C costs**

- i. To achieve runway opening in 2026 we rely on activities on the critical path being carried out ahead of DCO consent i.e. pre-DCO Category C investment. We have provided a detailed forecast that, including risk, this investment could total up to £2.8 billion by 2022. This spend is part of the £14 billion – it is a matter of timing only and does not change the overall total costs. Without it, there is no way to deliver the schedule and thus realise the consumer benefit from runway opening in 2026.
- ii. To invest such a sum to progress these activities within the critical path, we need to understand how the CAA will regulate them. Absent regulatory certainty, no rational company would commit to the significant sums involved within pre-DCO category C costs. While the CAA has previously outlined elements of its thinking in support of this investment, all parties

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<sup>3</sup> Annex 1: Estimating the congestion premium at Heathrow, Frontier Economics

<sup>4</sup> Ibid

need full clarity by September 2019 if we are to maintain the schedule and meet the expectations of local communities.

- iii. Given that economic regulation should aim to mimic competitive market behaviours, it is important to understand what would happen in an unregulated market. If Heathrow was to be unregulated, it would aim to secure the development of expansion as soon as practicably possible in order to meet unsatisfied demand, provided the investment would generate returns in line with the risks investors would take. Equally, Heathrow would be able to price its activities in line with current<sup>5</sup> and future consumers' willingness to pay.
- iv. In today's context, Heathrow is aiming to meet the unsatisfied demand by developing expansion as prescribed by the SoS, but without the ability to define the ultimate airport charge for consumers. Absent this ability, the CAA should intervene by making regulatory determinations that provide the certainty required on how investment is going to be treated, and therefore facilitating the outcome one would expect in an unregulated market.
- v. Spend is also continuing to achieve the DCO itself. We understand the CAA will soon consult on changes to treatment of these Category B costs. Heathrow has provided an independent review illustrating the reasonableness of the forecast Category B Cost spend. We need the CAA to resolve any remaining uncertainty on this investment, and to do so in a way which ensures the recovery of efficiently incurred costs, so as to foster delivering new capacity in a timely way for consumer benefit, as would be seen under market conditions.

**c. A policy determination for surface access contributions**

- i. We are still seeking a finalised surface access policy, despite this being a topic in numerous CAA consultations. Although the CAA's October 2018 consultation set out proposed wording to update the policy, the consultation on this wording has not yet been drawn to a close.
- ii. While we understand that the CAA will not be proposing changes to the main principles of the policy, we have repeatedly stated that a final policy is necessary for Heathrow to engage effectively with stakeholders on our surface access strategy. Without a finalised policy, we face questions from stakeholders regarding our ability to make commitments or to take decisions on surface access matters. Heading into our Airport Expansion consultation in June, it is becoming even more important to ensure that we have a firm policy basis on which we can engage with stakeholders in order to give confidence about our ability to deliver. Holding back on a firm policy for surface access, risks delaying long-term improvements for consumers in how they reach the airport as well as affecting how we are able to deliver wider airport expansion.

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<sup>5</sup> In a competitive market, current unmet demand would enable Heathrow to increase current charges to fund expansion

- iii. Added to this is the current discussion regarding Heathrow's contribution to the Western Rail scheme. It has always been the case that delivery of the scheme is dependent on a suitable contribution being made by Heathrow, a factor that was discussed by the CAA as part of the Q6 review. In line with the CAA's draft surface access policy, we are currently working internally and with the DfT to establish the appropriate level of contribution. It is imperative that the CAA implements its policy as set out in its April letter, once we have sufficient information regarding the contribution the DfT is requesting.

**d. Providing longer term regulatory certainty and the methodology to assess the risk premium associated with expansion**

- i. We reiterate the key points of our response to CAP1762. This is a priority area for ensuring Heathrow can expand with private financing. Heathrow's expansion plan over the next decade or more is not business as usual investment. It involves committing very large funds for a long period at higher risk than the existing business. The regulatory framework needs to adapt to reflect the characteristics and risks associated with this reality.
- ii. Heathrow and its investors need to understand the characteristics of the regulatory framework for delivering expansion over the next 15 years, including how risks are allocated and compensated, and more importantly than ever, how long the regulatory framework and associated return is going to be in place for. Longevity is particularly critical given the desire to smooth charges over a longer period and in response to the affordability challenge.
- iii. Heathrow thus formally requests the CAA to significantly advance its thinking regarding the methodology to quantify the risks associated with expansion, as the CAA outlined in CAP1762, so that in its October consultation the CAA can provide meaningful insight and assurance to investors.
- iv. In addition, Heathrow formally requests the CAA to investigate options for ensuring that a predictable and stable regulatory framework is in place throughout the development, delivery and early operation of expansion, in outline terms for the next 15 years<sup>6</sup>.

**e. Providing clarity on process for H7**

- i. Regulatory certainty is generated not only by developing the regulatory framework in a timely manner, but through delivering against a planned programme of activities.
- ii. It is important that the CAA operates to a coherent and deliverable plan to define the H7 regulatory framework. The CAA should stick to its plan throughout the different phases of the process unless significant changes outside of the CAA's control take place. We have consistently discussed with the CAA that there will never be perfect alignment between the

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<sup>6</sup> For a further discussion refer to Appendix 1

regulatory timetable and the expansion timetable. This is however not an argument for not providing clarity on the regulatory timetable. Heathrow believes that any relative lack of alignment between both timetables can be solved by defining a regulatory framework that is flexible enough to react to changes in Heathrow's environment – whether they are before or after the start of H7 in 2022.

iii. We request that the CAA:

1. Sticks to the workstreams defined in CAP1762 and achieves significant progress on them ahead of the October consultation. In addition, we request the CAA works to achieve progress on all the areas outlined above ahead of the October consultation. We are open to engaging on any of the workstreams defined by the CAA.
2. Defines a clear and deliverable timetable for the H7 decision that incorporates the industry feedback regarding the need for Heathrow to develop a Final Business Plan in 2020, in addition to the Initial Business Plan.
3. Avoids delays in the publication of consultations and/or working papers relative to the CAA's own timetable of publications. In particular when these are critical to providing regulatory certainty. Lately the CAA has delayed important consultations such as financial resilience, cost of debt indexation, H7 timetable, pre-DCO Category C costs and surface access policy decision.
4. Ensures that it is making the most of the work it is commissioning from third parties. It is notable for example that the CAA is redeveloping a model to define the H7 decision with Grant Thornton. Only 2 years ago PWC developed a model to achieve a very similar outcome, if not the same one. Equally, we have on a number of occasions challenged the quality of the work developed by PWC when advising the CAA on WACC related matters. The CAA does not appear to be taking this feedback onboard, nor insisting its advisors address these issues substantively. This leaves us with ongoing concerns about the independent work underpinning the CAA's analysis.

## Approach to Financeability

### Incorporating financeability throughout the price control

15. Heathrow has consistently argued that the regulatory framework for expansion should reflect the characteristics of the programme and the risks associated with developing, delivering and operating an expanded Heathrow.
16. Financing is a key part of delivering expansion. Absent the right regulatory and economic conditions Heathrow will not be able to finance and hence deliver expansion for the benefit of consumers. For the avoidance of doubt, financing expansion is one of the biggest challenges for Heathrow over the coming 15 years. Private markets are capable of providing this funding efficiently. Nevertheless, it will require raising incremental debt and equity at levels

unprecedented for an airport and will be one of the largest privately financed programmes in the UK and Europe.

17. Alongside the CAA's duty to ensure that Heathrow can finance its activities, we think the following principles should drive the CAA's thinking when developing a financeable regulatory framework for expansion:

- a. **The regulatory framework for expansion should be reflective of the characteristics of the programme and the risks associated with developing, delivering and operating an expanded Heathrow.** Heathrow recognises the CAA's discussions to date on this front. Nevertheless, we urge the CAA to move from theoretical risk recognition towards a clear methodology for assessing how enhanced risks will be priced and rewarded through the cost of capital determination. In addition, the investment programme will outlast standard five-year price control reviews. As described above, this reality should be reflected in the CAA's decisions going forward. Given the longer investment profile, the CAA must consider how to provide longer term regulatory certainty.
- b. **Stable credit quality is fundamental to financeability.** Our existing A- credit ratings are essential to efficiently finance expansion given the quantum of debt that will be required. Our debt funding platform also includes rating triggers to support our existing A- Class A credit ratings. The CAA should start from this basis.
- c. **Financeability assessment should be fully integrated within the regulatory framework and decision making.** We have consistently argued that this should be the case and therefore welcome the CAA's integrated approach to financeability as defined in CAP1782.
- d. **Assessing financeability should be informed by market participants' views, including banks, financial institutions and rating agencies.** It is utterly crucial that the CAA is fully aware of how the market is going to perceive and assess Heathrow's financing platform, the wider expansion programme and the actions the CAA could take to provide stability and predictability to support efficient financing. Heathrow believes it is critically important that the CAA engages an experienced financial advisor going forward. Management consultancies and similar advisors lack the skills and knowledge required to provide insightful support to the CAA in this area.
- e. **Meeting financeability involves providing a fair return to equity investors.** Equity investors can invest worldwide, based on available global returns. Future CAA decisions should be mindful not only of UK regulatory benchmarks but of international comparators. These decisions of course must also reflect a globally informed view of the nature of the expansion programme. Debt finance is also dependent on equity support. As we set out in our response to CAP1610, international decisions on regulated airports, for their business as usual operation, show an average real cost of equity of 9.1%<sup>7</sup>. We are concerned therefore that the CAA continues to be complacent, in following the path of other UK regulators without addressing fundamentally different industries and circumstances, and in taking advice from advisors who are not market participants. This risks settling on cost of capital estimates that are simply not reflective of the market reality.

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<sup>7</sup> Heathrow Airport Limited response to CAP1610, Page 21 paragraph 97 c.

Financeability is not met only through ensuring debt financeability but also equity *investability*. Absent a fair return to equity, equity injections are difficult to contemplate, impacting the ability to raise significant amount of debt.

- f. **Additional licence conditions are not a silver bullet to ensuring a financeable regulatory outcome.** Financeability comes from creating fair risk adjusted returns, not from compulsion or extra constraints and complexity. For example, additional licence conditions without the appropriate underlying economics for expansion provide no protection for any stakeholder.
18. The CAA recognises that financeability should be an integral part of the price control. We welcome that view. However, we would highlight the risk that that the financeability framework set out in Figure 1 in CAP1782 is potentially overly simplistic. Cost of debt and equity will be driven by all the parameters noted and some elements will become circular. As an example, the relationship between cost of debt and rating are dependent on each other. Heathrow therefore recommends that any analysis needs to carefully consider any second order effects to avoid unintended consequences.
19. The CAA appears to approach its expansion financeability assessment as an exercise in determining some theoretical threshold of the limits of any possible financing. This is a recipe for future problems. To support the delivery of expansion funding requirements, the CAA's financeability assessment should test that the H7 decision provides fair and risk adjusted economic conditions to incentivise an efficient delivery of expansion, including the funding requirements associated with it.
20. Therefore, the CAA should develop an equity *investability* assessment, analysing potential choices that investors may have, including risks and reward associated with these choices. This would mitigate the risk of focusing only on debt financeability. Following a similar approach to the one undertaken in relation to NATS En Route plc will not be enough for a programme such as Heathrow faces. The CAA's approach to date has only focused on debt financeability. It needs to also assess the impact of downside sensitivities and stress scenarios to RORE. This is because it must assume that equity support will be required to protect the key debt metrics in those scenarios.

### Capital structure and gearing

21. Heathrow agrees that it is for Heathrow's management to decide the actual capital structure to ensure that the business is financeable. Regulators have therefore tended to assume a notionally efficient capital structure when determining the WACC and undertaking financeability assessments.
22. We note the CAA's desire to test the impact of certain decisions, policies and sensitivities on different capital structures, and hence the CAA's proposal to develop notional capital structures with different gearing levels.
23. We are supportive of the CAA's approach to carrying out a financeability assessment based on Capital Structure 1. It would be consistent with regulatory practice and would enable an internally consistent assessment with regard to the WACC determination. We are nevertheless unsure about the relative merits of Capital Structure 2. In particular, we are concerned about the insight and information that an assessment based on this capital structure would provide since:

- a. Capital Structure 2 appears to be an arbitrary structure. It is a “half way house” solution between Heathrow’s actual capital structure (which the CAA states is Heathrow’s own responsibility and choice) and Capital Structure 1, which is consistent with precedent and WACC determinations.
- b. In order to develop a more meaningful analysis, Capital Structure 2 would require defining a fundamentally different approach. This is because the parameters for Capital Structure 1 would not be correct and could not be simply transposed. Relevant questions that would have to be answered include what additional costs would need to be factored, which financing strategy should be adopted, how different ratios and targets are defined, what additional risks are assumed to be taken or mitigated and so forth. Trying to model a more highly geared capital structure without considering the complexities associated to it would not give a full picture. Any conclusions about benefits and risks to consumers would need to be heavily caveated, be incomplete at best, and be misleading at worst.
- c. We are unsure about the insight the CAA would gain when undertaking a financeability assessment relative to Capital Structure 2. In addition, we are unsure whether the CAA would change its approach to assessing financeability if it is using different capital structures. This is particularly relevant when talking about credit ratings, downside scenarios and stress testing. Sensitivities on independent variables such as leverage levels may provide more meaningful insight.

24. Therefore, we consider the CAA should focus on Capital Structure 1 as the primary structure to assess financeability. It should confirm this in its next policy consultation. If time constraints allow, the CAA could continue working on a Capital Structure 2 as a crosscheck to assess financeability. We would be keen to continue engagement with the CAA in the context of the development of the Price Control Model on this approach.

25. Appendix B of CAP1782 discusses gearing sharing mechanisms. We believe that such mechanisms are not warranted. They also contradict standard corporate finance theory that the cost of capital is largely independent of the level of gearing. As such, no outperformance arises from higher levels of gearing, but simply a different choice of risk and reward for equity holders. In addition, there is no objective evidence that higher levels of gearing have resulted in a detriment to consumers at Heathrow, nor at any firm in other UK regulated sectors. Moreover, introduction of any such mechanism would result in a significant negative impact on investor sentiment and form a significant impediment to financing expansion. Given this, we agree that the CAA is right in thinking that gearing mechanisms should not be investigated further.

### Financeability testing

26. An A- rating is critical to deliver expansion. The financeability assessment should be based upon A- target ratios because targeting anything below A- rating would:

- a. **Reduce market capacity.** The scale of the project implies that the amount of debt required would come up against boundaries for the level of exposure investors may want to take on in a single name credit. Financial market regulatory constraints, especially Solvency 2, could shrink the pool of investors willing to invest in Heathrow significantly. This is important not only for thinking about the

debt requirements but also about the balance sheet support required from banks when providing facilities and derivatives needed to support the overall structure.

- b. **Materially increase the risk of volatility in cost.** The lower the rating targets are, the higher the cost volatility. The standard deviation on the BBB 10+ index is more than double that of the iBoxx A 10+.
  - c. **Significantly reduce market confidence.** An A- target provides flexibility even if things don't go as planned. Such an A- target starting structure is more likely to be able to keep funding the project at a higher cost if needed and there is far lower risk of losing an investment grade rating.
27. When testing debt financeability and calibrating a credit rating, it is important to understand what methodologies and considerations would apply to Heathrow for the next 10-15 years. The credit metrics that the CAA will use to assess whether a targeted credit rating is met should be consistent with the methodologies rating agencies can be expected to use in practice for these changed circumstances. They cannot focus only on the current rating threshold levels.
28. Rating agencies will each use their own methodologies to assess risk and each one will focus on different ratios and targets. Risk will be assessed in comparison with peers i.e. similar risk from similar investments, usually in the same sector. When a new risk is not clearly recognised or categorised in a rating agency's methodologies, they are likely to draw on methodological principles from other sectors or project finance.
29. Given the significance of the investment programme, rating agencies will want to understand how Heathrow will mitigate risks. For the next 15 years they will especially focus on increases in costs and liquidity. It is anticipated that rating agencies will have a far greater focus than historically on cash-flow metrics.
30. It is also important to be aware that the rating agencies tend to take a conservative approach to risks. The forecast used by the CAA to define the price control will almost certainly be more optimistic than the base case assumed by any rating agency as "*the rating case*" in their future assessments. For example, in a "*rating case*" agencies would likely strip out any unrealised efficiency gains assumed by the CAA's determination.
31. Stress testing will also be important to understand the level of headroom required to credit metrics to sustain any given target rating level. Stress testing should be done from a "*rating case*", just as a rating agency will actually do.
32. Mitigation actions during stress testing should be consistent with the level of mitigation that rating agencies would consider achievable in those circumstances not on arbitrary judgement:
- a. Rating agencies could consider that seeking additional equity is not a viable mitigating action and would therefore only factor in equity provided or supported by an up-front guarantee.
  - b. Deferring non-essential capital expenditure may not be assumed to be viable in certain phases of the project. For example, agencies may assume capital expenditure has been committed already, or that deferral could imply the politically unacceptable delay of expansion delivery, or such deferral would reduce service levels and thus hit revenues.

- c. Agencies may also assume a downgrade could happen despite a reduction of future dividend payments until the previous financial position is re-established.
33. Based on the CAA's discussion of stress testing in CAP1782, it appears to be trying to implicitly determine how equity should act in stress cases without reflecting what would be the impact on equity returns required to create that environment. It would be more appropriate to limit assumed management actions to no more than dividend adjustments and capex adjustments which would align with the analysis that rating agencies will undertake.
  34. Rating agencies would expect credit ratios to be sufficiently supportive to be able to withstand downside scenarios, especially when mitigated by management actions. They will work on the basis that ratios could only be assumed to breach certain guidance levels in severe stress scenarios, with multiple cumulative downsides. In these severe stress scenarios rating agencies would focus more on recoverability ratios and creditor protections than sustaining an investment grade rating. In our opinion, trying to back solve to a BBB- rating in severe stress scenarios would not be appropriate or a realistic test.
  35. Rating agencies generally take a conservative approach to any risk or mitigating actions. This must be factored when assessing credit ratios against the targeted credit rating. This should be considered in all stages of the assessment: when building the base case, sensitivities, stress cases and assessing available mitigating actions by management.
  36. To be clear, it is very important that the CAA's financeability testing is aligned with rating agencies' methodologies and assessment. Firstly, this allows a real-world test. Secondly it would in turn mitigate the risk of a downgrade by rating agencies to Heathrow's credit ratings based on CAA analysis and determinations. This scenario, which would be highly detrimental to the deliverability of the expansion programme, must be avoided ensure that Heathrow has access to efficient finance.

### Financeability adjustments

37. We note that the cost of finance which we can achieve during expansion over the next 15 years or more is subject a combination of market conditions and Heathrow's credit profile. The CAA's financing case should make reasonable assumptions for the cost of both debt and equity. It should also work in context that the current historically low interest rate environment is unlikely to be sustained for the full delivery period of new capacity.
38. To be considered financeable, an appropriate base case should demonstrate sufficient robustness to absorb expected additional risks. Therefore, reasonable management mitigating actions should only be assumed in response to a stress scenario and not assumed in a base case. Accordingly, financeability issues in the base case should first be corrected by modifying assumptions like risk sharing arrangements and incentives including:
  - a. Risk allocation principles, and their application through incentive baselines and risk sharing arrangements
  - b. The cost of equity including the expansion risk premium and the cost of debt
39. If financeability problems are apparent in a stress case, we consider it would be appropriate to assume mitigating actions from Heathrow's management such as dividend and capital investment adjustment.

40. However, we do not consider it appropriate to assume further efficiencies in operational variables over and above those assumed in the base case when assessing financeability in the stress case. This would be inconsistent with the CAA's stated rationale for performing stress tests. The CAA discusses the concept that non-controllable factors like GDP would affect passenger numbers and hence non-aeronautical revenue and operational expenditure. The CAA should not therefore assume further efficiencies artificially overriding these relationships.
41. Regulatory risk has been one of the main risks flagged by rating agencies in the past. Providing assurance and fixing certain parameters beyond the next 5 years would support debt financeability as well as equity financeability. The CAA should focus on this aspect, which is largely within its control, in both thinking through financeability and promoting consumers' financial interests in pursuing expansion as efficiently as possible.
42. Heathrow agrees with the CAA that revenue re-profiling through regulatory depreciation should not be used as a "silver bullet" to solve financeability or affordability. Significant shifts in depreciation could alter the risk profile of the business, for example by artificially delaying the recovery of investment and therefore creating cash flow constraints. This is particularly pertinent given the likely shift of focus toward cash flow metrics. In addition, as the CAA discusses, rating agencies tend to reverse these depreciation adjustments in their assessments. There is a real danger of adding unnecessary costs and financing constraints to the next 15 years through unthinking use of depreciation re-profiling. Heathrow therefore believes that regulatory depreciation should continue to reflect the economic life of the investment.

### **Incentives for capital expenditure efficiency**

43. Heathrow has already engaged extensively with the CAA on ex-ante incentives. Building on the technical reports and analysis submitted, we have demonstrated that the complexity, uncertainty and one-off nature of the expansion programme makes it particularly unsuitable for ex-ante incentives. Applied to the major parts of the new runway build such incentives are likely to create additional build costs for consumers – in either price or inflexibility of programme or design. Application of such incentives to programme elements of this type flies in the face of established industry best-practice and advice – as for example produced by Project 13 comprised of major infrastructure deliverers.
44. We have demonstrated to the CAA that, in the context of expansion, delivery risk will significantly increase as against 'business as usual' capex. The quantum and nature of elements of the expansion programme could change at numerous point in the next decade or more given NPS conditions or other factors. Flexibility will be required throughout for the airport, airlines and consumers. This risk is already going to change Heathrow's risk profile for financing purposes. Further radical changes to the regulatory framework would only increase risk and thus cost in addition to the impacts in the supply chain noted above that are driving up cost.
45. We have explained to the CAA that delivery risk does not disappear given different contractual, or in this setting, regulatory arrangements. It just gets allocated in different ways and priced accordingly. In doing so, we have provided analysis illustrating how ex-ante incentives would not only make expansion difficult to finance, but definitely less affordable for consumers.

46. We have also provided the CAA with evidence and industry guidance suggesting that if it was determined to introduce ex-ante incentives, these would be appropriate only on more routine capital expenditure. This could be linked to streamlined governance and simpler output measures. While this does not necessarily mean such incentives are needed or good for consumers it would at least align better with the nature and logic of the investment.
47. We have shown the CAA that the current framework is flexible enough to incorporate operational changes, and that it has a governance process agreed by all stakeholders. The current framework responds to airline requests to have closer involvement with the capital expenditure process, giving them the ability to input into capital expenditure decisions throughout the period and have close involvement in projects throughout their lifecycle. We have explained to the CAA that the current portfolio approach and regulatory incentives enable Heathrow to adapt to unforeseen circumstances and that it optimises scope, time, costs and risk. Over the last 5 years the current framework has enabled investment decisions that are industry led, with minimum interference from the regulator.
48. We have explained to the CAA that the current portfolio approach and the current regulatory framework enables a continuous delivery of capital investment projects, avoiding the unintended consequences of price control reviews.
49. We have demonstrated to the CAA and its consultants, CEPA, that the current framework does not incentivise Heathrow to overspend. This is clear from the Q6 experience, where we have spent less than the initial regulatory allowance in the Q6 decision.
50. We have ample evidence from the IFS stating that Heathrow's approach to delivering capital investment is consistent with the framework agreed with the industry and that it is providing value for consumers. In addition, benchmarking exercises from the IFS repeatedly demonstrate that we are delivering capital investment well within industry ranges.
51. We have record levels of passenger satisfaction in a period in which we have delivered more than 160 business cases within the Q6 portfolio and have had no formal escalations to the CAA after investment decisions at Gateway 3.
52. We have stated to the CAA that the current framework protects consumers, since they only pay for the capital investment that a) has been agreed with the airline community and b) after the ex-post review, the capital investment that has been deemed efficient by the CAA.
53. The CAA appears not to have incorporated any of this background in its thinking. Instead the CEPA analysis appears to propose high-level conceptual frameworks with little basis in demonstrated consumer benefit, no reference to industry lessons and no link to the reality of the programme. We now formally request the CAA to analyse and demonstrate how any of the frameworks developed by CEPA would result in a better outcome for consumers. The analysis should be informed by the definition of capital efficiency jointly agreed by the airline community and Heathrow:

*“Efficient capex is the delivery of an asset in a manner which optimises and balances scope, time, cost and risk, provided in an appropriate manner having followed a structured development process with appropriate decision points and governance”*

And the general CAA's objective of *“defining an affordable and financeable regulatory framework for H7”*.

54. Based on these, the CAA could set out a number of areas to assess the relative merits of each scenario. These areas could include the following questions:
- a. Do the regulatory arrangements provide the optimal balance to delivering full scope, cost efficient and timely capital investment?
  - b. Do the regulatory arrangements enable an affordable outcome for H7?
  - c. Do the regulatory arrangements enable a financeable outcome for H7?
  - d. Do the regulatory arrangements enable a collaborative and commercially minded delivery of capital investment?
  - e. Do the regulatory arrangements generate manageable workload for all stakeholders involved, including the CAA?
  - f. Do the regulatory arrangements generate additional costs for all stakeholders involved, including the CAA?
  - g. Do the regulatory arrangements promote an approach to capital investment that is in line with best practice in major infrastructure in the UK and worldwide?
55. We note that there is not a consistent view within the airline community regarding the value of introducing ex-ante incentives. We formally ask the CAA to demonstrate what is the value for consumers of moving away from the current framework.
56. Although it is clear that ex-ante capital investment incentives are used in other sectors, such as water or energy, it is important to understand the nature of the projects that are subject to these incentives. For example, Ofgem clearly outlines the use of uncertainty mechanisms for those projects where *“uncertainty is outside of the companies’ control and has the potential to affect significantly their expenditure, then the use of an ‘uncertainty mechanism’ may be appropriate. Uncertainty mechanisms allow network company revenues to change in line with changes in requirements.”*<sup>8</sup>. This approach is consistent with Heathrow’s argument that ex-ante incentives are not suitable for most if not all expansion related investment.
57. We also note that the benefits that Heathrow’s current investment framework provides are recognised by other aviation regulators. It is notable for example that the Commission for Aviation Regulation (CAR) in Ireland is looking to implement a very similar framework as the one currently in place at Heathrow.
58. Up to now, CAR’s approach to regulating capital expenditure has been very prescriptive in terms of project scope, costs and delivery timings definition. CAR’s framework included strong ex-ante controls. Recognising the shortcomings of a very prescriptive framework, such as a lack of flexibility to adapt to market reality or lack of commercial engagement between airport and airline community, in its recent consultation<sup>9</sup>, CAR is moving away from this rigid approach for those projects for which the costs are above €20m and where significant uncertainty exists regarding the scope. In effect CAR is proposing to implement a framework similar to Heathrow’s for more than 70% (or €1307m) of the Dublin Airport capital plan.

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<sup>8</sup> RIIO-2 Sector Specific Methodology

<sup>9</sup> <http://www.aviationreg.ie/regulation-of-airport-charges-dublin-airport/2019-determination.841.html>

59. CAR continues to support an ex-ante framework only for those projects which outputs are fully defined and that are wholly within Dublin's control - for example asset replacement, commercial or IT projects. At the same time, it introduces more flexibility for those projects that are less well developed. This is consistent with Heathrow's representations on the most applicable use of ex-ante incentives. It simply flies in the face of regulatory best practice across aviation, infrastructure and construction to set broad, general ex-ante incentives when the scope is not fully defined, such as for expansion projects.
60. To be clear, we are not rejecting outright the value of ex-ante incentives per se. We recognise that there are circumstances where they can be useful when done properly<sup>10</sup>. The key consideration, is whether the project/business case concerned is suitable for an ex-ante setting. Examples like Ofgem for RIIO2 and the CAR for Dublin Airport, and even the evolution of Heathrow's own framework over the last 10-15 years demonstrate that for complex, not fully defined and large value projects a flexible mechanism – usually based on target costs - is likely to provide a better outcome for consumers.
61. We are disappointed with the very limited progress achieved by the CAA and CEPA. The options outlined by CEPA are no more sophisticated than the initial options the CAA outlined one year ago in its consultation document. CEPA's paper provides a theoretical and superficial attempt to describe a number of frameworks without diving into the required detail to understand the impact of these frameworks in enabling a timely, affordable and financeable expansion programme. These elements would include:
- a. Impacts on Heathrow's cost of capital and quantum of capital at risk and therefore affordability and financeability
  - b. Required governance arrangements and the resulting nature of airport and airline engagement
  - c. CAA resources and cost implications of defining the upfront budget, delivery obligations, in price control delivery oversight and ex-post reviews
  - d. How these frameworks would affect time, scope and budget of business cases
  - e. Impacts on delivery costs in line with wider supply chain experience
  - f. The appropriate scope and scale for incentives in light of these considerations
  - g. Comparisons to other relevant construction delivery examples and best practice
62. We do not intend to provide an in-depth review of CEPA's paper since, in our opinion, it does not enable the CAA to advance in its thinking regarding the relative value of ex ante incentives frameworks in comparison with the current framework. Nevertheless, there are a number of areas that need to be highlighted, given the potential to mislead the CAA:
- a. CEPA's underlying assumptions. In particular, the first two<sup>11</sup> assumptions which refer to granting the DCO, H7 start, and setting the cost baseline. Consent is expected to be granted by the end 2021 and it could potentially impose additional

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<sup>10</sup> In fact, we would like to explore ex-ante incentives for projects like asset replacement or even commercial/passenger experience with the CAA and the airline community

<sup>11</sup> CEPA, Possible ways of implementing ex ante incentives for Heathrow's capital expenditure, Page 6

costs in Heathrow’s plan, with the CAA expected to amend Heathrow’s licence in Q4 2021, having published its final proposals ahead of this. CEPA assumes that the DCO will have been granted ahead of the CAA setting costs allowances. This is not correct. In order for CEPA’s assumptions to hold true, the H7 start would need to be delayed for at least another year. In addition to this CEPA implicitly ignores the reality that various material factors flowing from the DCO/expansion will be conditional or remain uncertain in timing or scope. Airspace change, and the delivery of early growth air transport movements (ATMs) are two prime examples in H7. Both airport and airlines will want the flexibility to respond to these potential changes.

- b. CEPA and Arcadis’ review of costs controllability and ability to define outputs does not feature in the paper. It appears to be based on an opinion rather than a thorough exercise. This is not acceptable, and the CAA cannot rely on such input. In addition, the review does not take into account the fact that Heathrow’s negotiating position with suppliers will be hindered once the CAA discloses the total allowance for H7 or the amounts allocated against each delivery obligation.
- c. In all the models defined by CEPA, there remains a strong need and presumption for an ex-post review to determine whether Heathrow’s investments have been efficient. This is exacerbated given the expansion programme will outlast the standard 5 years’ regulatory cycle. CEPA proposes both high-level obligations and detailed requirements that will evolve over time – further doubling up the risk of interpretation and efficiency assessment. This compounds risk upon risk with no regard for cost, time and quality implications for delivery. There is a clear risk of changing the goal posts for assessing efficiency. This will further increase Heathrow’s overall risk profile.
- d. The scenarios defined do not provide a well thought out governance process, nor investigate how setting up front cost allowances can affect stakeholders’ dynamics and whether this is in the interest of consumers. In addition, it appears that the scenarios suggest that the role of the airline community could be scaled down.
- e. The scenarios defined talk about the potential need for extraordinary reviews. CEPA fails to consider, assess and discuss the nature and implications of such a review – how long would it take, what resources would be required, how it would affect Heathrow’s on time delivery of capital investment, how it would affect market’s perception of Heathrow and our ability to finance the programme.
- f. CEPA’s lessons learnt from case studies point towards a continuation of the current regulatory approach. A discussion is provided below:

<b>Lessons learnt</b>	<b>Commentary</b>
Lesson 1. Cost allowances and outputs should remain flexible for as long as is feasible	This is exactly what happens in the current framework where airlines and Heathrow agree to proceed with business cases at G3, once costs and scope are firmed up. In addition, airlines and Heathrow constructively engage in previous gateways to find the best solution for consumers.

Lesson 2. Reopeners and adjustments to allowances can be useful tools	In effect this is built in within the current framework (given the flexibility it provides) without the need to trigger re-openers from the CAA, which are lengthy and contentious. In the current process adjustments to business cases and allowances is done through commercial discussion between Heathrow and the airlines.
Lesson 3. Importance of a programme-level contingency	Under the current framework there is enough flexibility to allocate contingency in different ways.
Lesson 4. There are approaches to managing risk and uncertainty in contracts	Heathrow will use a range of contractual arrangements for expansion. As CEPA discusses, the CAA is not in a position to decide a regulatory mechanism that is consistent with Heathrow's procurement approach, since these options are still being developed. The important point here is to understand how the different approach to managing uncertainty (from a regulatory perspective) affects costs and therefore affordability. NEC3 Option A is more akin to ex-ante incentives, whereas NEC3 Option E is more akin to the Development and Core framework. As discussed in previous submissions, greater risk taken by the contractor (or from a regulatory framework, Heathrow) has a cost, affecting overall project value.
Lesson 5. Annual targets are unlikely to be an effective incentive mechanism	This learning should be extended to price control targets as well, given that the expansion project will feature in more than one price control. Therefore, the current framework offers more suitable incentives.
Lesson 6. Investors seek downside protection	This is not correct. In effect investors are willing to take risks that they are able to mitigate, by for example minimising costs overruns, and that are commensurate to the return that they are able to achieve. This means that investors are willing to take risks regarding capital investment delivery once the business cases are fully developed as in the current framework. Setting ex-ante incentives involve exposing investors and consumers to forecast risks, which none are able to mitigate, increasing the costs of the project. Defining a cap and collar to limit downside risk is an artificial solution generated by exposing investors and consumers to forecast risk. In addition, based on the proposed methodology

	there is no effective downside protection given CEPA's discussion on ex-post efficiency reviews.
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63. Heathrow is due to publish its Initial Business Plan at the end of 2019. It is not acceptable that the CAA has not yet come to a resolution regarding the way in which it plans to regulate capital investment. We urge it to use evidence to define the improvements it wishes to achieve, engage with expertise across construction and do so quickly.

## Promoting economy and efficiency

### The need for an efficiency condition

64. Heathrow maintains that the proposed licence condition is misconceived and should not be brought into effect. Heathrow rejects the CAA's assertion that it has fully justified the need for the introduction of an economy and efficiency licence condition in its October 2018 consultation. In contrast, it is not yet apparent to Heathrow that the CAA has carried out due process in compliance with its statutory duties to ensure that the proposed condition is necessary, proportionate to any conceivable risk, targeted and ultimately provides benefits to consumers in excess of, or at least proportionate to, the detriment and burden, including regulatory uncertainty and potential costs, it will cause.
65. Although the CAA has set out the objective it is trying to achieve, to promote economy and efficiency across Heathrow's activities<sup>12</sup>, it remains unclear how the CAA has assessed and determined that it does not have effective powers within the existing regulatory regime to ensure economic and efficient provision of airport operation services by Heathrow. The CAA has not provided examples or otherwise substantiated its claim that its existing toolkit is ineffective or unable to meet this objective. The only example referenced in paragraph 3.19 and expanded upon in footnote 24 in fact reinforces that the CAA has appropriate powers to respond to issues arising in "real time". The document linked through footnote 24 sets out that the CAA had in fact been able to influence Heathrow's expected level of engagement with airlines by mandating the development and content of the enhanced engagement protocol. The CAA also made reference in this document to its powers to issue formal information requests under Section 50 of CAA12 as a method it might consider to "facilitate the disclosure of high quality information by HAL"<sup>13</sup>. In addition, it remains unclear as to how the CAA has determined a licence condition is the best method to meet this objective or that the licence condition goes no further than necessary to achieve this objective.
66. It is also noticeable that the CAA has failed to carry out a full and quantified impact assessment and cost benefit analysis of the licence condition. This would have aided its proportionality assessment and ensured that it does not impose unjustifiable and/or disproportionate extra cost or regulatory burden. Provision of this type of analysis would also be in line with regulatory best practice and guidance regarding the Better Regulation Framework<sup>14</sup>.

<sup>12</sup> CAP 1782, page 39, para 3.16

<sup>13</sup>[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Commercial/Airports/CAA%20Assessment%20of%20airport%20-airline%20engagement%20under%20Enhanced%20Engagement%20ToR%20-%2028092018.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/CAA%20Assessment%20of%20airport%20-airline%20engagement%20under%20Enhanced%20Engagement%20ToR%20-%2028092018.pdf), page 4, paragraph 13

<sup>14</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/776507/Business\\_Impact\\_Target\\_Statutory\\_Guidance\\_January\\_2019.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776507/Business_Impact_Target_Statutory_Guidance_January_2019.pdf)

67. We expect the CAA to complete these steps in order to show that a licence condition meets the tests of proportionality and is appropriately targeted.
68. The CAA's failure to do so is a significant area of concern for Heathrow as it calls into question the CAA's compliance with its statutory duties and its ability to develop policy and appropriate regulatory interventions that are transparent, justified, substantiated by evidence, proportionate and targeted. At a time where consistent and stable regulatory policy is key, the CAA's proposal and its approach in this consultation is concerning and we urge the CAA to review its position.

### **The drafting of a condition**

69. As stated above, we do not accept that the required justification for the implementation of the proposed condition has been given. We have however considered the drafting of the proposed condition set out in Appendix D, CAP1782, and, without prejudice to our primary position and objections, set out our view of the wording below.
70. We remain strongly of the view that, should any such condition be contemplated, the wording must be clear and properly reflect the CAA's duties. Any such licence condition must be able to stand the test of time over multiple regulatory periods. We agree with the CAA's continued focus on Heathrow's behaviours rather than the delivery of specific outputs in the framing and drafting of the condition. In particular, the CAA's continued confirmation that the aim of the proposed condition is not to mandate the delivery of capacity expansion<sup>15</sup>.
71. We note the CAA's recognition of the realities of running a complex, operational business such as Heathrow. The statement that economic and efficient management of the airport may not always mean delivering all the outputs and outcomes all of the time due to these complexities and constraints<sup>16</sup> is thus important in the context of the proposed condition. Given this view, it is important that the focus of the condition in its drafting remains on ensuring Heathrow's behaviours, as a privately owned, commercial company, are economical and efficient, rather than setting out explicit outcomes that Heathrow should deliver.
72. Any move by the CAA to specify the outputs that Heathrow should deliver through implementation of this licence condition would undermine the CAA's move to an outcomes-based regulatory framework, informed by consumer engagement and insight. It would also hinder Heathrow's ability, as a private business, to take commercial decisions on the actions it should take to deliver these outcomes. It is for these reasons that we continue to oppose the introduction of "areas of focus" suggested by the CAA.
73. The setting of "areas of focus" which are supported by a licence condition would naturally move Heathrow's focus from the delivery of projects needed to meet consumer requirements, to the delivery of these specified outputs in order to avoid licence enforcement action. This is not consistent with the CAA's primary duty nor the primary purpose of the CAA's new outcomes-based framework.
74. In its document, the CAA does not propose any further drafting for the proposed "areas of focus", but instead states that the drafting of any such additions could be "more targeted"<sup>17</sup>

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<sup>15</sup> CAP1782, page 41, paragraph 3.25

<sup>16</sup> CAP1782, page 41, paragraph 3.24

<sup>17</sup> CAP1782, page 45, paragraph 3.39

and could be informed by consultation with stakeholders<sup>18</sup>. As per our response to the CAA's October 2018 consultation, we dispute the assertion that the proposed "areas of focus" provide increased clarity and suggest that they instead create further uncertainty by providing a non-exhaustive list of areas the CAA would take into account when monitoring compliance with the condition. We therefore do not consider the addition of areas of focus to be helpful in our interpretation of the condition.

75. Should the CAA continue to pursue the implementation of "areas of focus" alongside the proposed condition, it is important that Heathrow is fully consulted and given adequate opportunity to comment on any proposed wording.
76. We note the CAA's revised wording of the condition and that this takes into account a number of points made by Heathrow in response to the CAA's previous consultation. However, we are still concerned that the wording is not sufficiently targeted and does not fully reflect the CAA's duties.
77. The CAA's proposed wording, including references to "the greatest extent reasonably practicable", does not sufficiently target the condition and is not proportionate. It creates a high regulatory burden, creates uncertainty, and provides no clarity on the situations which could lead to investigation and enforcement action. We would urge the CAA to take into account each of our areas of concern set out below and, without prejudice to our position that any such general condition lacks justification. We attach at Appendix 2 an example mark-up of the CAA's draft condition to exemplify the issues:
- a. **Scope of activities covered by the condition:** The current drafting proposed by the CAA in B3.1 brings into scope not just Heathrow's provision of airport operation services but also activities that relate to this. Taking into account comments by stakeholders regarding potential unintended consequences of the breadth of the condition, notably that it could apply to other, non-regulated, activities, narrowing this scope to cover just those activities to which Heathrow's licence applies is critical. This would help to ensure the condition is properly targeted.
  - b. **Definition of economical and efficient:** While we note the CAA's view that it would not be appropriate to define the terms economical and efficient, it is important and reasonable to expect certain parameters or scope be included to ensure that the drafting of the condition does not remain so ambiguous that it limits Heathrow's ability to comply with the condition or poses a disproportionate burden. It is only appropriate that the competitive environment is reflected in any condition assessing economy and efficiency, as previously suggested in our response to the CAA's October 2018 consultation. Such competitive environment could be reflected by, for example, including a benchmark of a "prudent private market operator" against which the CAA would assess whether Heathrow is behaving economically and efficiently, based on the behaviour of other private operators, behaving as would be expected in similar situations.
  - c. **Timely enhancement and development:** As set out in our response to the CAA's previous consultation on this topic, the inclusion of "timely" to define enhancement and development of the airport is inappropriate in this circumstance. The CAA should ensure that Heathrow's decision-making is not unduly fettered and allow for wider inclusion of user requirements when reviewing how the airport should be

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<sup>18</sup> CAP1782, page 44, paragraph 3.36

enhanced and developed. As such, we would urge the CAA to remove the reference to “timely” and consider the use of “appropriate” enhancement and development in any further consultation. An even simpler, more straightforward approach would be to remove the unnecessary reference to timely development altogether, given it is not entirely consistent with licences in other regulated sectors.

- d. **Reasonable requirements of users:** In our response to the CAA’s October 2018 consultation, we set out that a reference to the reasonable requirements of users<sup>19</sup> would be helpful to provide greater definition around the condition. Although the CAA has recognised the point of this in its revised drafting, we consider that the CAA’s wording in regard to the “demands” of users in B3.2 is highly burdensome and could, in fact, lead to actions that are uneconomical and inefficient. Furthermore, the CAA’s wording states that Heathrow should “secure” that these “demands” are met. Taken in the round, this obligation could lead to Heathrow being forced to make investments or take an approach, which is not economical or efficient, solely to meet user “demands”, which may not represent reasonable requirements and could have an overall detrimental impact on Heathrow and its users. Instead, a condition requiring Heathrow to “take into account the objectively justified requirements of users” would better allow Heathrow to take economical and efficient decisions, which are based on substantiated user requirements and take into account the relevant context.
- e. **Stakeholder engagement:** As per our response to the CAA’s previous consultation, we recognise the rationale for the inclusion of a provision regarding stakeholder engagement in order to properly identify the requirements of users. However, the CAA’s proposed drafting in B3.2 of the condition goes further than requiring the engagement needed to understand users’ requirements for the purpose of complying with the condition. Consultation should be appropriate and with “users and/or providers of air transport services” as better reflects the wide range of stakeholders whose views are important to understand the requirements of users and ensures there is not a blanket requirement, which fails to take into account the varying circumstances that may arise.
- f. **Financeability:** Again, we note the CAA’s reference to financeability in its draft condition. However, the CAA’s proposed wording in B3.3 is not sufficient to reflect the CAA’s duty and ensure that any obligation on Heathrow is subject to its ability to finance its licence activities. As currently proposed, the condition simply references Heathrow’s ability to finance the provision of airport operation services as another contextual point to be taken into account, rather than a duty to be secured. As set out in section 3 of this response, ensuring financeability is essential to ensuring that Heathrow can deliver for consumers. We maintain therefore our response to the CAA’s previous consultation on this topic and urge the CAA to ensure that Heathrow is not required to take actions which might reasonably be expected to adversely affect its ability to finance its activities under the licence.
- g. **Context and trade-offs:** In its proposed drafting for section B3.3 of the licence, the CAA recognises the need for Heathrow to take account of “all relevant

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<sup>19</sup> Users in this case refers to the definition of users of air transport services as set out in CAA12 and included in provision of A2.2 of Heathrow’s licence

circumstances” when taking actions. In addition to our above point regarding financeability, we agree that the condition should allow Heathrow to take account of users’ requirements. However, we suggest that parameters should be included to recognise that, in evaluating these requirements, Heathrow is entitled to take into account all available evidence and make assessments on the strength of the evidence. This is consistent with the recognition from the CAA and Consumer Challenge Board, that Heathrow will be required to make informed trade-off decisions as part of its business planning process, in order to come to an outcome that best balances the needs of all stakeholders. Wording that better reflects the need for Heathrow to be able to make decisions on this basis helps to reinforce the CAA’s focus on behaviours rather than outputs and also ensures the condition remains proportionate.

### The implementation of the condition

78. Should the CAA decide it appropriate to implement the proposed condition after completing the analysis and consultation to justify it, we would urge the CAA to consider both the timeline for implementation and the intended threshold for the use of the condition.
79. In its document, the CAA continues to argue for introducing the proposed condition alongside arrangements for the interim period. Heathrow does not agree, given the lack of analysis and justification for the proposed condition to date. It is not appropriate for the CAA to seek to rush to include it alongside other, unrelated, work as a matter of convenience.
80. Circumstances have also changed since the CAA’s October consultation where it set out this timeline. Heathrow and the airlines have accepted a commercial agreement which will sit alongside the regulatory provisions for the iH7 period. It provides additional and contractual rights and obligations directly enforceable by the airlines and will be supplemented by a licence change. This marks a change in the regulatory context. We therefore suggest that the CAA considers whether such a condition is required in the context of a more commercial relationship between Heathrow and the airline community.
81. In regard to the implementation of the condition, we note the CAA’s point that the condition would only be used in circumstances where there is a material impact on consumers, and not for “trivial” issues or commercial disputes<sup>20</sup>. We also note the CAA’s point that any investigation action would have to be in line with the CAA’s enforcement policy and prioritisation principles<sup>21</sup>. Accordingly, Heathrow considers that the CAA’s proposed usage of the condition should be made sufficiently clear in the statutory consultation and any notice accompanying the licence modification. Absent any clear statement of the intended use of the condition, Heathrow is exposed to inappropriate regulatory uncertainty and could be open to abuse and used in inappropriate circumstances, which increases the regulatory burden, and does not further the interests of consumers.

### Alternative delivery arrangements

82. Heathrow’s expansion scheme has been subject to robust scrutiny for a number of years now. It was part of the Airports Commission process, which was open to all proposals. The scheme was further reviewed by Government and Parliament over a period of years. It has been and will continue to be scrutinised through the consultations and examinations required as part of the DCO planning process to ensure it delivers the requirements of the NPS. Heathrow’s

<sup>20</sup> CAP1782, page 42, paragraph 3.28

<sup>21</sup> Ibid

scheme is also undergoing robust review and scrutiny by the CAA as part of the economic regulation process.

83. Arora chose not to take part in the Airports Commission process. Nor have its proposals been reviewed by Government. In effect, Arcadis' review is the first independent review of Arora's proposals.
84. Arora's proposals did not stand up to independent scrutiny by the CAA's technical advisor. Heathrow's expansion plan does. Arcadis' review aimed to understand and assess whether Arora could demonstrate an ability to deliver the objectives of airport expansion at Heathrow. These objectives included whether Arora's proposals are able to deliver 740,000 ATMs and terminal capacity for 130 million passengers per annum. Arcadis was unable to conclude that Arora's proposal would deliver the much-needed capacity.
85. Arcadis' review focused on four aspects of Arora's proposals: scope and design, cost and affordability, operability, and timing and delivery. The report, albeit published with redactions, provides unequivocal conclusions regarding the maturity, feasibility and therefore credibility of Arora's proposal. Arora's proposal, at this stage, is no more than an idea unsupported by reliable data, modelling, analysis and thorough operational consideration.
86. The report provides insight to the lack of maturity and credibility of Arora's proposals, for example Arcadis outlines that:
  - a. **Project maturity.** Arora's existing proposal is at RIBA Stage 0/1: 'Strategic Definition' and 'Preparation and Brief.'
  - b. **NPS compliant.** It is unable to conclude that Arora's proposal is compliant with the NPS. At this stage, there is limited evidence to suggest sustainability, air quality and noise have been considered at an equivalent level of maturity to design. This has a material impact on the time required to progress design to support a DCO submission.
  - c. **Cost estimation.** Arora outlines a total cost of £14.4bn. Arcadis is unable to determine whether Arora can meet its specified budget given the level of design maturity. Arcadis outlines a lack of market tested data and that risk allowances are inconsistent with project maturity, Arora appears to use risk allowances associated to RIBA 2 rather than RIBA 0/1. Correcting for this error alone for example would materially increase Arora's total costs.
  - d. **Affordability.** Arcadis is not able to conclude that there will be no increase in Heathrow airport charges (in real prices) resulting from Arora's proposal, or that it will be able to achieve its aspiration for a 'real reduction' in airport charges.
  - e. **DCO timetable.** Arcadis deems Arora's ability to meet its proposed DCO delivery dates to be a principal risk of the proposal.
  - f. **Deliverability.** Arcadis is unaware of plans to keep Heathrow operating at required capacity during construction. There are huge and obvious risks of impact on the current airport even from the little information so far revealed – for example the need to potentially shut significant parts of Terminal 5's facilities through the build phase.

- g. **Operability.** Arcadis was unable to comment on the ability of Arora's proposal to support long-term flexibility for the airport operation, in particular given parallel design with the rest of Heathrow Airport. In addition, Arora's proposal lacks instrumental documents and information such as Concepts of Operations (CONOPS), Terminal and Airfield Operations Simulation and Traffic Modelling.
- h. **Consumer interest.** Given the lack of development on the scope and design, cost and affordability, operability, and timing and delivery, Arcadis is not able to validate that target outcomes for consumers can be met.

87. It is evident that no further work is needed or should be pursued on a potential regulatory framework for Arora's proposal. Arcadis' finding on each of the areas analysed demonstrates that Arora's proposals cannot be classed as feasible, deliverable and operable. It cannot and does not further the interest of consumers, in particular, when these are compared with Heathrow's expansion plan.

88. We note that the DfT considers Heathrow as the only credible promoter for expanding the airport. Following the Arcadis review for the CAA and the airline community, this view is strongly reinforced because of the lack of credibility of Arora's proposal. We invite the CAA to formally recognise Heathrow as the only credible promoter and to focus all its efforts and resources on Heathrow's H7 regulatory framework.

89. Heathrow has consistently argued that developing work on alternative regulatory frameworks, not only puts the CAA's resources under pressure, but more importantly has a damaging effect on the development of Heathrow's H7 regulatory framework. It undermines the regulatory certainty, predictability and confidence that Heathrow needs to commit extraordinary sums of investment to expanding the airport. This is twofold:

- a. It undermines the limited decisions made by the CAA so far to enable recovery of Heathrow's expansion related costs.
- b. It jeopardises the very foundations of the current regulatory framework, where even the current Market Power Assessment (MPA) would likely need revisiting.

Arora appears to seek control of Terminal 5 as well as to build a terminal extension. Setting aside that it is not within the CAA's powers to mandate splitting Heathrow's business and operation, Arora's proposal is a fundamental change to Heathrow's operational and regulatory environment. Heathrow's debt and equity investors will find it nigh on impossible to commit to major, long term and risky investment against a background of exponentially heightened regulatory risk. Ultimately, the consequence of any delay to the delivery of expansion caused by a lack of certainty in the framework for H7 will be higher costs to consumers. The CAA should, therefore, put an end to this uncertainty as soon as possible.

90. The timing of delivery should be a key consideration for the CAA when assessing whether expansion is in the interest of consumers. Putting aside the questionable deliverability, integrated operability and tested lack of maturity of Arora's proposal, the CAA indicates that Arora proposes to submit its DCO application after Heathrow's<sup>22</sup>. Arcadis highlights a clear risk that Arora is not able to meet its own timetable for DCO application. There is therefore a clear risk that an Arora scheme would result in a delay in providing terminal capacity. This

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<sup>22</sup> CAP1782, page 55, paragraph 4.26

would further increase the congestion premium costs, running counter to consumers' interests.

91. We agree with the CAA's statement that it is for the Planning Inspectorate and the SoS to consider the merits of alternative DCO applications under the Planning Act 2008. Nevertheless, the CAA will play an important role as a statutory consultee in both applications. It is important that the CAA has an informed opinion of the relative merits of each application with regard to its primary duty, including important considerations like those outlined in the Frontier Economics report, Economic regulation of terminal expansion, we submitted to the CAA as part of our response to CAP1722. Heathrow extends an offer to the CAA to engage on this paper and any related issues.
92. Heathrow understands that the CAA, guided by its statutory duties, needs to engage in a fair, proportionate and appropriate manner with relevant stakeholders. Given Arcadis' findings, which clearly outline the relative difference of maturity of Heathrow's expansion programme and Arora's proposals, and the regulatory uncertainty for Heathrow's H7 determination that further work on a regulatory framework that incorporates Arora's proposal creates to the detriment of consumers, Heathrow considers that the tests defined by the CAA for commencing regulatory work should be strengthened. In particular, the CAA should:
  - a. replace "*initial evidence*" with "*sufficient evidence*" in all the tests defined so far.
  - b. define a test that incorporates sufficient evidence that Arora's proposal is financeable. Absent clear evidence that the programme is financeable, and therefore deliverable, consumers' interests will not be furthered.
  - c. seek robust quantifications of how any Arora proposal that might emerge in future, and the associated regulatory framework, would further the interests of consumers over and above Heathrow's plan.

## Appendix 1: Longer term regulatory certainty

1. A key issue missed in the latest consultation paper is any consideration of the appropriate length (i.e. number of years) of a future price cap or elements of a future price cap. This is an important choice in the design of any price control. Particularly given Heathrow's likely investment profile over the next 15 years it will require careful, active consideration in its own right. It is also integrally important to the issues under consideration in CAP1782. In particular the length of the price control will directly affect:
  - a. affordability – since the underlying business case requires large upfront funding to invest to create capacity only used, and paid for, by consumers later in the multi-decade period. To achieve this in line with the SoS's challenge also requires thinking about the airport charge over the longer period and providing a stable framework to do so
  - b. financeability – because certainly over a longer period will affect the cost of capital and is also a way to avoid higher financing costs arising from the mismatch between the regulatory period and the underlying business and funding case; and
  - c. the incentive properties of any control – because incentives change depending on how long a price-controlled regulatee is allowed to enjoy the benefits of any efficiencies.
2. In the past the CAA has tended to settle for a 5-year control. Simply defaulting to 5 years will clearly not be sufficient for H7-H9. It will be essential that the CAA have regard to the need for long-term certainty. Certainty beyond the span of a 5-year price control is essential, in light of:
  - a. Heathrow's need for significantly greater equity and debt financing, to allow expansion to occur; and
  - b. The greater degree of risk associated with the expansion project.
3. The CAA has correctly identified that there is a need to carefully calibrate the regulatory regime to ensure that in light of the large amounts of new finance necessary regulation does not “create undue risks for [Heathrow] or raise its financing costs” in a way that would increase prices for consumers.<sup>23</sup> It is therefore essential that expansion does not compromise either:
  - a. The current investment-grade rating, which minimises Heathrow's cost of debt; or
  - b. The attractiveness of Heathrow to very long term institutional investors, focused on achieving risk adjusted and relatively predictable returns.
4. Expansion will put pressure on these positions – firstly, because Heathrow will likely require significant new financing and, secondly, because the activities associated with expansion imply greater levels of risk and uncertainty than “business as usual”. For example, investors may be concerned that:
  - a. there is potential for significant volatility – e.g. as forecasts will be for activities that are not part of Heathrow's every day activities; and that

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<sup>23</sup> CAP1782, para 1.1

- b. core elements of the price control could change midway through the expansion process – given that the project will take longer than a standard 5-year price control period.
5. To deliver expansion Heathrow needs committed equity capital at a reasonable cost for a long period. Yet investors will only commit capital for longer terms with certainty or a materially higher risk premium that will increase sharply as time horizons lengthen.
6. Rather than accepting the higher costs associated with this uncertainty as a “cost of expansion” that must be passed through to consumers, Heathrow considers that it is in consumers’ interests for the CAA to:
  - a. Engage on options for providing this certainty for the duration of the expansion project; and
  - b. Commit to providing long-term regulatory certainty in the most efficient way.
7. Heathrow’s request is not novel. It reflects the common practice among regulators in dealing with capital-intensive, higher-risk investments of national importance – and it is consistent with examples such as:
  - a. Ofcom’s long-term commitments about the price regulation of fibre broadband;
  - b. The long-term profitability certainty Ofgem has delivered for interconnector assets and offshore transmission projects;
  - c. Ofgem RIIO-2 framework, potential for setting revenue allowances for longer than one price control;
  - d. Ofwat’s approach to economic regulation of Thames Tideway; and
  - e. Fixed principles of Australian telecoms legislation. The copper network RAB is fixed for 10 years; the principles for the fibre network RAB valuation are fixed until 2040.
8. These are all examples where regulators and/or government determined that the risks associated with transformative long-term projects meant that rolling short-term price controls would not be appropriate or lead to efficient financing costs. Accordingly, in each a case type of longer-term regulatory certainty was necessary to ensure that:
  - a. the investment took place as there was otherwise a real risk of these investments not being made at all; and
  - b. that costs were reduced as the likely costs of underwriting a high-risk project in the context of rolling short-term price controls would have led to sharply higher prices.
9. Both of these factors are key to meeting the CAA’s objective of finding a regulatory framework that enables an affordable and financeable expansion. They ensure it can meet its statutory duties of: (i) ensuring reasonable demands for airport operation services are met, and to further consumers interests in terms of availability and quality;<sup>24</sup> and (ii) ensuring expansion is financeable and that economy and efficiency are promoted.<sup>25</sup>

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<sup>24</sup> CA Act ss 1(1) and 1(3)(b).

<sup>25</sup> CA Act ss 1(3)(a) and 1(3)(c).

10. We recognise there are various ways to achieve more certainty. For example, could be provided by extending the term of the price control beyond 5 years, so that it provides both debt and equity investors with a clear view of the regulatory arrangements for the duration of the expansion project. This could be combined with more frequent reviews of other building blocks to reduce the risks of excessive deviations from actual performance over time. Other options include “locking in” core elements of the price control for multiple price control periods (including but not limited to the equity return and expansion risk premium and cost of debt methodology) in the licence. At this stage we are simply seeking an indication that long-term certainty is a mutual goal of Heathrow and the CAA, to enable expansion and rapid engagement on the practical application of this in the regulatory framework ahead of the Initial Business Plan at year-end.

## Appendix 2: Proposed text of an economy and efficiency condition

### Heathrow's proposed wording

B3.1 The Licensee shall conduct its provision of airport operation services subject to this Licence in the economical and efficient manner of a prudent private market operator so as to secure the: (a) operation and maintenance; and (b) appropriate enhancement and development of the Airport in accordance with the other requirements and terms of the Licence and the Act.

B3.2 In complying with [Condition B3.1], the Licensee shall:

- a) seek to take into account insofar as practicable the objectively justified requirements of present and/or future users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services at the Airport. In so doing, the Licensee shall appropriately consult with users and/or providers of air transport services; and;
- b) not be required to take or omit any action that might reasonably be expected to adversely affect its ability to finance its activities under the Licence.

B.3.3 In evaluating the objectively justified requirements of present and/or future users, the Licensee shall be entitled to take into account all available evidence and, where there are competing requirements, be entitled to assess the strength of such evidence as is provided to it (including, among other factors, the materiality of the costs at issue).

### Mark-up of the CAA's proposed wording

B3.1 The Licensee shall conduct its provision of airport operation services subject to this Licence ~~business and its activities that relate to the provision of airport operation services at the Airport~~ in the economical and efficient manner of a prudent private market operator so as to secure the ~~economical and efficient~~: (a) operation and maintenance; and (b) ~~timely~~ appropriate enhancement and development of the Airport in accordance with the other requirements and terms of the Licence and the Act.

B3.2 In complying with [Condition B3.1], the Licensee shall:

- a) seek to ~~secure that~~ take into account insofar as practicable the reasonable demands objectively justified requirements of present and/or future users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services at the Airport ~~are met~~. In so doing, the Licensee ~~shall carry out appropriate engagement~~ appropriately consult with users and/or providers of air transport services; and, airlines and other stakeholders, including providing timely and accurate information to them, so that it can identify present and/or future users' reasonable demands.
- b) not be required to take or omit any action that might reasonably be expected to adversely affect its ability to finance its activities under the Licence.

B.3.3 ~~The Licensee shall fulfil its obligations under this condition to the greatest extent reasonably practicable, taking into account all relevant circumstances, including the need for it to finance its provision of airport services at the Airport~~ In evaluating the objectively justified requirements of present and/or future users, the Licensee shall be entitled to take into account all available

evidence and, where there are competing requirements, be entitled to assess the strength of such evidence as is provided to it (including, among other factors, the materiality of the costs at issue).