Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (CAP2139)

Heathrow’s response

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Contents

Executive Summary

1. The CAA's Way Forward consultation (CAP2139) raises a number of issues that will be important in the success or failure of the H7 price control – and thus of the airport – through to 2026.

    a. The backdrop to H7 will be the unprecedented impact of the Covid-19 pandemic, Heathrow's, its stakeholders' and the CAA's response to it and the shape of any recovery.

    b. Uncertainty over many factors will be higher in H7 than in previous periods, as the CAA rightly highlights in CAP2139. This is caused not only by the uncertainty of the pandemic and border closures in the aviation market, but also multiple rapid shifts in wider government policy and, increasingly, regulatory uncertainty too.

    c. Flexibility in the settlement mechanisms, applied within a robust, simple framework is the key to success. False precision and complex interventions will not work. Nor will a framework where the parts do not follow consistent principles to form a coherent whole. Heathrow fears both of these outcomes based on some of the CAA discussion to date.

    d. These considerations inform our view of the issues raised in CAP2139 and also the update to the RBP which will we provide to the CAA shortly after this response

2. The CAA should be building on the core principles of RAB based regulation. Enabling private finance to deliver a resilient airport at an affordable charge is the question at the core of H7, and CAA decisions on the form of regulation and its impact on our financeability in the next few months will set the tone for years to come. If it focuses on short-term concerns around headline price or relies on unevidenced assumptions it will sacrifice resilience and service, harm sustainability, endanger efficient private financing and ultimately compromise the interests of consumers, in particular future consumers.

3. The CAA does not yet know the problem it is trying to resolve and should therefore not seek to control for outcomes which may not arise. The context for aviation has changed dramatically over the last two years. Peoples' freedom to travel by air as and when they want has been severely curtailed by Government action throughout the world to protect public health. The long-term impacts of this are not clear. In addition to restrictions, significant additional costs for consumers wanting to travel as a result of testing and quarantine requirements have increased the overall cost of travel for consumers. At the same time, they have added additional burdens on the airport such as additional processes and removal of the VAT res scheme. All this means that the challenges for H7 are no longer the standard issues of regulatory design the CAA was looking at in previous H7 documents. This is now about a sector recovering from the impact of Covid and ensuring its success in the long-term.

4. The CAA's focus for Initial Proposals should be:

    a. Addressing the risk / reward balance issues highlighted by Covid 19 to ensure access to efficient private debt and equity financing. This is not confined to forward-looking actions in the H7 framework but must include the CAA demonstrating the credibility of regulation in practice through ensuring the framework set in Q6 is implemented. We agree with the CAA that explicit risk-sharing will be valuable. But this alone will not mitigate all of the financeability challenges facing investors.

    b. Reinforcing the principle of regulatory depreciation by taking adequate action to show this fundamental concept of RAB based frameworks operates in practice. The CAA's interim 'targeted intervention' of a £300m RAB adjustment acknowledges to some degree the immediate impacts of Covid 19 on service and capacity for consumers. But it fails to deal with the scale of the crisis and will be insufficient to deliver an H7 with the lowest average charge and consumer outcomes most preferred by consumers. It also fails to address the fundamental principle that Heathrow's investors should be able to recover efficiently incurred expenditure. As set out in the report from Frontier Economics provided alongside our CAP2098 response and in the CAA's Q5 policy documents, the recovery of efficiently incurred expenditure is a basic principle of the stability of RAB-based regulation.[1] A full RAB adjustment is, therefore, still indispensable to deliver an H7 Settlement which best protects the interests of consumers.

c. Facing into the integrated financing challenges of H7. This particularly means addressing the interplay of cashflow, depreciation and cost of capital. It means a realistic market-based approach to maintaining A- investment grade debt financing. It means addressing equity financeability with a rational dividend assumption to 2026 not an assumption of permanent dividend forbearance.

d. Avoiding complex and unnecessary changes to the regulatory framework which were targeted at resolving old problems and not the fundamental issues brought about by Covid-19. This includes the CAA's outdated proposals on capital efficiency and taxation treatment.

5. A stable and investable H7 framework which can deliver in the interests of consumers therefore requires:

a. A five-year regulatory framework to provide a longer-term stable base for aviation to rebuild growth at Heathrow. We welcome the CAA confirming this approach.

b. A mechanism for adjusting the opening H7 RAB to ensure it reflects the extreme and unforeseeable impact of Covid-19 on Heathrow in order to reinstate investor confidence in both the regulatory framework and the regulator's fair application of it and ensure an efficient cost of capital and appropriate investment plan for H7 in the interests of consumers.

c. A financeability policy which enables Heathrow to return to the equivalent of an A- credit rating and a return to dividends within H7 in order to retain access to efficient debt and equity financing and therefore ensure that the cost to consumers does not increase inefficiently.

d. A cost of capital which reflects the characteristics of Heathrow and the impact that Covid has had on investors' perceptions of airport risk to ensure that the long-term interests of consumers are protected through access to investment in H7. To this end, the approach taken by the CMA in the NERL and Water cases provides a key benchmark for a number of parameters.

e. Methodologies for forecasting passenger volumes, operating costs and commercial revenues which (i) set an efficient overall level of costs and revenues for Heathrow across H7 in a data-based way (ii) allow for transparent, flexible and rapid adjustment as circumstances develop in the lead up to a Final Determination and (iii) ensure that costs remain affordable for consumers and that Heathrow has incentives to drive

[1] "*Depreciation policy should ensure that the company is remunerated once for the investment made.*" https://webarchive.nationalarchives.gov.uk/20140606022204/http://www.caa.co.uk/docs/5/ergdocs/airportsdec06/wholedoc.pdf

efficiencies. We continue to believe this is best achieved through drivers rather than rigid scenario plans.

f. A revenue risk sharing mechanism, as distinct from passenger mechanism, to transparently take into account the full impact of any future extreme variability in Heathrow's financial position and accommodate uncertainty on commercial revenues in H7. This should be set using dead bands to create a risk reward balance consistent with Heathrow's comparators and competitors and foster both closer commercial cooperation with airlines within this band and commercial incentives on Heathrow. It should also be designed to protect minimum cashflow generation to protect financeability at all times.

g. A capital investment framework which (i) retains the flexibility for Heathrow and the airline community to jointly define the investments which most benefit consumers on an ongoing basis through the H7 period, (ii) ensures airport charges only reflect the capital actually invested, and (iii) is straightforward enough to efficiently implement to deliver capital investments on-time and on-budget.

h. A service quality framework which identifies the outcomes that consumers want from their airport journey, reports on how Heathrow and all parties at the airport are delivering on these outcomes and incentivises performance improvements which most benefit consumers, with financial incentives aligned to who runs the processes.

i. The right uncertainty mechanisms in the framework and Licence, such as an expanded S-factor, clear reopening provision, pass through of business rates and flexible treatment of the revenue from Terminal Drop Off charge in order to ensure that the framework is flexible to deal with changes – particularly in government policy and regulation - and remains fit for purpose in the face of uncertainty over the H7 period.

j. Continued use of a pre-tax approach to tax allowances that prioritises stability at a time of huge external uncertainty, avoids material time inconsistency between regulatory periods, and acknowledges the impacts of UK tax changes over multiple years.

k. Charge profiling over H7 that acknowledges and addresses the very real financing challenges and the interaction between RAB, regulatory depreciation, cashflow and private financing constraints to support both recovery and financial resilience.

6. The CAA's consultation puts very few of these requirements in place. While the CAA's decision to set a five-year price control settlement is a step forward in ensuring this much needed stability for the H7 period, more work is required to ensure that the framework for the H7 settlement can reliably and flexibly deal with the uncertainty and changed circumstances we are facing. The CAA has all the tools it needs in order to set this framework but it will require a laser-like focus from the CAA on its statutory duties as a whole, in particular the balance between affordability and financeability.

7. The evidence from this consultation is that the CAA is not working with this focus. If the CAA does not change its approach to provide a financeable and affordable price control in its Initial Proposals it risks the success of Heathrow and delivery in the interests of consumers in the H7 period. In this case we will be forced to review our options for further action, including eventual appeal of the CAA's final decision.

8. The CAA made a number of observations on the RBP in CAP2139. The RBP was a transparent, comprehensive and substantive effort to plan for consumer outcomes given huge uncertainty and limited time and resources. We consider a number of the issues raised in CAP2139 to be

misunderstandings or misguided. We set out in detail our response to the criticisms levelled by the CAA in CAP2139 throughout in response to Chapter 3 and Appendix E.

9. While we do not agree with many of the criticisms of the RBP set out by the CAA we are committed to engaging constructively with the CAA to address these comments and provide further clarity where we can. Our RBP Update, which will be published shortly after this response, evidences this commitment. Our RBP Update will also set out areas where we have new or additional information to support the CAA's work, including asset management plan details, new consumer research, and some updated data to support passenger and commercial revenue forecasts

10. Alongside this consultation response we are also providing the CAA with:

    a. An updated version of our December RBP will follow shortly after submission of this response. This takes into account key changes since December and feedback from the CAA and airline community;
    b. An initial view of the licence changes required to implement the H7 settlement (Annex 1);
    c. A legal Annex from Towerhouse LLP setting out legal comments on certain aspects of the CAA's consultation document (Annex 2); and
    d. A letter to the CAA from our Head of Tax setting out our full response on changes proposed to the treatment of taxation in CAP1876A (Annex 3).

11. For clarity, our response follows the structure of the CAA's document and sets out our detailed views on the issues raised.

Chapter 1: The CAA's Initial Assessment of Heathrow's RBP

12. The CAA's assessment of our RBP against its guidance ignores the points raised by Heathrow in both:

    a. Our response to CAP1940; and
    b. Through bilateral engagement about the appropriateness of the requirements in the CAA's guidance and our actual ability to provide the information required.[2]

13. The CAA's assessment of our capital plan is particularly flawed in this regard. We have been clear with the CAA that we are in the process of developing our capital plan in collaboration with the airline community following the fundamental changes to our capital programme caused by the pause of the Expansion programme and the impact of Covid-19 on our plans in 2020 and 2021. We committed to providing updated information on the detail of our plan as this becomes available through this engagement process. Detail on the process and the updates which have been made will be available in our RBP Update. Even then it will not be entirely fixed in every detail.

14. The CAA's characterisation of our RBP as having a "*lack of meaningful integration across different elements*"[3] is manifestly wrong. Our RBP provided six alternative scenarios for the H7 period. These included scenarios on alternative passenger volumes, alternative regulatory period lengths and alternative outcomes of the CAA's decision on Heathrow's request for a Covid-related RAB adjustment. All of our cost and revenue building blocks are integrated, and thus vary, with these scenarios through our driver-based methodology which takes into account the impact of passenger volumes and operational terminal space on our cost and revenue forecasts, and they also set out the anticipated impact on service. This is clearly set out in our RBP model[4] which the CAA can use to explore the impact of any of the various passenger volume scenarios on each of the building blocks of the price control.

15. With respect, it is unhelpful for the CAA simply to comment that the plan *"lacks meaningful integration".* We are happy to respond constructively to constructive criticisms, however given the high level of integration described in the previous paragraph, the CAA's comment as it stands is disingenuous and unhelpful. We have provided more detail on our responses to the CAA's comments in response to Appendix E. Going forward, we urge the CAA to be specific in both its criticisms and the level of further detail and evidence it requires. While the information requirement table provided at Appendix F sets out some requirements at a high level, it is clear that many of these comments are generic and the information can be readily found within our RBP as we provided it.

16. The £3.5bn capital plan included in the RBP was the capital envelope for our base case. While we proposed that a lower capital plan of around £2bn covering only critical compliance spend be adopted in the case of 'low' passenger volume case and in the case that no RAB adjustment was given, we set out that, in all other cases, a capital envelope of £3.5bn was required to both continue to increase the efficiency of Heathrow's operations and ensure resilience and service

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[2] Pages 9-12 of our response to CAP1940 set out our response to the CAA's business plan guidance. Here we made it clear that CAA expectations on agreed scenarios, opex and commercial revenue modelling and capital plan detail could not be provided in the RBP.
https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/H7/CAP1940%20Heathrow%20Airport%20Limited%20(HAL).pdf
[3] CAP2139, Page 22, Table 1.2
[4] Model: Heathrow RBP – External v1.00, The 'RoA' tab lists the assumptions for all scenarios and the 'Control' tab can be used to toggle through the different scenarios.

levels meet ever increasing consumer expectations. As such, our proposals on OBR, opex and commercial revenue were based on this £3.5bn plan.

17. The CAA's statement that our plan *"does not fully meet the requirements of consumers and stakeholders"*[5] is unevidenced. There is a really fundamental flaw in the CAA's approach here, it has carried out no consumer-based work, which we are aware of, to understand the needs of consumers in regard to our business plan and so has no evidence to support this statement. In fact, the CAA abolished the Consumer Challenge Board it had established to ensure that Heathrow's plans were in the interests of consumers. It is also resisting all calls for similar consumer groups, such as its own consumer panel, to directly represent the interests of consumers through the process.[6] The CAA's assessment that our plan does not fully meet the requirements of consumers is therefore unsupported by any evidence. The CAA's approach is falling short in delivering upon its over-riding duty to the users of air transport services.

18. As set out above, despite multiple representations to the contrary, the CAA has continued to expect to receive a level of detail and reassurance on future forecasts which is patently unrealistic and has misunderstood the contents of our RBP and RBP model. Moreover, the CAA appears to seek additional detail to help resolve the significant uncertainty in the next period, instead of recognising that this uncertainty can make such additional detail irrelevant.

Chapter 2: Developing projections for the Initial Proposals

19. While it is clear that more information has become and will continue to become available through 2021 and that this further detail will be important to ensure that the H7 settlement is set on the basis of as robust forecasts as possible, we disagree with a number of the CAA's conclusions regarding our December RBP.

20. The CAA asserts that we have taken a *"relatively simple"* approach to our opex and commercial revenue forecasting for H7. Our driver-based forecasting methodology reflects best practice across other regulated sectors and is a well evidenced and transparent forecasting methodology.[7] This transparency and clarity should not be mistaken for simplicity or a lack of robustness, sufficient detail to engage upon or lack of evidence.

21. The CAA's quest for ever more detail will, ultimately, not help it resolve the issues central to the H7 settlement. The aviation industry has been materially impacted by Covid-19, passenger volumes are low and uncertainty is high. The impact this will have on Heathrow's WACC, cost base and ultimately airport charge cannot be changed. There is no silver bullet in the detail around Heathrow's cost and revenue forecasting that will solve this issue. The answer is, instead, in the CAA's approach to the regulatory framework.

22. The purpose of Heathrow's regulatory process is to set an efficient envelope of costs and revenues which creates the right incentives for Heathrow to continue to be efficient and seek out further efficiencies where these exist. The CAA's requests for more and more detail on smaller and smaller aspects of Heathrow's operations, for example changes in staffing levels over the H7 period, specific contract costs or the number of car parking spaces and price per product, will only serve to provide the CAA with a spurious sense of accuracy about its understanding of Heathrow's costs and revenues and may lead to it missing the bigger picture of overall efficiency.

23. Seeking more detail will not help the CAA better protect the interests of users. It will only serve to constrain Heathrow's decision making in-period by predefining the detailed actions Heathrow should and shouldn't take at a time when it is particularly important for Heathrow to have flexibility

[5] CAP2139, Page 25, Paragraph 1.26
[6] CAP2139, Page 83, Paragraph 5.27
[7] Our methodology reflects that used by the Commission for Aviation Regulation in Ireland for it' regulation of Dublin Airport.

to react quickly to a fast-changing operating environment. As we have seen, this flexibility will be particularly important in dealing with and recovering from Covid-19. Such an approach from the CAA would be more likely to prevent innovation and change than promote it.

24. This quest for excessive and fundamentally irrelevant detail would be fruitless in any regulatory period[8]. But its particularly perverse in current circumstances for two reasons.

    a. The first is the spurious nature of detailed forecasts in a period of such uncertainty. On the one hand the CAA acknowledges the inherent uncertainty in passenger forecasting for the period and the need for regulatory mechanisms to address this. Yet on the other it is requesting specific detail on our staff numbers for the period which will serve these passengers in order to forecast operating costs through a bottom-up methodology. This will only build further uncertainty into the forecasts and create a sense of false accuracy.

    b. The second is that it reveals a lack of strategy for the price control from the CAA and a failure to grapple with the underlying challenge for the airport, airlines and consumers. The core challenge is how to prevent long term deterioration in resilience and service, while safeguarding private financing and delivering the lowest possible charge. We need plan that manages these very real tensions and is flexible enough to deal with an extraordinary period. That will require facing into some difficult choices and bolder decisions. There is sense the CAA is, understandably, worried by these decisions so seeking comfort in calling for more detail instead.

25. The CAA's demands in this regard are therefore neither proportionate nor targeted only at cases where action is needed. This is contrary to the requirements under the Civil Aviation Act 2012 (CAA12).

26. Indeed, our analysis presented to the CAA and airline community in the first session of Constructive Engagement and in bilateral sessions with the CAA on our RBP on 30 November 2020 (operating costs) and 4 December 2020 (Commercial Revenues) shows that our driver-based forecasting methodology was in fact more accurate at forecasting the overall levels of opex and commercial revenue for Q6 when the overall environment was more stable than the more bottom-up approach used at the time. It also showed that our driver based methodology provided a robust forecast of our cost and revenues for 2020 taking into account the impact of Covid-19. This gives us real confidence that our approach is robust, even in the current extreme circumstances It also showed that our driver-based methodology provided a robust forecast of our cost and revenues for 2020 taking into account the impact of Covid-19. This gives us real confidence that our approach is robust, even in extreme circumstances.

[8] RedRoute work on commercial shows that while it was able to set an appropriate overall envelope through a bottom-up commercial revenue forecasting methodology for Q6, its ability to forecast individual line items was limited. This work was submitted to the CAA and airline community through CE.

Table 1: Extract from analysis of Heathrow's 2020 costs versus forecast using Heathrow's driver based methodology

	F1	Variance to Model Output	
Operating Cost Forecast [£m, 2018p]	**2020**		
People costs	[redacted]	[redacted]	0%
Operational costs excl. insurance	[redacted]	[redacted]	12%
Insurance	[redacted]	[redacted]	-12%
Facilities maintenance costs	[redacted]	[redacted]	-2%
Rent rate costs	[redacted]	[redacted]	-12%
Utility costs excl. distribution contract	[redacted]	[redacted]	4%
Distribution contract	[redacted]	[redacted]	3%
General expenses incl. consultants & marketing, gen ex & interco	[redacted]	[redacted]	-39%
Total	**930**	**(13)**	**-1.4%**

27. The CAA's document, quite properly, provides robust challenge of our forecasts and evidence base. Yet it largely presents and accepts views and 'plans' from the airline community and its consultants as a primary source of evidence without equivalent challenge. We agree that the views and 'Alternative Business Plan' provided by the airline community as stakeholders in this process are very different in nature and status to our RBP. The RBP is a robustly evidenced and integrated plan put forward by the regulated business, and therefore necessitates different treatment and scrutiny by the CAA. However, it is misleading of the CAA to present such views or alternative 'plans' as near fact without appropriate challenge. We would expect to see material further evidence of the CAA's analysis and challenge of the airline views if it intends to use them as evidence in forming its Initial Proposals.

28. In the RBP, we set out a number of areas where the views put forward by the airlines in their ABP were unevidenced, not aligned with market data or actually incorrect:

    a. The ABP proposed a WACC of 2.9%, which is lower than the pre-tax WACC for water companies identified by the CMA of 3.12% and is not reflective of the risk of airports in any environment. This alone is a good indicator of the degree of rigour in the ABP.

    b. Taylor Airey's assessment of the impact of the government policy on VAT significantly underestimates the impact on Heathrow's revenues by failing to consider both direct loss of commissions from VAT refund and the associated reduction in sales per passenger.

    c. The ABP states that CPI should be used to inflate our operating costs, rather than RPI. Our forecasts use nominal input price inflation from the OBR and would thus be the same in outturn prices whichever inflationary approach was adopted.

d. The ABP proposed removing the funding of Heathrow's pension deficit from operating costs. This would be completely inconsistent from a policy perspective as the benefit of previous lower pension payments were passed on to consumers.

29. Heathrow always seeks to engage constructively with airlines because they are our direct customers. The position of Heathrow, though, is quite different from that of the CAA, which has a statutory duty to passengers and cargo owners. The CAA should not take, from our responsible approach to our customers, that it too should be looking primarily at the airline perspective or affording it particular weight, on the contrary, the CAA's focus should be on its statutory duties.

30. We also note that the CAA refers to work from consultants which has informed its assessment of the RBP but without publishing this information. We request that this information and other information the CAA has used to reach its conclusions in this document, such as the work carried out by FTI Consulting citied in Appendix N, be published, with appropriate redactions to ensure commercial confidentiality, to ensure a transparent process. These issues are set out in more detail in the legal Annex to this submission.

RBP Update 1

31. Alongside our response to CAP2139, we will be publishing our first update to the December RBP. This will set out how key assumptions have changed since our December RBP, any changes we have made to our forecasting or our plan following feedback or changes in CAA policy position and provides increased detail where this is available.

32. Our overall approach to our first RBP update will be consistent with the approach to the RBP itself. We will present an updated plan with a set of core assumptions, including the full RAB adjustment requested by Heathrow, and a plan reflecting the impact of the interim adjustment confirmed by the CAA in CAP2140. A range of updated sensitivities have been developed to demonstrate the detailed outturn of potential different outcomes, for example higher or lower passenger volumes.

33. Our RBP update takes account of additional consumer research carried out since publication of our RBP, as well as new market data, CMA decisions and CAA policy developments that have been published over the same time period. We have also considered feedback received from both the CAA and airlines since publication of our RBP and have provided responses to this feedback where it evidence exists to make it possible for us to do so.

34. Our RBP update aims to address the information requirements set out by the CAA in both Chapter 2 of the document and Appendix G or provide evidence as to why an alternative approach is necessary.

35. Our update is comprised of five core sections:
- Developments since publication of the December 2020 RBP;
- Updates to our consumer insights;
- Updates to our key building blocks;
- Updates to our regulatory framework proposals; and
- Additional evidence to support RBP scenarios.

36. Key changes and areas with increased levels of detail are:

a. Plan sensitivities:
   i. A new 'low RAB adjustment' case;
   ii. Discontinued RBP 'no RAB adjustment' and '2021 RAB adjustment' sensitivities following the publication of CAP2140; and

    iii. Discontinued RBP '5-year regulatory period' and '7-year regulatory period' sensitivities to reflect confirmation in CAP2139 that H7 will be a 5-year regulatory period.

b. Passenger forecast
    i. Updated passenger forecast to reflect latest market data; and
    ii. Market disaggregation of the passenger forecast.
c. Capital Plan:
    i. Providing further detail around our proposed Protect the Business portfolio;
    ii. Providing further detail at individual asset level around our Asset Replacement and Compliance Programme;
    iii. Providing updates reflecting further engagement that has taken place with the airline community around our capital plans;
    iv. Providing an update to our H7 programme framework with benefits and prioritisation measures for capital investment;
    v. Reiterating the link between our H7 capital plans and our operating costs/commercial revenue models, as set out in our RBP.
d. Operating Costs:
    i. An updated operating costs forecast using the RBP drivers model;
    ii. Further explanation of Expansion impacts on the 2019 baseline;
    iii. An update on the Cost of Change business case; and
    iv. Additional evidence to support operating cost overlays.
e. Commercial Revenues
    i. An updated commercial revenues forecast using the RBP drivers model;
    ii. Reiterating the link between H7 capital investment and commercial revenue generation;
    iii. Detail around updated mode share assumptions;
    iv. Detail around the Heathrow Express business case; and
    v. Further updates to our assumptions around the VAT impact overlay and other overlays.
f. RAB adjustment, WACC and depreciation
    i. Update to the RAB adjustment to reflect the latest forecast outturn for 2021;
    ii. Update to the WACC to reflect the final CMA outcome for water, updated market data, changes to the cost of embedded debt since October, and changes to the outlook for the corporation tax rate.
g. Financial modelling and financeability
    i. Update on actions taken to protect financial resilience since our RBP
    ii. Assessment of the financeability of our scenarios and different sensitivities
h. Consumer Insights:
    i. An updated view of consumer insights, taking into account further research since December 2020; and
    ii. Incorporation of independent Consumer Acceptability Testing to understand consumers' acceptance of the levels of the Passenger Charge and service improvements set out in our RBP.
i. Scenarios:
    i. Explaining how the various aspects of the plan derive from integrated scenarios based on a range of passenger forecast scenarios; and
    ii. Providing detail around the 'low RAB adjustment' case.

37. The sections below respond directly to the points raised by the CAA in its CAP2139 consultation and align with the content of the RBP update.

Passenger forecasts and scenarios

38. In the light of the significant uncertainty surrounding passenger forecasting for H7, we welcome the CAA's conclusion that our passenger forecasting approach is *"well-considered and structured"*[9].

39. As the CAA highlights, there have been a number of changes since the RBP which may have negatively impacted passenger forecasts in 2021 and 2022. In light of these changes we have reviewed our 2021 and H7 forecasts and will provide an updated position in the RBP update document. In our June 2021 Investor Report we confirmed that our 2021 passenger volume base case now assumes 21.5m passengers in 2021. This is down from a forecast of 37.1m in our December 2020 Investor Report and 36m in April 2021.[10] This reduction in passengers compared to our December 2020 guidance reflects the impact of five months of significant travel restrictions and cautious gradual reopening now expected during the months ahead. The Investor Report also flags that a low scenario of 13m passengers in 2021 is still plausible.

40. In its assessment of our passenger forecasting, the CAA has raised a number of specific concerns. We address these in turn below:

    a. ***"the use of a method that has not been used previously for a price control, and which cannot easily be validated, also generates a range of risks"*** While Heathrow's H7 forecasting approach does include some new approaches, it should be noted that the methodology is largely built on that used for passenger forecasting in Q6. This methodology was more accurate than previous approaches used. We therefore have confidence that the base of our passenger forecasting approach is tested and robust.

    In regard to the changed elements of our forecast, we do not necessarily agree that using a new forecasting methodology poses risks for the H7 settlement. The impact of Covid-19 necessitates a revised approach to parts of our forecasting in order to appropriately assess and analyse the wide range of potential outcomes and provide an informed final forecast based on this information. In fact, the greater risk to the accuracy of the H7 settlement would be not to update the forecasting methodology to better reflect the uniquely uncertain operating environment.

    The approach we have taken effectively takes account of the uncertainty to provide a robust H7 forecast and it appears that all stakeholders, including the CAA itself agrees with this assessment. In fact, in the document the CAA notes its intentions to use our forecasting suite to form its Initial Proposals and in Appendix E notes that: *"it appears appropriate that HAL has sought to develop its methodology to better take account of volatility and to develop several scenarios that should aim to capture a reasonable range of possible outcomes, and which can be updated as and when there is more evidence and certainty."* While noting some areas of disagreement in the assumptions used, the airline community also confirms in its response to our RBP that it "*recognises the particular challenges associated with forecasting at this time and concurs with an iterative approach as laid out by the CAA and being undertaken by HAL."*[11]

    Reviews against other sources as presented in our RBP also highlight that our forecasts are in line with other market views. Figures 21 and 22 of the RBP clearly showed that our forecasts for the period were in line with those set out by Eurocontrol

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[9] CAP2139, Page 28, Paragraph 2.6

[10] https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_(SP)_investor_report_June_2021_Final.pdf

[11] Airline Community written feedback Initial Comments to Heathrow's Revised Business Plan March 2021

and IATA. This gives us further confidence that our forecasting approach is robust and can in fact be validated.

b. ***"HAL has included downward adjustments to all scenarios to reflect potential demand shocks in H7, which includes taking account of the impact of the covid-19 pandemic in H7. Given that the forecast scenarios already assume varying degrees of continuation of, and subsequent recovery from, the impact of the covid-19 pandemic, this appears to double count the impact of the covid-19 pandemic and thus may be somewhat pessimistic"*** The principle of including a shock factor is that the impact of shocks experienced is averaged over the period and then applied to the forecast. It is not based on an explicit judgement over how likely each event is to occur but assumes that the average of the range of historical impacts is the best estimate for any future impact. The fact that Covid 19 started in 2019 does not nullify the risk of another pandemic, or of other less material shocks (e.g. a volcano or geopolitical event), happening before the end of 2026. To exclude the impact of Covid in the shock factor would mean stating that there was no possibility of a further event like those listed above occurring again. This is not the case as evidenced by the prevalence of pandemics: Russian Flu 1889-90 (1m deaths), Third Plague 1894-1922 (12m), Spanish Flu 1918-19 (50m), Asian Flu 1957-58 (2-5m), and Hong Kong Flu 1968-69 (1-4m). More recently, SARS 2003 and Swine Flu 2009-10 (0.5m) have been smaller pandemics that affected air travel. The historical evidence shows that there have been at least 6 major pandemics in the last 132 years, and therefore including the impact of one pandemic in a thirty-year historical period is likely to be broadly appropriate. In taking a view that including Covid-19 could double count its impact, the CAA is underestimating the risk of a future pandemic occurring.

   The shock factor reflects the mitigated impact of the pandemic. In the no adjustment case presented in the December RBP, there is no mitigation and the impact of the pandemic is greater and therefore its resultant impact on the shock factor is greater. In the adjustment case, only the first 10% of the traffic losses are reflected in the shock factor as the residual losses beyond this are mitigated through the adjustment.

   It is also interesting to note that the CAA refers to the application of a shock factor as a key mitigation to ensure that the expected outcome for Heathrow is fair given the asymmetric passenger volume risk to which it is exposed. In Appendix J, the CAA notes that the continued use of a shock factor to baseline forecasts, alongside potential risk sharing, is a key factor in the CAA's view that the balance of the risk under the price control package is unlikely to warrant any aiming up of the WACC for the period. We note that the shock factor does not reduce the risk – it merely adjusts the expected outcome so the Determination is a fair bet for Heathrow. Because the shock factor does not impact risk it has no impact on WACC, and therefore the CAA are incorrect to make this link. However, if the CAA were to make any changes to how this shock factor is applied or calculated, this could have an impact on the expected outcome and therefore on whether the Determination was a fair bet for Heathrow.

c. ***"we are currently unclear on the rationale for HAL combining four input scenarios into Low, Mid and High cases by applying subjective weighting factors, based on assumptions on probability of occurrence"*** To add to our above response to point a, this is a key part of the methodology to tackle the uncertainty, allowing a probabilistic and scenario-based approach, as was agreed with the airline community to be necessary. As set out in our response to point (a), the airline community is supportive of this iterative approach. This has the advantage of considering all potential scenarios and combining them in a way which gives a probabilistic output, to give the breadth and depth to look at sensitivity and scenario analysis, and to calibrate the framework and approach to risk sharing. The combination of scenarios avoids the need to 'pick' a particular scenario, and so be overly reliant on a single narrative of events. Point and interval forecasting have been left behind as best statistical practice by probabilistic forecasting in many varied disciplines ranging from banking and finance, energy, disease modelling and even sports.

d. ***"while HAL produces passenger scenarios by market level disaggregation, only the "Mid" case is used in estimating other relevant building blocks in the RBP, without disaggregation by market"*** It is incorrect for the CAA to state that only our Mid case scenario is used in estimating RBP building blocks. Our RBP also sets out the impact of our High and Low passenger cases on the key RBP building blocks, service levels and ultimately the average H7 charge. This is set out in both Chapter 10.2 of the RBP and in our RBP model provided to the CAA.[12]

   Our approach to forecasting revenues also included an assumption that a change in passenger mix and spending habits would impact revenue per passenger by around 12% post-Covid, falling to 0% at the end of H7 as the impact is reduced. For our RBP update we have reviewed in more detail the impact of passenger mix changes on our forecast of commercial revenues. The updated forecast in our update will combine passenger retail transaction data and our demand forecasts by market to calculate this Covid-related impact more precisely.

41. It is also appropriate to consider the ability of any future risk sharing mechanism to mitigate these potential risks within H7. A properly calibrated risk sharing mechanism will ensure that consumers, Heathrow and the airline community are not exposed to the risk of potentially large variations between outturn and forecast passenger volumes across H7.

42. Following the RBP, we have continued to engage with the CAA on our forecasting methodology and the impact of key assumptions and drivers on the overall H7 forecast. We will continue to engage with the CAA ahead of Initial Proposals to ensure that it has the information it needs to fully understand our methodology. Given the fluid market and pandemic situation we also anticipate updating the data and assumptions later in the year as part of our second RBP update.

Opex

43. We welcome the CAA's conclusion that our approach to forecasting opex is clear and logical. The approach used in our RBP builds on the approach used in our IBP and Building Block Update, taking into account feedback from the airline community and CAA.

44. To ensure confidence in our forecasting methodology, as noted earlier in the response, we carried out an assessment of the ability of our driver-based methodology to accurately forecast the change in costs we experienced following the onset of the Covid-19 pandemic. The analysis showed that our methodology was able to accurately forecast our overall opex envelope even in the face of this unprecedented shock and change to our operations. Actual costs were within 1.3% of the costs forecast through our model. This ability to accurately forecast the impact of the crisis gives us confidence that our methodology can accurately forecast our costs through the recovery.

45. However, following feedback and challenge from the airline community and CAA and building on the methodology used for IBP and BBU, we have implemented specific overlays and used specific adjustments where material changes in our cost base are not fully reflected by the driver-based methodology. These include elements such as the Cost of Change, which was agreed as

[12] The 'RoA' tab lists the assumptions for all scenarios and the 'Control' tab can be used to toggle through the different scenarios

part of a separate agreement with the airline community. These are all explicitly quantified in our forecast.

46. The CAA notes that while we have considered the views of the airline community in our forecasting approach, we have not implemented actions to address some concerns raised, such as concerns regarding pension costs and efficiencies from some capital programmes. This is factually incorrect. In our RBP we expressly addressed all of the views raised by the airline community through the Constructive Engagement (CE) process setting out either the changes we had made to our plans or the reasons why we did not think it was appropriate to make any changes based on the feedback given. This was set out in both Chapter 2.4 – Constructive Engagement and in Section 7.1.3 of Chapter 7.1 – Operating costs. We therefore consider that all airline views have been recognised and considered, with changes implemented where appropriate and not implemented where this would not be appropriate.

47. In paragraph 2.21, the CAA raises some specific concerns around our approach. We address these each in turn below:

    a. ***"We consider that HAL needs to provide further evidence to support its assumption that its 2019 base year is efficient"*** Both our IBP and RBP provide a robust external evidence base demonstrating the efficiency of Heathrow's cost base. Analysis from KPMG highlights that Heathrow is at the efficient frontier for operating costs.[13] Our RBP Update 1 submission will further substantiate the efficiency of our 2019 baseline. Our update will also correct the incorrect assertions made by the airline community that the level of savings made in 2020 indicate inefficiency in the baseline. Key points include:

        i. The airlines' assertion that our 2019 cost base is inefficient because we have found further 'efficiencies' in 2020 is misguided. Organisational changes such as temporary pay cuts, furlough and changes to contract agreements reflect the substantially lower passenger volumes and other impacts caused by Covid-19. 2020 was an unprecedented year and required actions which would not have been reasonable or possible in 2019 and which could not be considered to be sustainable over time.

        ii. The efficiency savings from the baggage contract renewal represent those that would be expected as part of ongoing efficiencies when contract renewals occur, reflecting current circumstances at the time of renewal and do not indicate that the previous contract was inefficient. This type of effect is captured going forward in our ongoing efficiency challenge.

    b. ***"HAL has not provided sufficient assurance that the adjustments that it made to the 2019 opex base year are appropriate. For example, it is unclear whether the level of expansion costs that have been removed from the base year is accurate"*** The CAA continues to ask for additional evidence in regard to adjustments to the 2019 baseline despite the clear, comprehensive and evidenced explanations in our RBP. We are therefore confused about what additional evidence the CAA wants to see, in particular in relation to the expansion programme. Our RBP clearly set out that we had removed £1.8m of operating costs from our baseline which reflected purely expansion-related activities to ensure that this cost is not flowed forward into the H7 forecast.[14] This £1.8m is consistent with submissions made to the CAA on the levels of Category

[13] Heathrow RBP Annexes, Annex 21
[14] Heathrow RBP, https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/RBP-detailed-plan.pdf, Section 7.1.6.1

B costs incurred in 2019. This is also demonstrated through our reconciliation of the 2019 regulatory and statutory accounts which shows that the baseline operating costs included in the RBP are net of any capitalizable expansion costs.

We would therefore welcome further clarification from the CAA regarding their concerns and the additional information and evidence they would expect to see in order to fully evidence this.

c. ***"HAL has provided limited justification for upward cost overlays and has not provided analysis to support the adjustments that it has proposed"*** Again, this information has previously been covered with the CAA. During engagement with the CAA following the submission of the RBP, we provided additional clarification on a number of the cost overlays included within our forecast.[15] At this point the CAA did not follow this up with further requests for information. In order to meet the CAA's information request set out in Appendix G we will provide full justification of these cost overlays, in line with the information provided to the CAA through previous engagement, in our RBP Update. This sets out that, in order that the exercise remains proportionate to its objective and to avoid errors that might be generated in pursuit of spurious accuracy, our proposed overlays have been implemented only for material changes, defined as greater than £5m per annum or ~1% of total operating costs, and provides evidence for the assumptions underpinning our overlays for Covid-19 costs, Surface Access Strategy costs, and Enhanced Service costs.

d. ***"the sequencing of some of the key forecasting assumptions could create risks of either double counting or exclusions, for example, when the input price inflation and ongoing efficiency assumptions are applied"*** Following questions and feedback from the CAA, we have reviewed the potential impact of changes to sequencing of forecasting assumptions on our cost base. Overall, this has shown that any changes to the sequencing of forecasting assumptions would have a minor impact on the overall H7 costs. For example, the CAA queried that we had not applied input price inflation and ongoing efficiency assumptions to the Covid-19, surface access and service overlays in the RBP. The impact of this was shown to be immaterial, with an increase in costs of £3-4m over the whole of H7.

48. In regard to the CAA's next steps, we understand that the CAA will need to carry out further work to assure itself that our forecasts and associated evidence base are robust. We will continue to engage with the CAA on these matters and are, as always, willing to engage with its consultants as required in order to ensure that its review is successful. However, we note that the CAA's proposal to use bottom-up analysis to assess our forecast contradicts its own previous position. In CAP1940, the CAA noted that a bottom-up approach to *forecasting was "unlikely to be useful for consumers and stakeholders in the short term"*[16]. We are therefore unclear why the CAA now considers that bottom-up analysis of Heathrow's opex forecasts is in the interests of consumers. This issue is discussed in more detail in section 3 of the legal Annex.

Commercial Revenues

49. We agree with the CAA's assessment both in this chapter and in chapter 4 that there is significant fundamental uncertainty around the level of commercial revenues through the H7 period. It is for this reason that more work will be required to refine and further evidence the correct overlays to reflect both the impacts of Covid-19 and the change in VAT policy on our commercial revenues going forwards.

[15] Meeting with CAA on 16 February 2021,document reference: CAA-H7-452
[16] CAA, CAP1940, Page 32, Paragraph 2.20

50. The impacts of VAT policy changes remain particularly uncertain at this stage. Further lockdown restrictions on both retail and travel have meant that we have been unable to gather any meaningful further real-world evidence on the impact in the airport context. We will continue to review the situation and provide updated evidence as this becomes available with actual trading.

51. While we continue to wait for further direct evidence on the impacts of both Covid-19 and the VAT policy changes on commercial revenues we have continued to review any evidence available to us at this time to further update our assumptions from those set out in the December RBP. This will be set out in detail in our RBP update.

52. The high levels of uncertainty, both in regard to the size of the impacts and the timelines on which we will be able to obtain any clear observable evidence lead to the need for flexibility from the CAA and for this uncertainty to be taken into account in the regulatory framework.

53. This is an important reason why we consider a revenue sharing mechanism would be preferable to one focused solely on passenger volumes.

54. A mechanism focusing on revenue would mean that the CAA does not need to lock-in a decision on the level of commercial revenues per passenger for the H7 period at the start of the period. Instead, the mechanism would review the revenues earned by Heathrow as a whole, taking into account any changes in the relationship between passenger numbers and passenger mix through the period, and ensure that Heathrow was not overcompensated through forecasting errors or exposed to increased financial risk. Further details on our proposals on revenue sharing can be found in our response to Chapter 4 of the CAA's document.

55. In its assessment of our commercial revenue forecasting, the CAA raises a number of specific points which we address in turn below:

    a. ***"HAL has proposed a significant £600m capex programme supporting commercial revenue generation opportunities in H7. However, there is not a clear "line of sight" from this plan through to its commercial revenue projections"*** Our proposed £700m capital envelope for commercial revenue generation set out in the RBP was based on an assessment of historic data to understand the level of capital spend needed to both maintain and then improve commercial revenues. This was split between our £100m allowance for protecting commercial revenues and £600m allowance for incremental revenue generation. In our RBP we set out that, absent this £600m portfolio of spend, there would be a reduction in commercial revenues over H7. We will set out further information on the detail of the business cases which could form part of our commercial revenues programme and their impact on commercial revenues in H7 in our RBP update.

    b. ***"We consider that HAL's surface access mode share analysis was not appropriately updated to reflect the significant changes since the preparation of the IBP"*** This is not correct. The surface access modelling used for our RBP was updated following the significant impact of Covid-19 on consumer behaviour. We followed the following process to update our modelling:

        i. We used Heathrow's Profiler survey data to re-baseline the transport models to reflect August 2020 mode share data. This allowed the baseline of the transport models to take into account the impact of Covid-19 on passenger behaviour.

        ii. We have assumed that mode shares would return to pre-pandemic levels by 2024 with mode shares being forecasted for the intervening period through interpolation. Our assumption of a return to pre-pandemic mode shares by

2024 was informed by post Covid forecasts made by other organisations, specifically:

1. The TfL Financial Sustainability Plan, which forecasts a return to 2019 business plan passenger income by financial year 2023/24[17]
2. Network Rail assumptions provided to the Western Route Supervisory Board.

iii. It has been assumed that from 2024 onwards, baseline mode shares would remain constant in the absence of any major changes to the transport network serving Heathrow.

iv. For H7 there are two changes which are likely to impact mode share – (i) the forecourt charge at Heathrow and (ii) the introduction of the Elizabeth Line. To forecast the impact of these two changes on mode share, we used the baseline two-runway outputs from the LASAM model used for the expansion programme.

v. As part of our RBP update, we have reflected updated assumptions on the level of charge and 2023 introduction on the Elizabeth Line in our modelling. Detail on the mode shares themselves is provided in our RBP update

56. In regard to the CAA's proposed next steps, our views are in line with those expressed for opex above.

Capex

57. The CAA's assessment of our capital plan both fails to take into account our previous statements confirming that we would not be physically able to provide the level of detail the CAA was requesting in its CAP1940 guidance at the point of publication of our RBP and the increased levels of detail we have provided to the CAA following publication of our RBP through document submissions and airline engagement sessions at which the CAA team were present.

58. Our response to CAP1940 in August 2020 was clear in this regard:

"We agree with the CAA that sufficient detail on our capital programme is required to allow stakeholders to understand and assess our proposals. However, it is unlikely that the level of detail requested by the CAA will be available for every project at RBP submission. Trying to create a one-time list and assessment of all projects to fix at the start of a regulatory period was a mutually identified weakness in Q5. The benefit of the Development and Core approach to capex introduced to Q6 is that Heathrow and the airlines can be flexible in the delivery of projects through the regulatory period to meet consumer and operational needs as they arise. This flexibility will be particularly important for the H7 period given the inherent uncertainty that all parties face. The CAA should therefore not seek to assess and set the entire capex portfolio at RBP as it would fundamentally undermine this flexibility."

59. We are concerned that there is a sense of a misapprehension that the airport capex should and will all be set by the first day of H7. This is not what happened in Q6 – where the ultimate programme was made up of projects already agreed, costed and begun at the beginning of the Q (around 12.5% of the total investment), others developed between airlines and airport over the Q6 and some initially considered and later changed or stopped because of airline and airport review. This more dynamic capital planning works well in a consumer, technology heavy environment like the airport with customers (i.e. airlines) with very specific and well-informed

[17] https://content.tfl.gov.uk/financial-sustainability-plan-11-january-2021.pdf

needs. It perhaps differs somewhat from the longer cycle capital planning in some other regulated sectors like water,

60. We have also engaged extensively with the CAA following the publication of the RBP, providing further evidence requested on our 'Protect the Business' portfolio and asset management plans[18] and ensuring the CAA were present at airline engagement sessions so they could witness the development of the plan.

61. Since publication of our RBP, we have continued to engage with the airline community to build the capital plan for H7. As per the CAA's requests for further information, full detail on both the engagement process we have followed and the changes we have made to our capital plan will be set out in our RBP update. In summary key changes since our RBP are:

    a. Following the publication of the RBP we have continued to engage with the airline community on the capital plan for H7. This includes both engagement on the overall level of investment and the criteria for prioritising investment through H7. This engagement has been carried out through the Future Portfolio Group and subject specific working groups, such as the baggage and security working groups, to ensure that the right specialists are involved in these conversations. The CAA has also been present for this engagement. Through these sessions we have continued to evolve the programmes proposed in the RBP including by reviewing the consumer outcomes which are supported by each programme, reviewing and agreeing draft Delivery Objectives for each programme and reviewing the existing or emerging business cases within each programme which support delivery of the defined objectives.

    b. Based on this engagement, we have developed Programme Mandates for each programme. These confirm the Delivery Objectives as wells as setting out our current view on the pipeline of projects for prioritisation within each programme. These programme mandates will be provided alongside our RBP Update. As accepted by the CAA, the different areas of focus and characteristics of our programmes mean that differing levels of detail are available for each programme at this stage. Where detail is available, we will provide it, for example, a breakdown of our proposed asset management programme spend by asset type and year in order to provide a robust baseline for this part of our capital envelope.

62. In its assessment the CAA states that, due to the level of detail which has currently been provided Heathrow *"will risk all capex being treated as development"*[19]. This statement is confused and epitomises the CAA's misunderstanding of the Development and Core capital framework. The Development and Core framework is intended precisely to treat the majority of capex as development at the start of a period. Capital transitions from Development to Core when it is determined that the project should proceed at the G3 Gateway through the process set out in our capital investment protocol. This is not related to the level of detail provided at the settlement and as such setting an ex-ante baseline for core capex through the period at the time of the settlement is not required. In fact, we have confirmed to the CAA on multiple occasions that only £400m of the £3.2bn capital envelope set for the Q6 period (i.e. 12.5%) was already agreed as Core expenditure at the start of the period.

63. In its document the CAA states, if we do not provide greater detail and an enhanced evidence base in our RBP update *"HAL will be exposed to greater risks in relation to capex and financeability as we would adopt a relatively conservative approach to estimating its capex requirements, but would take a robust approach to setting quality of service targets"*[20]. This

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[18] CAA-H7-458
[19] CAP2139, Page 42, Paragraph 2.57
[20] Ibid

'threat' is further evidence that the CAA continue to consider each element of the regulatory framework in isolation, failing to recognise the interrelationships and interdependencies between them. It is clearly not logical to set service targets without due regard to the levels of investment and resource available to deliver them. At a time of intense financeability challenges which will need to be overcome as part of the H7 settlement, as noted by the CAA in other parts of its document, it would not be in line with the CAA's duty to ensure that Heathrow could finance its activities and would not provide Heathrow with a framework that gave its investors a 'fair bet' of achieving its cost of capital.

64. As demonstrated through our plans for future airline engagement and the detail provided in our RBP update, we are continuing to review and refine our capital plan for the H7 period alongside the airline community, ensuring that it delivers improvements valued by consumers and which deliver on the key outcomes they want to see from their airport journey.

Chapter 3: Financial Framework

65. We agree with the CAA's statement on the importance of the right financial framework for both Heathrow and consumers. This is particularly noteworthy under the current circumstances following the deeply negative impact of Covid-19 on Heathrow's financial position and how it has highlighted the asymmetric nature of the risk reward balance for Heathrow's investors.

66. A framework which allows for access to efficient debt and equity financing is ultimately in the interests of consumers by minimising costs in the short-term and allowing the longer-term interests of users to be served through maintaining the right levels of private investment.

67. The importance of a consistent and stable regulatory and financial framework and the CAA's actions to maintain this have been made clear by credit rating agencies and credit analysts:

S&P

04/03/21
"We think the U.K. aviation regulator, the CAA, will take a balanced approach that will support Heathrow Funding Ltd.'s (HFL) financeability. ***We therefore think the regulatory framework in the period starting January 2022 (H7: 2022-2026) should remain supportive and transparent*** *[…]"*

"We still expect HFL to deliver its weighted average FFO to senior debt of 6%-7% during 2021-2023 and FFO to total debt of 4%-5%. We consider these ratios to be very tight for the rating, limiting the company's financial flexibility given the high level of debt issued by entities outside the group ring fence. However, ***we expect these ratios to improve in 2022, subject to the outcome of the regulatory reset in 2022****."*

*"****Based on the CAA's track record and statutory duty, we think it will take a balanced approach such that HFL can sustain credit metrics at least commensurate with the current ratings****, considering our traffic assumptions. We think the CAA will support HFL's financeability while considering the affordability of charges for airlines and ultimate customers, as well as future expansion needs."*

"We would also downgrade the Class A and Class debt if the regulatory tariff set for H7 is such that HFL cannot achieve weighted average FFO to senior debt of at least 7% and weighted average FFO to total debt of at least 5%"

09/08/19
"Key strengths: A supportive regulatory environment, ensuring recovery of investment and good predictability of cash flows over five yearly resets*."*

"In our view, the regulatory framework under which Heathrow operates is predictable and supportive. ***It is based on the RAB concept, which encourages investment by allowing recovery of capex costs via tariffs. A fair return over the RAB ensures the business' profitability and shareholder returns, which grow in line with capex****."*

Fitch

31/03/21
"The affirmation reflects our expectation that Heathrow's supportive regulation and significant market power as primary hub airport, will allow it to significantly increase 2022 aero tariffs, by around 40% to 50% in nominal terms …"

"We also note the regulator's mandate to ensure capex can be financed in addition to affordability to end-users as supportive"

Moody's

15/12/20
"Credit strength: long established framework of economic regulation"

"LHR is subject to a framework of economic regulation that is considered appropriate and transparent. It is a form of price cap regulation that has proven to permit fair recovery of costs and generates a reasonable return on invested capital."

68. The CAA must therefore ensure that its H7 proposals meet these market expectations if the H7 settlement is truly to further the interests of users by enabling efficient future investment.

69. Chapter 3 of the CAA's document highlights worrying inconsistencies in the CAA's approach. The CAA sets out the conclusions of its analysis on important aspects of financeability through H7 in each of its sub sections, but these conclusions appear to be independent of each other.

70. In the subsection regarding gearing post Covid-19, the CAA concludes that gearing can be reduced back to around Q6 levels without a RAB adjustment and even with a WACC of around 3% if it is assumed that no dividends are paid through the period. However, the CAA then goes on to say that, for H7, the cost of capital for H7 will be material in whether Heathrow is financeable in H7 and that long-term dividend forbearance is not in the interests of consumers. This demonstrates that the CAA's analysis on gearing glide paths is incompatible with its views of financeability elsewhere in the document.

Capital structure and the impact of the Covid-19 pandemic

71. We agree with the CAA's conclusion that it is appropriate to use a notional gearing assumption to assess financeability and Heathrow's allowed return. We also agree with the CAA's assessment that Covid-19 has had a material impact on the levels of gearing at airports as operations are being funded by borrowing rather than revenue.

72. For this reason, as set out in Section 8.2.3.2 of Chapter 8.2 of our RBP we adopted a quasi-notional approach to gearing for H7 in order to reflect the impact that Covid-19 would have had on the gearing of the notional company. Our approach assumed that, in line with regulatory precedent[21] and in order to maintain regulatory consistency, gearing started at 60% in 2019. We then reflected the impact of Covid-19 during 2020 and 2021 and then allowed gearing to reduce

[21] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, para 9.45

back to 60% by the end of 2026. The loss of revenue in 2020 and 2021 leads to gearing rising to 73% by the end of 2021 before the application of the RAB adjustment at the end of the year.

73. In its document the CAA discusses initial analysis it has performed on the potential ‘gearing glide paths’ for Heathrow across H7. In its analysis it concludes that *“de-leveraging is possible even without an equity injection or a RAB adjustment.[22]”*. However, this analysis was performed using the assumption that no dividends were paid during the H7 period. This is an outcome which the CAA itself says elsewhere would likely be unfinanceable and not in the interests of consumers: *“While dividend forbearance may be appropriate in the short run, in the long run, the notional entity will need to be able to pay dividends to attract ongoing investment, which furthers the interests of consumers”[23].* The CAA have not explained why the assumption of no dividends is appropriate for a notionally financed company. Given that such an assumption is a major departure from settled regulatory practice omission would expect the CAA to provide a clear rationale prior to proceeding. For this reason, the CAA’s analysis on Heathrow’s ability to deleverage over H7 is fundamentally flawed.

74. In assessing the notionally financed company, the CAA should make appropriate assumptions for dividend payments in line with appropriate regulatory precedent. If the CAA’s analysis is repeated for a case with a RAB adjustment of only £300m, no depreciation adjustment and dividends set at two-thirds of the cost of equity (consistent with the approach used by the CMA for water companies), then gearing does not return to 60% by the end of H7. Deferring depreciation would increase gearing further and is not therefore appropriate. We provide more evidence on this in the RBP update.

75. In our responses to CAP1966 and CAP2098 we provided the CAA with clear detail about both the need to deleverage over the H7 period and the criticality of a RAB adjustment to facilitate this.[24] We also provided evidence of this in our PCM submission to the CAA alongside our RBP. This showed that, in order to return to the notional level of gearing at the end of H7 while maintaining a financeable proposition for equity investors and ensuring that we can continue to invest to meet the interests of consumers, a RAB adjustment is needed. Given the flawed assumptions sitting behind the CAA’s analysis, we consider that contrary to the CAA’s assertions, our conclusion remains valid. We provide more detail on the interplay between the CAA’s conclusions here and the impact on equity financeability and depreciation in the following sections of our response.

Determining the allowed return

76. Our response in this section also responds to the information proved in Appendix J. Our positions on these issues are consistent with the methodology we put forward in our RBP and are aligned with our RBP Update. In line with CAA requirements, our approach is also in line with the CMA’s decision:

    a. **Gearing:** An assumption of 60% gearing for the notionally geared company should be retained for a case with an appropriate RAB adjustment. This is consistent with the approach of the CAA at Q5 and Q6. It is also consistent with the assumption in other regulatory sectors (e.g. water).[25] For a case with only a £300m RAB adjustment it is appropriate to use a higher notional gearing to reflect the impact of the pandemic from the Q6 assumption of 60% gearing in 2019 increasing to over 71% in 2021 and then falling to 60% over the period.

[22] CAA, CAP2139, Page 49, Paragraph 3.24
[23] CAA, CAP2139, Page 54, Paragraph 3.48
[24] Heathrow response to CAP2098, paragraphs 264 – 269, Heathrow RBP Chapter 8.3, Section 8.3.4.1
[25] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, para 9.45

b. **Total Market Return:** The CMA's updated estimate of TMR used for its final decision for water should be the basis of the CAA's assessment. It increased the range slightly to reflect the use of arithmetic returns concluding on a range from 5.2% to 6.5% RPI.[26] In its approach, it also separated out the impact of aiming up from the parameter estimate and therefore used the middle, rather than the upper quartile, of the range to give a TMR estimate of 5.85% (real RPI).[27]

c. **Risk Free Rate:** The CMA updated its approach to the RFR in its recent water decision. The CMA set the bottom of its estimated range as the 6-month average of the UK 20-yr ILG, and the top of the range as the 6-month average of the IHS iBoxx £ Non-Gilt AAA 10+ and 10-15 indices.[28] They did not include a forward adjustment. For their determination they adopted the middle of this range at -1.34% (CPIH) or -2.22% (RPI).[29] The CMA's approach should form the basis of the CAA's approach for H7 and should be updated for relevant market data through the process.

d. **Asset Beta:** The CMA inquiry into NERL set out a useful basis for assessing appropriate comparators, and estimation approaches to use to obtain asset betas, and the CAA approach should reflect this. However, investors view of airports has fundamentally changed since March 2020 and therefore the estimate of asset beta for H7 should be based only on data post this time, as earlier data is no longer relevant. We have updated our estimate of asset beta to reflect the latest market data, and an updated assessment of the impact of the pandemic and any potential mitigation. This will be set out in the RBP update.

   In Appendix J the CAA set out their view that they need to assess the pre-covid beta for Heathrow. We consider that the most appropriate estimate for this is that made by the CMA in the NERL inquiry which used data up to the start of March 2020 and therefore was an up-to-date estimate of the pre-covid asset beta for airports. This identified a range of 0.525 to 0.625 with a mid-point of 0.575. It would be inappropriate for the CAA to supplant this estimate of the pre-covid asset beta for airports with a different estimate of its own.

e. **Debt Beta:** For debt beta, we consider that it is more appropriate to place weight on the estimate of debt beta for airports set out by the CMA in its determination for NERL. This estimated a debt beta of 0.05.[30]

f. **Taxation:** As set out later in our response, a pre-tax approach to WACC is required to retain consistency across the Heathrow regulatory framework and regulatory periods. Tax rate assumptions should be updated to reflect the planned increases in UK corporation tax to 25% in 2023.

g. **Inflation:** This should be consistent with the approach used by the CMA in the water company determinations. This should thus use an assumption of 2.9% based on the

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[26] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, para 9.395
[27] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, Table 9.38
[28] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, para 9.241
[29] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report, March 2021, para 9.266 and Table 9.38
[30] CMA, NATS (En Route) Plc / CAA Regulatory Appeal, Provisional findings report, March 2020, para 12.115

Government target of 2.0% for CPI inflation, and the OBR's current estimate of the wedge between CPI and RPI of 0.9%.

h. **Cost of embedded debt:** In the RBP we used the actual cost of debt in place at 30/9/20 averaged over the period 2022 to 2026. This is consistent with the approach the CMA adopted for NERL, and also with the approach the CMA adopted for water companies in its final determination where it used the median actual cost of debt for the sector. We have updated the estimate of the cost of embedded debt to reflect changes in the debt portfolio since October 2021. This has reduced the cost of embedded debt slightly, as the most recent debt raised is lower cost than the average of the portfolio. We have also updated the trailing IBoxx debt cost approach consistent with that adopted by the CMA to confirm that the actual debt costs are efficient. Full details will be set out in the RBP update.

i. **Cost of new debt:** In the RBP we estimated the cost of new debt based on the average iBoxx index for the last 6 months with an adjustment to reflect the higher cost of Heathrow debt. We have updated this approach to reflect the latest market data for the iBoxx index, and the spread of Heathrow Bonds to the iBoxx index. The higher cost was calculated as the sum of the last 6-month spread, a new issue premium, and an adjustment to reflect the higher cost of index-linked debt. The CAA state that we have provided no new evidence on the new issue premium and cost of index-linked debt premium and that no premiums should apply. We note that the CAA has not yet engaged with the evidence provided by Heathrow on these matters and has provided no evidence or analysis to show that Heathrow's position is not correct. If the CAA consider that there is no premium for IL debt over nominal debt they should provide evidence justifying this and show why the evidence we have provided that there is a premium is incorrect. In addition, if they consider that there is no new issue premium when debt is issued despite the overwhelming market evidence that this is the case, then it should set out evidence supporting this and explain why the evidence we have provided is not correct. We consider this is a serious example of where the CAA have failed to engage with the evidence we have provided and failed to develop their own evidence.

j. **Issuance and liquidity costs:** In the RBP we provided a detailed analysis of the issuance and liquidity costs incurred by Heathrow (0.06% and 0.12% respectively). The CAA has not engaged with this evidence and is continuing to assert that an allowance of 0.1% is appropriate without providing any supporting analysis. This is a serious failure of regulatory due process. Our approach clearly links the costs of liquidity to the size of the liquidity facility required for a notional company and the costs of such a facility. If the CAA believe the cost should be lower, they should explain this by reference to alternative assumptions that are grounded in market data. Moreover, we are reconsidering the approach to liquidity requirements as the pandemic has highlighted the need for Heathrow to be able to access a large liquidity buffer to enable funding over a longer horizon. This could increase the size of liquidity buffer that is appropriate and therefore the estimate of the required level of liquidity costs may increase.

Debt financeability

77. In its document, the CAA confirms the importance of a reasonable investment grade credit rating in ensuring that the H7 price control is financeable. However, it is not clear about the 'reasonable investment grade credit rating' it is targeting. The CAA's analysis includes thresholds that it states are required for a BBB+ credit rating. If the CAA is indeed targeting this rating through its price control, then this should be stated transparently. We therefore urge the CAA to provide clarity on

its approach for H7 and set out how it has used the evidence we have provided to come it its conclusion.

78. Heathrow's senior debt is rated by Standard & Poor (S&P) and Fitch. In March 2020, as the passenger traffic outlook worsened, S&P downgraded Heathrow's debt by one notch, moving Heathrow's debt to BBB in some investor portfolios. While no further action has been taken to this point, credit rating agencies have been clear that further action could be taken in the event that passenger volume outlooks worsen or if, as shown above, the CAA does not take appropriate regulatory action. Any further downgrade by either S&P or Fitch at Class A to BBB/BBB+ would firmly anchor Class A debt in BBB territory. It would also move Class B debt to sub-investment grade territory as rating agencies apply a systematic gap between the two tranches.

79. In sections 8.1.4 and 8.1.6 of the RBP we clearly state and evidence that Heathrow must return to an A- credit rating swiftly through H7 in order to ensure that Heathrow can retain creditors' confidence and effectively and efficiently finance H7. Returning to stronger credit metrics is also critical to ensure access to deeper pools of liquidity and to the most cost-efficient sources of debt financing and hedging capacity. This is ultimately to the benefit of consumers, who would bear the costs of inefficient debt financing caused by targeting a credit rating lower than A-. In our RBP and response to CAP1966 we set out based on the current cost of debt for Heathrow that a credit rating downgrade would lead to at least a £300m additional interest cost to be reflected in charges over the H7 period.[31]

80. Investors have been explicit with Heathrow about the need to maintain and return to A- credit ratings in the market. For some investors, their capacity to invest in Heathrow's credit is defined by their portfolio mandate and will be constrained to holding A- rated bonds. A downgrade below A- will mean they need to reduce or remove any exposure to Heathrow's credit. For other investors, Heathrow losing its A- rating will mean they would face higher capital requirements to continue holding their Heathrow bonds. In both cases, the capacity to support refinancing will become more limited. This may also lead to them to sell their position or choosing not to further increase their exposure. Without a settlement from the CAA which allows this to happen raising debt will become increasingly difficult and expensive, which would be inefficient for consumers who would bear these costs.

81. The fact that Heathrow has been able to continue accessing financing despite being downgraded should not be mistaken for a signal that creditors will be content to retain this credit rating throughout the H7 period and beyond or that Heathrow can achieve the same cost efficient financing at this downgraded rating for H7. Continued access to debt financing was only possible during the last 18 months due to:

    a. The pandemic being considered a temporary event. This means that, over the long term, creditors will expect a return to stronger metrics and an A- credit rating. This is reinforced by the fact that Heathrow is regulated and with a regulatory reset due in 2022 allowing building blocks to be reset to reflect current market and trading conditions.

    b. Higher spreads than pre-pandemic and relatively higher spread than other regulated businesses offering creditors a good opportunity to buy bonds with Heathrow's credit fundamentals remaining effectively unchanged and the expectation that credit ratings will recover to A- after the impact of the pandemic.

[31] See detailed workings at section 8.1.6.2 of the RBP

82. There appears also to be a confusion in the discussion between whether the financial ratios to target are based on a notional or actual financial structure. Resolving this may mean that in practice targeting the metrics Heathrow needs to retain an A- rating would be the same as targeting a notionally financed company without structured debt to retain a BBB+ rating.

83. In the RBP we showed that at a notional gearing of 60% the appropriate financial ratios to target are those for BBB+. This is in line with our view that it is appropriate for the CAA to take a notional approach to Heathrow's financing. The use of BBB+ is consistent with the view taken by the CMA in 2008 for Heathrow with a notional gearing of 60%[32] and in 2020 for water companies with a gearing of 60%[33].

84. However, in practice, credit rating agencies give a one notch benefit for companies with structured debt. This means that the credit rating thresholds for a BBB+ rated company without structured debt (i.e. on a notional basis) are the same as those used for an A- rating with structured debt. Therefore, in order to be consistent with a BBB+ rating for the notional company at a gearing of 60% the CAA must target credit metrics consistent with an A- credit rating for Heathrow.

85. The CAA's document however, appears to use the thresholds for a structured BBB+ credit rating in order to assess the financeability of its proposals for the notional structure. If the CAA is proposing to target a BBB+ rating for the notional structure at a 60% gearing, it should use the correct thresholds for BBB+ based on a company with non-structured debt. These are the same as the ratios for Heathrow, with structured debt, to retain a credit rating of A-. Without targeting these thresholds, the CAA will not set a H7 settlement that can be funded efficiently through debt financing.

86. In its analysis, the CAA appears to assume that a positive trend of performance against credit metrics will be sufficient to restore credit metrics and maintain an investment grade rating for H7. However, it gives no consideration to constraints around timing, headroom or the impact of 2020 and 2021 on the views of credit rating agencies. Nor does it account for the potential for further shocks or downside, for example from a resurgence of the pandemic. In addition, rating agencies may place little weight on a positive trend that depends upon a rapid recovery of traffic if they consider such a return is uncertain.

87. As we set out in section 8.1.6.2 of the RBP, credit rating agencies do take a forward-looking approach to forming their credit opinions and the temporary challenges to credit metrics may be smoothed out by agencies looking at a horizon of longer than one year. Yet it is not likely that credit rating agencies will be able to look past both the impact of Covid-19 over recent years and lower performance against thresholds in the early years of H7 when making their assessments. That is they will not be able to assume away a period of many years. This is evidenced by comments made by Fitch stating "*Overall, we expect that this will enable Heathrow to deleverage below our rating sensitivities of 8x for the class a and 9x for the class B by 2022 and 10x for the HY notes by 2023.*"

88. The CAA also omits any consideration of the need for appropriate headroom against thresholds when considering whether or not its scenarios are financeable and consistent with an investment grade credit rating. Thresholds are negative rating action triggers so appropriate headroom against these thresholds must be maintained to ensure we can maintain the target credit rating.

[32] Competition Commission, *Heathrow Airport Ltd and Gatwick Airport Ltd price control review*, 2007, Appendix F, paragraph 27
[33]CMA, *Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Provisional Findings*, Sep 20, Para 10.91

89. The CAA's analysis of debt financeability in CAP2139 is devoid of any reference to the importance of equity support to debt investors. As set out clearly in Section 8.1.6.1 of the RBP, debt investors and credit rating agencies will take into consideration the strength of shareholder support when assessing Heathrow's credit. In addition to a transparent and stable regulatory framework, creditors take comfort from cautious financial management of the company. This includes liquidity, covenants, credit metrics and equity support.

90. Heathrow shareholders have taken swift action to ensure financeability through 2020 and 2021. This includes the injection of £600m of capital into the regulated company by Heathrow shareholders. This capital injection helped to strengthen our liquidity and create more headroom against financial covenants.[34]

Equity financeability

91. It is important for the CAA to set out a robust approach to ensuring equity financeability for H7. We welcome the CAA's acceptance that a return to dividend payment within a reasonable timescale is an important aspect of ensuring that the price control is financeable and, ultimately, can deliver in the interests of consumers. As set out above, ensuring equity financeability is vital not only so that investors making investments in Heathrow and its infrastructure is a rational decision going forwards, but also for ensuring that debt investors have the confidence to invest in Heathrow through H7.

92. The CAA states that a return to dividends in a reasonable timescale is required to ensure equity financeability. It does not give an indication of how it plans to define a 'reasonable timescale'. Importantly, it is not clear why there should be any assumption of a pause in dividends for a notionally financed company and the CAA has not set out why this would be appropriate. Financeability assessments in other sectors assume that dividends are paid. For example, the CMA assumed a dividend pay-out of two-thirds of the cost of equity in its financeability analysis for water companies. We consider that the CAA should use the CMA's approach as a starting point for any financeability analysis, rather than assuming that no dividends need be paid without any justification.

93. In its document, the CAA's references Standard & Poor's published analysis which suggests that rated European airports will pay almost no dividends in 2020, 2021 and 2022 with a gradual return to payment of dividends from 2023 onwards. Standard & Poor's rate companies' actual financial structures, not the notional financial structure. The CAA must exercise caution before applying expectations for the real company to the different situation of a notionally financed company. Moreover, the expectations of rating agencies set out above are also clear that they expect the regulatory reset of H7 to improve Heathrow's financeability: *"We think the U.K. aviation regulator, the CAA, will take a balanced approach that will support Heathrow Funding Ltd.'s (HFL) financeability.* ***We therefore think the regulatory framework in the period starting January 2022 (H7: 2022-2026) should remain supportive and transparent****"*

94. In its approach, the CMA put a heavy weighting on ensuring equity financeability was maintained. It was very clear in its view that if returns for investors were set too low, this could have a material impact on the delivery of investment for consumers, "*expectations of insufficient investment returns based on the current cost of capital may discourage companies from identifying and proposing otherwise desirable investment projects*."[35] It is important that the CAA's approach to equity financeability is consistent with that adopted by the CMA.

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[34] Heathrow secured a new £750m facility at ADI Finance 2 from private international infrastructure investors in October 2020. The capital has been injected into the Heathrow Finance Group. Some of these funds will be used to partially repay some debt at Heathrow Finance while £600 million have been pushed into the Heathrow SP Group. The CAA recognised this equity injection in paragraph 3 of its CAP2098 document.

[35] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf

Affordability and the profiling of revenues

95. We agree with the CAA that reprofiling depreciation could be a key lever to ensuring that charges in H7 are both financeable and affordable. It is also key to ensuring that charges are intergenerationally fair and that consumers now are not paying more than their fair share of depreciation.

96. For this reason, we included a depreciation adjustment in the base case of our H7 RBP. However, we were clear that, due to the need to maintain an investment grade credit rating and return to levels of gearing similar to those seen at Q6 under the notional structure, such an adjustment could only be made alongside the implementation of an appropriate RAB adjustment. We have been clear in both our RBP and in our response to CAP2098 on the reasons for this:

    a. A key parameter of RAB-based regulation is that investors have confidence that efficiently incurred capital will be returned to them through depreciation. This principle was made clear by the CAA in its Q5 decision, which was the last time the CAA made any formal comments on depreciation policy: "*Depreciation policy should ensure that the company is remunerated once for the investment made.*"[36] Without this confidence that capital will be returned in line with this principle, investors could not sanction a further deferral of depreciation which would increase the amount of capital at risk. Therefore, without an adjustment to Heathrow's RAB which represents the regulatory depreciation not recovered through 2020 and 2021, deferring depreciation would not be a rational decision for Heathrow's investors.

    b. In order to defer depreciation over H7, Heathrow must be able to return its gearing to initial levels to restore financial resilience and balance sheet efficiency. For a notional company with a RAB adjustment of £300m, paying dividends in line with the CMA assumptions for water, gearing would not reduce to 60% during H7 even with no deferral of depreciation. In such a situation deferral of depreciation would increase gearing further from the target and could not be accommodated.

97. In forming its position on the ability to use depreciation profiling for the H7 period even in a situation without a RAB adjustment, the CAA falls back on the analysis it carried out on Heathrow's ability to return gearing close to pre pandemic levels without a RAB adjustment. However, it fails to highlight that this analysis assumed that no dividends were paid through H7.

98. As explained above this is not a reasonable assumption for a notionally financed company. Indeed, even for the actual financial assumption it is not in line with the CAA's own observations that according to Standard & Poor's, rated European airports will return to payment of dividends from 2023 onwards. Therefore, the CAA's analysis is one which the CAA itself has declared as not consistent with ensuring equity financeability or in the interests of consumers. Given this no weight can be placed on it.

99. As set out in Section 8.3.5 of our RBP, any reprofiling of revenue by the CAA would need to be consistent with the minimum cashflows required for Heathrow in the early years of H7 to return to an A- credit rating. This means that for the start of H7 a minimum charge value will need to apply. This expectation is clearly set out by Fitch in its commentary: *"The affirmation reflects our expectation that Heathrow's supportive regulation and significant market power as primary hub airport, will allow it to significantly increase 2022 aero tariffs, by around 40% to 50% in nominal terms".* Our RBP update will reflect this minimum charge for 2022.

[36] https://webarchive.nationalarchives.gov.uk/20140606022204/http://www.caa.co.uk/docs/5/ergdocs/airportsdec06/wholedoc.pdf

Allowance for corporation tax

100. The CAA notes that our continued use of a pre-tax WACC in the RBP was not in line with business plan guidance set out in CAP1940. This is incorrect. The CAA's guidance in CAP1940 does not specify an approach to tax therefore the CAA's assessment that we have not followed the guidance given is wrong.

101. In CAP1940, the CAA confirmed that while it was minded to use a post-tax approach to setting the WACC, it would continue to carry out further work to refine the mechanisms it was reviewing for implementing its approach.[37] Indeed, even in CAP2139, the CAA notes that "*We will continue to engage with stakeholders as we explore the policy options outlined above. We will present our proposed approach to allowance for tax costs in our Initial Proposals*"[38]. Therefore, in the absence of any final policy from the CAA, we have chosen to continue with the approach we believe best supports an affordable and financeable H7 price control. The CAA's remarks that we are not following guidance or compliance with its views on tax for the H7 price control are therefore factually incorrect. Such a policy does not exist, as confirmed by the CAA in its own document[39]. In seeking to implement its views before it has finished consultation on its policy options, the CAA is demonstrating clear failures in its consultation process and risks fettering its discretion.

102. In CAP2139, the CAA notes that the current pre-tax approach to calculating the WACC is *"less transparent, inaccurate and prone to being overly generous"*[40]. The CAA uses the example of the impact of Covid-19 on Heathrow's tax position and how this would not have been accounted for in Heathrow's tax allowance. In paragraph 6 of Appendix I, the CAA goes on to equate these tax losses as a *"windfall gain"* for Heathrow. This characterisation is incredible. The tax losses accrued by Heathrow due to the impact of Covid-19 are due to **record** revenue losses across the period. To describe this as a *"windfall gain"* is a clear mischaracterisation of the situation.

103. Whether a pre- or post-tax approach is adopted for tax, companies would be expected to have their post-tax losses mitigated in the event of a low demand year by the ability to offset some of the losses though lower tax. The consumer benefit occurs in the low demand year when they do not pay airport charges. The tax system then provides the mitigation to Heathrow through lower tax bills in subsequent years. Taking account of such losses in the H7 Determination would therefore transfer a benefit that the regulatory framework intended should accrue to Heathrow from it to consumers, even though consumers have already benefitted. Therefore, it is not appropriate to take account of tax losses in 2020 and 2021 in H7.

104. We take issue with the CAA on all its characterisations of the current pre-tax approach. We have provided a detailed response in response to CAP1876A setting out our views on its proposals to move away from the current model and set a post-tax WACC for H7. Our full response is attached at Annex 3. In summary, our response concludes that:

    a. The two key drivers of the move away from the current pre-tax approach, as set out by Grant Thornton in this paper, are the significant expected spend due to expansion and the large historic discrepancies between the Q6 tax allowance and the actual Q6 tax liability. These drivers do not exist. The Expansion Programme is currently on pause and the Q6 methodology has in fact produced a reasonable tax allowance compared

[37] CAA, CAP1940, Page 52
[38] CAA, CAP2139, Page 58, Paragraph 3.67
[39] CAA, CAP2139, Page 58, Paragraph 3.67
[40] CAA, CAP2139, Page 57, Paragraph 3.63

to actual liability[41]. Therefore, there is no evidence to justify the CAA's proposed change in policy.

b. The current pre-tax methodology provides a time consistent approach to taxation, a point which was emphasised by the Competition Commission in their assessment of the correct approach to taxation for Heathrow in 2007. A post-tax methodology would mean that any tax losses incurred in one period would be carried into subsequent periods. This transfer across regulatory periods would be inappropriate and inconsistent with ensuring a transparent and stable regulatory framework. The issues caused by this time inconsistency would be particularly acute when taking into account the impact of Covid-19.

c. As well as being inconsistent over time, a post-tax approach would also be inconsistent with the risk allocation in other parts of the price control. Tax losses occur only when Heathrow's revenues are significantly lower than anticipated in the settlement. As such they are not a 'windfall gain'. The mitigation supplied by these tax losses is an important part of the risk allocation implicit in the level of WACC set by the CAA. However, a post-tax approach which takes account of these tax losses would remove this mitigation.

d. The current approach helps to incentivise Heathrow to manage its tax affairs efficiently, an incentive which would be removed in a move to a post-tax approach. Removing this incentive for efficiency would not be in the interests of consumers.

105. In addition to these policy points we are concerned about the ability of the CAA to implement a robust post-tax approach, a point also recognised by the CAA in its document. A post-tax approach would require a robust forecast of tax for the period on order for the CAA to set its price control. The detail required to do this is simply not available, in particular the detail required to set a forecast of for capital allowances.

106. In its document the CAA again notes *"the lack of detail provided on capital expenditure"* in our RBP and states that this is the reason it is not able to robustly calculate a forecast for tax across H7. However, as we have set out in our response to Chapter 2 of the CAA's document, providing a detailed forecast of capital expenditure at this point in the process is both not required, due to the inherent flexibility in our Development and Core framework, and would be unwise as it would reduce the flexibility we have to develop our capital plans in consultation with the airline community through the H7 period to better reflect the interests of consumers. In asking Heathrow to set out a detailed forecast for capital allowances, the CAA could serve to constrain Heathrow's ability to flexibly deliver the required capital investment or risk setting a forecast which will always be materially wrong. Neither outcome is in the interests of consumers.

107. The CAA notes that other approaches are also possible, including a pass-through type approach or a hybrid between the two approaches. However, carrying out any subsequent adjustment to tax allowances to reflect actual liabilities would remove the incentive on Heathrow to manage its tax affairs efficiently. This could lead to a higher level of actual tax paid and mean that consumers are increasingly taking more of the burden of Heathrow's management of tax.

[41] Analysis looking at the difference between the Q6 tax allowance and our tax computations, taking into account both the tax liability of Heathrow Airport Limited and the amount of tax that would otherwise have been owed had it not been for group relief claimed from other group companies, shows that over Q6 our tax allowance was £541m and our tax liability was £571m. This methodology is consistent with Grant Thornton, who state that "*No adjustments are proposed in respect of group relief, on the basis HAL pays for any group relief it receives, meaning the overall cost of tax remains the same."*

Chapter 4: Incentives

Risk sharing mechanisms

108. We agree with the CAA that some form of risk sharing will be important to ensure a financeable and affordable H7 price control. It is by now obvious that the risk and reward balance of the current price control structure is untenable and that the current mechanism for reviewing this within the regulatory period is unclear. All stakeholders would benefit from an explicit mechanism defined at the beginning of the settlement period.

The case for risk sharing

109. The CAA sets out the key reasons it sees for implementing risk sharing in H7. We largely agree with the reasons set out by the CAA:

    a. Avoiding windfall gains and losses will be important with the increased uncertainty heading into this price control. It is for this reason that calibrating any risk sharing to ensure it only captures these 'windfall' situations will be important.

    b. Unnecessary increases to the cost of capital should be avoided at all costs in order to ensure that the level of charges is efficient. Any risk sharing mechanism should therefore ensure it provides a clear and credible commitment to investors that it will be implemented.

    c. Allowing the CAA to provide certainty for a five-year period by clarifying the risks Heathrow is expected to bear will be key to avoid the issues highlighted over 2020 and 2021, build back investor confidence and give the aviation industry a stable platform from which to grow at Heathrow.

110. In our RBP and responses to the CAA's consultations on the RAB adjustment we set out a proposed mechanism which best provides the required stability and clarity for H7 onwards:

    a. We proposed a mechanism based on sharing **revenue** risk for H7. We believe that revenue is the best way of objectively and simply assessing the impact of major impacts on Heathrow's business and economics and is therefore the best way to implement a risk sharing mechanism where the aim is to provide clarity on the levels of risk being taken by Heathrow's investors

    b. We proposed an 8% dead band within which Heathrow would take full risk of deviations against forecast. This dead band is consistent with or higher than the level of risk taken by comparator airports and NERL[42] and is therefore consistent with the comparator asset betas the CAA is proposing to use to set the WACC for H7. Additionally, review of past performance shows that this dead band would only have been breached in the extreme circumstances caused by Covid-19. This makes it consistent with the aim of clarifying the level of risk to which Heathrow investors are exposed, rather than insulating Heathrow from normal business performance or business cycle risk which all stakeholders recognised is borne by Heathrow.

[42] AdP's framework has both a traffic risk sharing mechanism outside of a 0.5% deadband and a review mechnaims outside of a 6% cumulative deadband over three years, Fraport can reset charges annually, AdR has a risk sharing mechanism outside of a deadband of 5% and a potential for full tariff rebalancing outside of a 6% variance, Aena has a 10% threshold for review, NERL has a traffic risk sharing mechanism outside of a 2% deadband will full revenue recovery for variations above 10%

c. In our RBP we proposed a sharing rate of 95% outside of these dead bands. Following conversations with the CAA and further analysis of the relationship between our operating costs and passenger volumes, we set out a revised approach in our response to CAP2098, which proposed instead an 86% sharing rate, better reflecting how our opex changes with passenger volumes.

d. We proposed to use the RAB to implement our risk sharing proposals to ensure that, in the event of any large shocks to revenues, charges remained stable in the short-term.

The form of risk sharing

111. In the document, the CAA discusses the relative advantages and disadvantages of passenger volume risk and revenue sharing. It notes that while passenger risk sharing is more widely implemented, revenue risk sharing could have benefits in regard to dealing with the uncertainty which is apparent around our commercial revenue forecasts for H7. We continue to believe that, on balance, revenue risk sharing is the right mechanism for H7.

112. As the CAA notes, revenue risk sharing could help to mitigate the impact of any changes in the relationship between commercial revenues and passengers over the H7 period. As we set out in the RBP, the H7 period will potentially see two changes which could have a lasting impact on our commercial revenues. These are consumer behaviour post Covid and the Government's changes to VAT policy.

113. Both of these impacts remain difficult to forecast making identifying the exact impact of Covid-19 on our commercial revenues inherently uncertain. We are clearly in a unique situation where we are facing an unknown impact on commercial revenues with passenger volumes at a small percentage of what we experienced through Q6. A revenue risk sharing mechanism would mitigate this impact by accounting for any variations in spend per passenger as a result of these changes or potential changes in passenger mix and therefore revenue generation per passenger over the period. This would mean that consumers are both protected from any windfall gains as a consequence of uncertainty around the impact of these changes and the potential impacts on Heathrow's financeability of any windfall losses.

114. In addition to the benefits around commercial revenue uncertainty, only revenue risk sharing takes into account Heathrow's financial performance in the round, rather than focusing solely on passenger numbers. Our full year 2020 results showed that overall revenues in 2020 fell by 62% compared to 2019, which passenger numbers fell by 73%.[43] If a passenger volume risk sharing mechanism had been in place, this would have led to a bigger adjustment, sooner than a revenue sharing mechanism.

115. A focus solely on passenger volumes during the current crisis would have ignored the impact of the 650% increase in cargo revenues from 2019 to 2020, a factor which has been noted by the airline community.[44] Equally, the requirement to close retail outlets in terminals meant that our previous assumptions on a level of commercial revenue per passenger, which would have been used by the CAA to make the adjustment under a volume risk sharing arrangement, would have been wrong. Only using revenues can ensure that all of these factors are considered when any adjustments are made.

[43] https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/annual-accounts/airport-ltd/Heathrow-Airport-Limited-31-Dec-2020.pdf

[44] Revenue from non-passenger flights increased from £10m in 2019 to £75m in 2020 (https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/regulatory-accounts/Heathrow-SP-Regulatory-Accounts-2020.pdf)

116. Ultimately this highlights that, if a passenger volume metric were used, airlines could risk taking a share in Heathrow's losses if passenger numbers were below the deadband but Heathrow could in fact be earning more than was forecast at the settlement through other revenue sources. This would likely not be seen to be an appropriate outcome were it to occur. A revenue sharing mechanism avoids this issue.

117. In its document, the CAA notes concerns around its ability to track performance against revenue assumptions. The document notes concerns around 'boundary' issues for measuring revenues, in contrast to passenger volumes which the CAA notes is a more physical metric. We are clear that performance against revenue assumptions can be clearly and transparently tracked by using Heathrow's regulatory accounts for which the CAA sets guidance on preparation and publication and which are audited annually.

118. The regulatory accounts set out Heathrow's revenue by category of revenue alongside the corresponding CAA forecast made at the start of the regulatory period. This allows the CAA to clearly establish the variance between forecast and outturn revenues. In regard to boundary issues, revenue lines are broken down by category, allowing the CAA to clearly see the boundaries between different categories of revenue. This means that, if categories such as ORCs were not included in the risk sharing mechanism, due to the recovery mechanisms already in place, the CAA would be able to isolate these revenues through the regulatory accounts.

Figure 1: Extract from Heathrow 2018 regulatory accounts

3. Revenue

Summary

For the year ended 31 December 2018, revenue at £2,952 million was 5% favourable to the forecast based on the CAA decision.

£million		Actual	CAA Forecast[1]	Variance	(%)
Airport charges	*3.1*	**1,745**	**1,681**	**64**	**4%**
Retail (including car parking)	*3.2*	698	608	90	15%
Property		118	125	(7)	(6%)
Commercial Revenue		**816**	**733**	**83**	**11%**
Other regulated charges	*3.3*	**243**	**242**	**1**	**0%**
Rail		**137**	**137**	**0**	**0%**
Other		**11**	**26**	**(15)**	**(58%)**
Total revenue		**2,952**	**2,819**	**133**	**5%**

[1] CAA forecast has been uplifted from 11/12 prices based upon indexation included in section 9.

Source: Heathrow Regulatory accounts

119. In order to implement revenue risk sharing, we propose that the CAA use this breakdown in the regulatory accounts to establish performance against forecast revenue. Following further consideration of the position regarding ORCs, we are unsure whether inclusion of ORC revenue within this mechanism is required (further information is provided in our response to Appendix D). If this were to be agreed by the CAA, this breakdown would allow the CAA to transparently remove ORC revenues from its calculation of performance against forecast.

120. This use of audited revenue would be far simpler and more transparent than using a mechanism based on passenger volumes. In order to implement passenger risk sharing The CAA will need to take a view on a per passenger adjustment amount in order calculate the size of any required adjustment in the event that the risk sharing mechanism is triggered. This will need to take into account a forecast of per passenger commercial revenue generation in order to fully reflect Heathrow's single till structure. Even in a period without such significant uncertainty around

commercial revenues, this is likely to cause controversy. It will also cause complexity in administering the scheme and is likely to lead to additional resource requirements and, ultimately, delays in implementation. Revenue is therefore the simpler, cleaner and more transparent option.

121. In paragraph 4.10 of Chapter 4 and at various points in Appendix I, the CAA notes the potential impact of a forward-looking risk sharing mechanism on the cost of capital for H7. The CAA's conclusion throughout appears to be that a forward-looking risk sharing mechanism will lower the cost of capital by lowering or offsetting any increase in perceived risk by investors. We agree that, in principle, implementing a risk sharing mechanism should reduce the perception of risk by investors and therefore lead to a reduced WACC versus what it would be otherwise. However, for this to be effective, investors must have confidence that the mechanism is likely to be implemented. Without this confidence, any forward-looking mechanism has no impact on investor perceptions of risk.

122. Investor confidence in the regulatory framework is key to ensuring the efficient financing of Heathrow. This is clearly shown in the statements from credit rating agencies set out in our response to Chapter 3. Confidence that regulatory action will be taken leads to confidence in Heathrow's financing. The actions taken by the CAA in response to the Covid-19 crisis have shown that the CAA is not prepared to act to ensure the principles which have built Heathrow's regulatory framework will be enforced.

123. A key example of this is the principle of the return of efficiently incurred capital to investors. In the CAA's Q5 decision on depreciation policy, the last time the CAA made a clear statement about the recovery of depreciation when setting a price control, it stated "*The purpose of the depreciation allowance within the revenue requirement calculation is to remunerate the company for its capital expenditure over the long term. Depreciation policy should ensure that the company is remunerated once for the investment made.*"[45] However, it is clear that the CAA is not fully complying with this policy in its position on Heathrow's Covid-related RAB adjustment. If the CAA is so blatantly disregarding its own policy on depreciation, even under these extreme circumstances, what confidence can investors take that the CAA will comply with any policy set on risk sharing going forwards.

124. Even if appropriately done for 2020 and 2021 and introduced for H7, risk sharing is unlikely to be sufficient to reduce investors' perception of risk to pre-pandemic levels. The starting point for assessing the cost of finance must continue to be based on robust assessment of current market data. Even though the market data includes many comparable regulated airports that already have risk sharing mechanisms, any robust assessment still clearly shows market risks have risen. As we showed in our RAB adjustment proposal, it is perfectly possible to estimate the impact of risk sharing on cost of capital in a quantified way using market data and appropriate analysis. Risk sharing in itself is not a magic formula to wish away the higher risk relative to alternatives of investing in airports that has been revealed in the crisis. This is precisely why we designed our deadbands in line with the evidence in the data. We would urge the CAA to do likewise in considering its Initial Proposals so that it has a rational and integrated view on both how to calibrate risk sharing and the cost of capital associated with it.

The level of risk sharing

125. The CAA is incorrect to claim that dead bands are not appropriate for the proposed H7 risk sharing mechanism. Our proposals for risk sharing are focused around ensuring that there is clarity around the risk/reward balance investors are taking to address the issues highlighted under the current regulatory framework and avoid an unnecessary increase in the cost of capital

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[45] https://webarchive.nationalarchives.gov.uk/20140606022204/http://www.caa.co.uk/docs/5/ergdocs/airportsdec06/wholedoc.pdf

for H7 due to this. The CAA instead seems to be focusing more on implementing a mechanism which minimises its own forecasting risk. This is in spite of the CAA stating its reasons for implementing risk sharing are around avoiding either windfall gains or losses for Heathrow through H7 and clarifying the level of risk for investors. The focus on trying to avoid even normal forecast variance likely comes at the expense of ensuring the right outcomes for consumers. In doing so, the CAA is not discharging its primary duty.

126. The CAA notes avoiding either windfall gains or windfall loses through the period in its reasons for implementing risk sharing.[46] An approach without deadbands is not obviously driven by this objective. The deadbands in essence define the range of what is windfall or extreme variance outside the range that Heathrow managers and owners could control or for which they might be compensated.

127. We are concerned that removing all deadbands would instead mute the price control incentives on Heathrow to effectively manage performance in situations within Heathrow's control. These incentives are precisely the regulatory mechanism to drive increasing efficiency and growing revenues. They would blunt those incentives by sharing all or most of the gains and losses which are within an expected range of variance in the normal course of business.

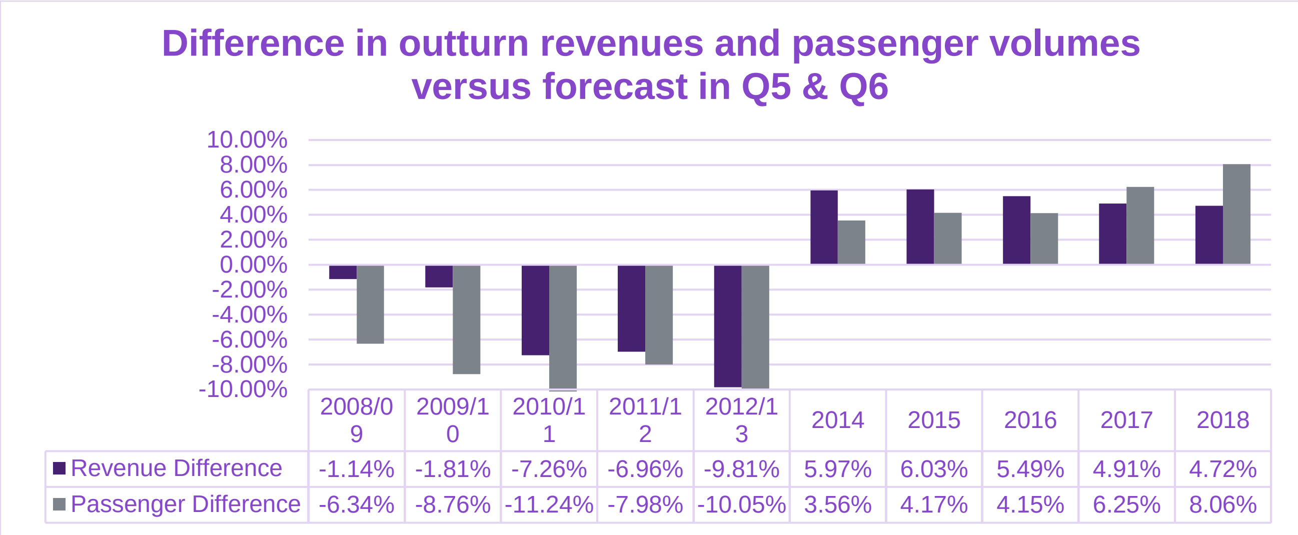
128. Without deadbands, all fluctuations in performance are passed on to consumers, including those which could stem from Heathrow management inefficiencies or Heathrow management successes. Without a deadband, incentives on Heathrow to outperform the settlement are muted as a share of all outperformance is passed back. Additionally, Heathrow has a level of protection for all under performance meaning further muted as risk is limited. Rather than providing a stable H7 framework, this would lead to frequent fluctuations in the level of Heathrow's RAB, continuous adjustments leading to complexity and increasing risk passed to consumers.

129. Our proposed approach, which sets out a deadband within which Heathrow takes all risk, is designed to moderate uncertainty by providing clarity on the levels of risk to which Heathrow's investors are exposed and a clear view of what happens when this risk threshold is passed. This is fully in line with precedent across other airports and regulated sectors, including the price control put in place by the CAA for NERL.

130. The 8% deadband we have proposed has been calibrated by both looking at precedent from comparators but also by looking at historical Heathrow performance. This deadband would nonly have been breached once in Q5, despite large positive and negative swings through these periods. This clearly shows that a deviation of above or below 8% is an extreme circumstance, above what would be expected within the normal course of business and management control.

[46] CAA, CAP2139, Page 62, Paragraph 4.7

Figure 2: Difference in passenger volume and revenue outturn against CAA settlement in Q6 & Q6



Source: Heathrow regulatory accounts

131. Implementing a deadband ensures that, inside of this threshold, Heathrow is incentivised to continue to reduce opex and increase commercial revenues and passenger volumes, thereby retaining the sharp incentives set by the price control model unless and until there is a large shock which would trigger the mechanism. We believe that in the H7 period, which our mid passenger case forecasts to be a growth scenario, albeit off a low base, ensuring these incentives are maintained will be crucial for delivering the right consumer outcomes.

132. We note the CAA's concerns about the 95% sharing rate we proposed in our RBP risk sharing mechanism. Following earlier CAA feedback on this issue we have reviewed the appropriate sharing rate using our modelling on opex elasticities which informs our RBP opex forecasting methodology[47] and by reviewing the actual cost savings made in 2020[48]. This has demonstrated that a sharing rate of 86% would be more appropriate to reflect this relationship. We carried out this work both including and excluding the impact of ORCs.

Table 2: Cost recovery rates

Approach	RBP Opex elasticity	Total opex savings compared to revenue losses	Opex savings compared to revenue losses excluding ORC revenue and costs
Equivalent recovery rate	0.86	0.85	0.86

133. We therefore believe that a sharing rate of 86% is appropriate to both ensure that changes in costs caused by changes in volumes are accounted for and to ensure that Heathrow is incentivised to continue to operate efficiently. The short run opex elasticity used to forecast our opex represents the lower quartile (i.e. 25th percentile of best performance) short run passenger elasticity drawn from analysis of cost and passenger data at over 30 large airports from 2001-2017.[49] Maintaining a relationship between costs and revenues using this elasticity therefore

[47] Applying the short run opex elasticity of 0.39 to 2020 forecast revenues of £2,786m (exc ORCs) and costs of £998m (exc ORC costs) results in a cost to revenue ratio of 0.14.
[48] Actual cost savings for 2020 were 15% of revenue losses, excluding ORC revenues and costs, actual cost savings were 14% of revenue losses.
[49] RBP Annex 10, Frontier Economics – Developing opex and commercial revenue elasticities, Section 3.3

ensures that Heathrow is incentivised to perform to a level that is in the upper quartile of efficiency among comparative airports.

Implementation

134. We agree with the CAA's assessment that mechanisms which rely only on adjusting prices one or two years later have proven to be difficult to implement following the impact of Covid-19. It is for this reason that we proposed to use the RAB to make adjustments required under our proposed risk sharing mechanism. This continues to be the right approach for H7.

135. As the CAA sets out in its CAP2140 document, the RAB is well understood by investors and has been used frequently to smooth the impact on user charges. We therefore continue to believe that using the RAB to smooth the implementation of the risk sharing mechanism is both a pragmatic solution and in the interests of consumers and investors. We also think ensuring the impact is smoothed across future years and regulatory periods will help to reach the airline community's aim of price predictability, in particular following a period of such instability.

136. The CAA raises a question on whether the mechanism should implement changes on an annual basis or on a cumulative basis across H7 as a whole. In order to protect financeability and ensure the mechanism is applied consistently, it should be applied on an annual basis. This means changes made to Heathrow's RAB each year to reflect the outturn situation. This can be implemented easily as part of Heathrow's RAB roll forward policy and would allow for transparency on how and when the adjustment is being applied when outturn revenues are realised each year. Ensuring that the RAB is updated annually will help mitigate the impacts of these large deviations on Heathrow's performance against credit metrics and financial covenants.

137. However, the CAA should note that it cannot rely solely on using the RAB and recovering the impact of deviations from forecast in future periods. The CAA must consider how it can best ensure revenues are brought forward in a timely manner to ensure that Heathrow continues to be financeable in the event of material or prolonged deviations from forecast. The charge set out in our RBP and RBP Update has been fully optimised to ensure affordability without compromising Heathrow's ability to retain its credit rating. Deviations from this revenue would lead to financeability impacts which must be considered.

138. Upon further analysis of our risk sharing proposals under different outturn traffic scenarios, it is clear that, if a price control were to be set using Heathrow's mid case passenger forecast, but the outturn were materially lower, even with the proposed mechanism and annual adjustments to Heathrow's RAB, Heathrow's plan would not be financeable due to impacts on cashflow. Notably, a financeability challenge. Using only a solution where recovery of cashflows is deferred to future periods through RAB accrual would not be sufficient.

139. This impact ties closely with the minimum cashflow requirements and the need for a minimum charge set out in paragraph 99. In order to ensure that Heathrow is not at risk of breaching covenants or the settlement becoming unfinanceable, the CAA must ensure that any risk sharing mechanism reflects this requirement.

140. Analysis shows that, in order to mitigate this impact there are a number of potential options which could be implemented, these include:

    a. The introduction of a second shoulder in the proposed risk sharing mechanism after which at least a proportion of the over or under recovery is passed on through charges. This would set a clear threshold which could be calibrated to align with Heathrow's debt and financeability requirements and provide a clear mechanism for when and how the revenue would be passed back through charges.

b. The treatment of any annual RAB additions made through the risk sharing mechanism effectively as capital expenditure. This would function in a similar way to the current Development and Core framework under which the return on actual Development capital and actual Core capital forecast and spend within the year is factored into the airport charge. This would effectively mean that the return on additions to the RAB under the mechanism are factored into the airport charge more quickly, allowing Heathrow to remain financeable. Heathrow will favour this option due to its simplicity as would use existing well-tested regulatory mechanisms.

141. We urge the CAA to conduct detailed analysis of the various options outlined in this response, and will continue to work with the CAA ahead of the Initial Proposals to share our understanding of these risks and potential options so that we can agree an appropriate mechanism for H7.

142. In order to implement risk sharing mechanism, we propose that the CAA include:

a. A condition in Heathrow's licence which sets out the arrangements in place for risk sharing; and
b. A change to the RAB roll forward policy to include provisions for the required changes to the RAB following implementation of the mechanism.

Reopeners

143. We propose that there should also be a qualitative condition to facilitate the request that the price control be adjusted in the case that there is a major change in assumptions from those on which the price control was based. We note that throughout its document the CAA makes reference to the potential for material change across building block assumptions in H7. These include building blocks such as capital which may not be directly covered in the scope of the proposed risk sharing mechanism. A qualitative condition would allow for a review of these assumptions should a worst-case outturn scenario outside of management control materialise.

144. It is also the case that, as set out above, a risk sharing mechanism that excludes cashflow generation for Heathrow within the regulatory period will impact the financeability of our plane in the event of a material or prolonged impact on revenues. In this case, ensuring there is a clear provision to reopen the settlement in the case of continuing and very extreme circumstance will be vital.

145. We note the CAA's concerns in CAP2139 that:

a. a risk sharing mechanism may provide a reasonable degree of protection, so the specific circumstances for reviewing the price control could be more complex in nature;
b. a formal reopener might in practice provide relatively little certainty; and
c. policy guidance might allow for more detailed explanation than a formal licence condition.

146. In response to the CAA's point that a risk-sharing mechanism could make the specific circumstances for reopening the price control more complex, we do not necessarily agree and think that there can be a high-level Licence condition that provides clarity. The CAA's concern indicates in our view that there is even more reason to have an agreed process in advance of H7.

147. The CAA's intention to "*provide a clearer statement of the circumstances that might justify reopening a price control than there was during Q6*[50]" is welcome. However, we disagree that policy guidance alone is more effective than a formal reopener included within the Licence.

148. We consider the optimal approach is the establishment of a Licence condition which sets out, at a high-level, the arrangements that enable the price control to be reopened, alongside policy guidance which sets out more detail. This combination will provide the benefits the CAA has stated regarding the ability to provide more detail in policy guidance, while ensuring there is clarity within Heathrow's Licence itself.

Capex incentives

149. It is astonishing that the CAA acknowledges it has been consulting on incentives for capital efficiency **for four years**. It is unacceptable therefore that the CAA has not offered a clear policy direction on implementation less than 6 months before the start of the H7 period. This level of uncertainly means that it may just not be practicable for the CAA's proposals to be implemented at this late stage.

150. At this late stage the CAA's proposals are still without vital detail on (i) how incentives will be implemented, (ii) the key role of the reconciliation at the end of the period (iii) how it will impact the charge in-period and (iv) the role of the CAA/ and or its advisors within the period. The most notable omission is the strength of the capex incentive the CAA plan to implement. This strength could have a significant impact on the approach and scale of capital plan that would be included in our preferred approach. Without this vital detail it is impossible for us to give a clear view on the acceptability of the CAA's proposals for H7 or whether they are workable given current resource constraints. This hinders our and others ability to engage in proper consultation on the proposals.

151. In its document, the CAA states that it remains of the view that improvements to the current capital framework are required to create clearer and stronger incentives to ensure efficient delivery. It believes this is best achieved through ex-ante incentives. The CAA's reasoning for this is that:

    a. The current ex-post review process is challenging and contentious to carry out; and
    b. The current process may not have provided a sufficiently strong incentive for efficiency.

152. However, in this reasoning, as in all previous documents, the CAA has not been able to point to any concrete evidence of inefficiency which has resulted from the current capital framework. This is an important gap in the CAA's evidence base when considering what changes to the framework are really required in the interests of consumers.

153. We remain concerned on the CAA's approach to apply ex-ante across the entire capital envelope in H7. Whilst we recognise the understandable desire by regulators to continue to strengthen incentives, this must be in response to real challenges and be targeted and proportionate based on real world evidence of the impact of the incentives.

154. Both internal and external evidence shows that ex-ante incentives may work for certain types of spend or certain characteristics of regulated infrastructure sectors but may not be appropriate everywhere. Ex-ante incentives provide cost certainty, but they do not guarantee efficiency. If not employed correctly they could serve to increase costs through impacts on risk. They are also liable to add delays to project timelines and thus delivering consumer outcomes. Heathrow is not opposed in all cases in principle to ex-ante incentives. We do believe it is important to consider

[50] CAA, CAP2139, Page 65, Paragraph 4.18

the real-world impacts and appropriateness of changes in incentives. The CAA has not considered any of these potential impacts, or how it will mitigate them in its document.

155. Over Q6, Heathrow has delivered £2.9bn of investment which has led to increased levels of passenger satisfaction[51] and helped Heathrow to reach the efficient frontier for both opex and commercial revenue generation[52]. As we set out in the RBP and in our response to CAP1951, both the airline community and the Independent Fund Surveyor (IFS) have made clear their support of the Q6 framework. In its end of Q6 report the IFS noted that the improvements made over Q6 have ensured that no points of learning from Q5 have gone unaddressed.[53] Over Q6, 720 projects have passed through the G3 Gateway with a total value of £2.9bn. All of this has been carried out in agreement with the airline community and no decisions have been escalated to the CAA. Of the £2.9bn portfolio only four projects have been identified as areas of concern for the CAA and its consultants[54] with the rest being completed within 0.5% of their estimated G3 value. This marks a story of real success.

156. When looking at these projects which have seen overspends through the period, the CAA's consultants Arcadis and the IFS have identified a potential inefficiency of £12.7m through the end of Q6 review process out of this £2.9bn portfolio.[55] Additionally, in its end of Q6 report, the IFS noted that cost and time overruns for high value and high complexity projects are often caused by reasons outside of the project team's control, with low value and low complexity projects generally delivered on time and under budget.[56] Given all these facts, we therefore request that the CAA sets out the quantified evidence it has used to identify that the current framework may not have provided sufficiently strong incentives for efficiency over Q6.

157. In regard to the CAA's comments on the 'challenging' nature of the ex-post review process, the Q6 process has provided the CAA with a wealth of information on the efficiency of Heathrow's capital delivery. Over Q6 the IFS has provided in excess of 650 reports on Heathrow's delivery of capital projects. These reports provide unparalleled levels of transparency for the CAA and airline community in order to robustly assess Heathrow's efficiency.

158. The inherent flexibility of the Development and Core process also allows us to deal with the uncertainty we will be facing at the start of the H7 period. The current framework ensures that airport charges reflect only the levels of Development capital and the capital which has transitioned to Core. This allows us to reflect a flexing up or down of the envelope set at the start of H7 to reflect the investment needed in-period. This along with the flexibility provided by reopener provisions and OBR continual improvement mechanisms as part of the framework will allow us to reflect the reality of the H7 period and ensure this is reflected in charges.

159. We remain concerned that the CAA's proposals to implement an ex-ante capital framework for H7 will serve only to increase costs and regulatory burden without commensurate benefit to consumers. This is especially so given the positive outcomes generated by the current framework and the lack of evidence pointing to current inefficiency within the delivery of capital. We therefore call on the CAA to provide its full evidence base to support the proposed move to an increasingly ex-ante capital framework and to carry out a robust cost benefit analysis of its full proposals as part of its Initial Proposals.

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[51] ASQ increased from 4.06 in Q1 2014 to 4.25 in Q1 2021
[52] Reports provided by KPMG on opex and commercial revenue efficiency benchmarking evidence that Heathrow is at the efficient frontier for both opex and commercial revenue generation. RBP Annexes 20 and 21
[53] Gardiner & Theobald, *End of regulatory period Q6 report for CAA*, Page 5
[54] Tunnels, HBS and T3IB projects
[55] CAA, CAP1996
[56]Gardiner & Theobald, *End of regulatory period Q6 report for CAA*, Page 5

160. While noting our continuing concern, in our response to CAP1951 and in our RBP we sought to engage constructively and in good faith with the CAA's proposals for H7. We proposed our view of a workable capital efficiency framework which retains the advantages of the Q6 framework, adapts governance to meet the resourcing pressures we are all facing and ensures that we can still put every pound to work in the interests of consumers. Our proposal built on both the CAA's proposals to strengthen ex-ante incentives and our existing Development and Core framework. In summary, our proposal was:

   a. Retain the current process of setting the capital envelope for the price control, with the CAA setting the proposed envelope which feeds into baseline charges for the H7 period.
   b. Our plan will be split into capex categories which correspond to the programmes identified in conjunction with the airline community.
   c. Each of these capex categories will have an assigned 'Delivery Objective' which sets out the joint objective Heathrow and airlines are aiming to achieve through delivery of the category.
   d. Retain the current Development and Core capital framework to agree capital expenditure with the airlines through the H7 period, with agreed capex being adjusted for through the airport charge.
   e. Implement an ex-ante incentive of 15% for programmes which are within Heathrow's control, assessed as lower risk and benchmarkable.
   f. For these programmes, governance will be undertaken at a programme, rather than project level, with governance decisions being taken at the 'P2' level of the IFS' programme lifecycle governance to ensure that scarce resources can be focused on the delivery of more innovative and complex capex categories.
   g. As capital transitions from Development to Core, quality requirements are set based on the scope and deliverables set out in the agreed scope through governance as "Delivery obligations".
   h. Care should be taken when setting quality requirements, in particular where delivery of scope and outcomes is incentivised through other parts of the regulatory framework, for example, the asset management measures within the proposed OBR framework.
   i. Where required, triggers are set for projects using the current triggers process
   j. At the end of the period, programmes subject to ex-ante incentives would be reconciled against the baseline set when capex transitioned.
   k. Programmes subject to ex-post treatment would be reviewed through an ex-post review process.

161. In its document, the CAA sets out that our proposal falls shorts of the requirements set out in the June 2020 CAP1940 guidance. It should be noted that the guidance included in CAP1940 was based on proposals which were under consultation by the CAA. The CAA has still not confirmed a policy on capital incentives. Given this and our disagreement with the CAA's proposals, our RBP set out our own view of an effective and targeted capital efficiency framework for H7 that seeks to address the perceived concerns by the CAA.

162. In the CAA's view, our proposals are not appropriate for the reasons listed on page 106 of its document. While we accept that more development of our proposals would be needed, in particular in regard to developing governance arrangements jointly with airlines, there are a number of areas where we disagree with the CAA's assessment:

   a. The CAA states that we have provided limited evidence to justify our proposed 15% ex-ante incentive relying only on ensuring consistency with the Q6 framework. It states that our proposed incentive is *"likely to be too weak"* and could not be relied on as the main efficiency mechanism.[57] As set out above, the Q6 framework, which includes an

[57] CAA, CAP2139, Page 70, Paragraph 4.35

average ex-ante incentive of 13% through the period, has ensured the efficient delivery of a capital portfolio of over £2.9bn over Q6. Therefore, our proposal of an ex-ante incentive of around 15% is consistent with maintaining a level of efficiency incentive which has aided efficient delivery in H7. As the CAA has provided no clear evidence that our current framework and effective 13% incentive lead to inefficient outcomes, we cannot agree that our proposed 15% incentive is too weak. Nonetheless, we welcome the CAA to put forward a view on the appropriate incentives. It has not so far provided any such proposal or any evidence to support a given level.

b. The CAA notes that our points regarding linking the outcomes from the asset management programme to service quality measures is underdeveloped and does not set out which measures are relevant. This shows a clear failing of the CAA to look across the range of incentives it is setting for Heathrow and ensure they are consistent. Our current SQRB scheme contains nine measures which are specific to asset availability.[58] All of these have been retained in our OBR proposals for H7. It is therefore clear that, should the CAA set capital efficiency incentives carrying a financial risk on our delivery of asset management, Heathrow could face double jeopardy.

163. The CAA also states that the evidence we have provided on the implication and application of ex-ante incentives is now *“less relevant”* as the capital plan for H7 is smaller and less complex than the portfolio containing the expansion programme. While it is clearly the case that our capital plan for H7 has changed, this does not mean that the principles underpinning our reports are any less relevant to the application of ex-ante incentives. The evidence is based upon experience across UK construction over many years – it is not likely to suddenly become irrelevant because the scope or nature of a 5-year programme changes.

164. Each of our capex categories (programmes) has a different objective, contains a different type of capital investment and therefore has a different level of risk and controllability associated to it. While none of these are expansion focused, it does not mean that they are all fully within Heathrow’s control or without the significant complexity of delivering large capital investments in a live operational environment. Therefore, evidence around where ex-ante incentives are and are not likely to be suitable is still very much valid.

165. The CAA notes that our evidence appears to suggest that large, complex projects cannot be delivered under an ex-ante incentive framework. This is not the case. Our evidence highlights where ex-ante incentives may not be appropriate, focusing on the level of control and risk for each capital project, and highlights the potential impact of ex-ante incentives on cost, delivery time and business risk. The conclusions of these reports were in line with the conclusions of the report from CEPA commissioned by the CAA[59] and in line with conclusions from other external reports such as the NAO report on the delivery model of Hinkley Point C[60].

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[58] Availability of Passenger Sensitive Equipment (PSE), availability of priority PSE assets, availability of arrivals baggage carousel, track transit system availability, Stand availability, Jetty availability, Fixed Electrical Ground Power availability, Stand Entry Guidance availability, Pre-conditioned air availability

[59] http://publicapps.caa.co.uk/docs/33/CAA_ExAnteCapexIncentives_310319.pdf: “*It is, however, important to note that the incentive needs to take into account HAL’s ability to bear cost overrun and to limit the upside that can be earned; any incentive applied should be calibrated to drive the desired behaviour without jeopardising the company’s financial sustainability or providing upside without sufficient passenger benefit being delivered”*

[60] https://www.nao.org.uk/wp-content/uploads/2017/06/Hinkley-Point-C.pdf: “*Alternative financing models would have exposed consumers and/or taxpayers to the risks of the project running over budget and increased the risk of the project needing to be on the government’s balance sheet. But our analysis suggests alternative approaches could have reduced the total project cost. The Department did not assess whether the reduced cost balanced against the increased exposure to risk would have resulted in better value for money for electricity consumers”*

166. It is also curious that, while the CAA assumes that evidence we have provided earlier in the H7 consultations is now *"less relevant"* due to the pause in the expansion programme it is continuing with policy proposals it made originally solely to facilitate the delivery of the expansion programme. These include proposals on tax policy and capital efficiency incentives. In a two-runway H7 framework, the CAA has not provided evidence on why these policy proposals are still required:

   a. A key driver of the CAA's proposals on tax treatment was the increased quantum of capital spend due to expansion. In spite of this not currently being included in the H7 plan, the CAA is continuing with its policy proposals.

   b. The CAA's proposals on capital efficiency incentives were focused on ensuring that consumers were not exposed to the impact of cost and time overruns in the delivery of Heathrow expansion, which could have had a large impact on affordability.[61] In spite of a move to a two runway focus in H7 with a materially lower capital expenditure plan, the CAA is continuing and identical direction in its policy on capital efficiency.

167. Our below response considers the further detail provided by the CAA in CAP2139. It gives our views on the appropriate capital efficiency incentives for the H7 period, including new independent evidence from Jacobs and the IFS. Specifically, we set out views on:

   a. The suitability of Heathrow's capital investment portfolio for an ex-ante capital incentive framework and the potential impacts of improper application
   b. The treatment of different capex categories
   c. The implementation of delivery obligations
   d. The reconciliation process
   e. Governance

168. Taking this into account, we provide below a revised view of our proposed capital efficiency framework for H7. This builds on the proposals in our RBP, CAA's revised detail and our proposals to manage implementation of key issues.

Table 3: Heathrow's H7 capital efficiency proposal

[61] The CAA set out the following in its CAP1782 consultation on the regulatory framework for Heathrow in H7: "*The risk of cost escalation in major infrastructure projects is well known, and an increase in the cost of Heathrow expansion could have a material adverse impact on affordability"*

<table>
<tr>
<td rowspan="2">Start of the period</td>
<td colspan="2">Overall capital envelope set for H7 period by the CAA
This will be split into capex categories, aligned to the programmes agreed with airlines. This will set out the sum of Development expenditure and Core expenditure which has already been committed to. Noting majority of capex will be Development.
Each capex category will have a Delivery Objective agreed between Heathrow and the airlines setting out what the programme is seeking to achieve with agreed prioritisation criteria for projects within the programme.
Capex categories would be assigned as either ex-ante or ex-post depending on whether ex-ante incentives are suitable using the criteria set out by Jacobs in their report:</td>
</tr>
<tr>
<td>EX-ANTE (Programmes with higher controllability, a higher ability to define outputs and which we are able to confidently cost)
Incentive rate set for each capex category</td>
<td>EX-POST (Programmes which are less controllable, higher risk and with a lower ability to define outputs and costs)
No incentive rate set for these programmes/ categories</td>
</tr>
<tr>
<td rowspan="3">During the period</td>
<td colspan="2">Transition to Core (consistent with today’s framework)
Capex category baseline adjusted as projects/ tranches go through airline governance and transition to Core
Airport charges adjusted for the difference in return on capex between the forecast in regulatory settlement and the latest capex forecast, this reflects ‘Core expenditure’ through the period and ‘Development expenditure’ pre-G3 and will be defined in the Price Control Condition
Actual capex added to the RAB
Regulatory settlement depreciation used for rolling forward the RAB and adjusted at the next regulatory period</td>
</tr>
<tr>
<td>EX-ANTE
Transition to core event agreed with airlines
‘Delivery obligations’ agreed with airlines and linked to service quality where applicable
Where timing is critical to the delivery of consumer benefit, triggers are set as per today’s process
Change control process for adjusting baseline if required and agreed with airlines
Quarterly reporting on delivery against G3 baseline</td>
<td>EX-POST
Trigger incentives set as per today’s methodology
Transition to core agreed with airlines</td>
</tr>
<tr>
<td colspan="2">Governance and benefits
Monthly tracking of benefits and performance against capex category envelopes and reporting process through governance forums
Focus monitoring and engagement at programme/ category level to ensure strategic input
Refocus IFS role on technical scrutiny at programme level to enable programme level monitoring
CAA involvement in case of dispute</td>
</tr>
</table>

End of the period	EX-ANTE 1. RAB adjusted at end of period for delivery against delivery obligations and cost	EX-POST 2. Ex-post review process to review efficiency and make adjustments to the RAB

The suitability of Heathrow's capital investment portfolio for an ex-ante capital incentive framework and the potential implications of improper application

169. Throughout the CAA's consultation process, we have raised concerns about the suitability of Heathrow's capital portfolio for ex-ante incentives and the impacts that ex-ante incentives may have if implemented incorrectly.[62] These concerns were also shared by the CAA in previous consultations with the CAA noting *"Nevertheless, we recognise the importance of considering the practical challenges and the risk of distortions that could arise if new incentives are introduced in an inappropriate way"*[63]*.* In its paper for the CAA, CEPA notes that when implementing ex-ante incentives *"the CAA should carefully consider the level of risk that HAL is willing and able (from a financeability perspective) to take on"*[64]*.*

170. Moving to a stronger ex-ante focused framework for capital efficiency will have an impact on the way we work and the level of risk we are exposed to, even under the CAA's proposals to implement ex-ante incentives only when capital is transitioned to Core. This does not mean it is not possible to do, but that the consequences should be thought through fully. Applying a stronger ex-ante incentive means that Heathrow is automatically exposed to more risk on its delivery of capital. To manage this, Heathrow will have to take actions, such as increasing risk allowances in projects or changing our approach to contracting. All of these changes will have real world consequences for the prices consumers pay.

171. These impacts could be magnified if ex-ante incentives are not implemented correctly. If implemented on capital investments which cannot reliably be costed or controlled, this will further increase Heathrow's risk exposure and the actions we must take to mitigate these risks. To understand more about the potential impacts of ex-ante incentives, whether they can be appropriately implemented at Heathrow and how such impacts can be avoided we have consulted internal experts on the procurement and delivery of capital projects as well as commissioning external independent input from Jacobs and the IFS to understand where ex-ante incentives are most suitable.

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[62] **Heathrow response to CAP1541**: *"Heathrow believes that ex-ante incentives represent a significant departure from current regulatory practice which could introduce new risks, including for financeability, and new costs in H7. We would like to see a clear evidence base for the benefits of this innovation and more acknowledgement of the real world trade-offs involved. We are not yet persuaded that ex-ante incentives are the best way to incentivise efficiency in the aviation sector."* **Heathrow response to CAP1610**: *"Ex-ante incentives are not a silver bullet for efficiency. They have both positives and negatives. The effects of ex-ante incentives are well demonstrated both in Heathrow's own procurement but also in construction and major projects worldwide. They can transfer risk and provide certainty. They do drive different contractor behaviour. On very large projects however, the actual risk transfer can be an illusion – illustrated in recent issues with fixed price contracts in UK construction and the public sector. Ex-ante arrangements also add inevitably cost to compensate for risk."* **Heathrow response to CAP1658**: ".*Other approaches, including a greater weighting of 'ex-ante' incentives seen in other regulatory sectors such as water, or energy are now being questioned in regard to the effectiveness of these incentives in protecting consumers' interests, and suitability these incentives in the context of a future that is not "steady state". The CAA needs to avoid a simplistic assumption that different incentives are by definition better, or that ex-ante incentives somehow always create lower cost, more certainty and better outcomes. Heathrow, at this stage, is uncertain and does not recognise the problem the CAA is trying to address with ex-ante incentives."*

[63] CAA, CAP1782, Page 29, Paragraph 2.16

[64] CEPA report for CAA, http://publicapps.caa.co.uk/docs/33/CAA_ExAnteCapexIncentives_310319.pdf,

172. The CAA's proposals in CAP2139 do not appear to have had any further consideration of these issues. In Appendix M, the CAA dismisses the previous evidence we have provided on the suitability of ex-ante incentives due to the risk and complexity of the investments in Heathrow's capital portfolio and notes that "*large, complex projects such as the Thames Tideway Tunnel (Ofwat), Ofgem's Strategic Wider Works and Network Rail enhancements have been subject to ex ante incentives*". While this is true, it does not represent the full story:

   a. As set out by Jacobs in their supporting report, the framework for the Thames Tideway project is very different to the framework under which Heathrow operates.[65] First of all, Thames Tideway is a standalone infrastructure programme and is not being delivered in a live operational environment, as many of Heathrow's programmes are. Second, Thames Tideway's model also includes a mechanism for recognising 'Additional Allowable Project Spend' during the construction phase. This means that cost increases which are deemed to be allowable through construction can be added to the RCV. This effectively creates an ex-post reconciliation mechanism which lessens the risk taken by investors at the outset by mitigating for the ability to effectively cost such a complex programme upfront. It should also be noted that the use of an ex-ante incentive structure is not preventing cost overruns and delivery delays on this programme.

   b. In regard to Network Rail, the IFS concludes in its report that for the regulation of rail enhancement schemes the ex-ante methodology has often proved more challenging to implement leading to the requirement for a long ex-post process to complement the ex-ante framework.[66]

173. These examples show that, while ex-ante may have been implemented across other sectors, including for larger, more complex projects and programmes, it has not always been more successful in incentivising cost control or timely delivery and has, in some cases led to more complexity and burden in the regulatory framework.

174. In regard to the suitability of Heathrow's capital portfolio for ex-ante incentives, Jacobs have reviewed how complex Heathrow's capital portfolio is compared with other regulated infrastructure providers who are subject to ex-ante capital regimes. In the first instance they reviewed the complexity of our asset portfolio to understand the variety of assets which we needed to invest in and maintain. It shows that, while other infrastructure sectors also have complexity, Heathrow has the most complex asset portfolio to manage:

Table 4: Comparison of asset types across regulated infrastructure sectors by infrastructure assets

Asset types	Airports	Rail	Toll Roads	Ports	Water	Electricity
Core infrastructure assets	Yes	Yes	Yes	Yes	Yes	Yes
Retail	Yes	Yes	Yes	No	No	No
Commercial property	Yes	Yes	No	Yes	No	No
Multi-modal assets	Yes	No	No	Yes	No	No

[65] Jacobs, H7 Capital Efficiency, June 2021, Page 17
[66] GARDINER & THEOBALD LLP, Heathrow Ex-Ante Regulation Approach for H7 Regulatory Control Period – 28th May 2021, Page 36

Public vehicle storage	Yes	Yes	No	No	No	No
Utilities	Yes	Yes	Yes	Yes	Yes	Yes
ICT	Yes	Yes	Yes	Yes	Yes	Yes

Source: Jacobs, H7 capital efficiency

175. Jacobs goes on to conclude that, due to the variety of assets held by Heathrow and the requirement to carry out maintenance and the delivery of new infrastructure in a live operating environment, airports are amongst the most complex infrastructure sectors. The unique nature of Heathrow's operations and processes, including the extensive governance process in place with the airline community also contribute to making Heathrow's capital investments uniquely complex and risky:

Table 5: Comparison of infrastructure asset class by investment implications

Infrastructure type	Airports	Rail	Toll Roads	Ports	Water	Electricity
Asset diversity	High	High	Low	Medium	Low	Low
Asset knowledge	Medium	Low	High	Low	High	Medium
Cost uncertainty	High	Medium	Medium	Low	Low	Medium
Stakeholders	High	High	Low	Medium	Low	Low
Investment governance	High	Medium	Low	Low	Low	Low

Source: Jacobs, H7 capital efficiency

176. This shows that the CAA must exercise caution in assuming it can take regulatory constructs used elsewhere and transpose them 'as is' to Heathrow without adverse impacts. Airports can be considered as a standalone "city". Where there are multiple types of infrastructure which vary in complexity, function and delivering to different segments of consumers who all have different expectations and needs. Heathrow's investment portfolio is therefore already substantially more risky than those at other regulated infrastructure companies. Implementing ex-ante incentives would likely increase this risk. This also highlights that the CAA is wrong to simply assume that, in the absence of expansion, Heathrow's capital portfolio is automatically less risky, less complex and therefore perfectly suited to ex-ante incentives.[67] Due to Heathrow's inherent complexity, any capital portfolio would contain levels of risk not seen in other sectors.

177. As highlighted by the IFS in its report, if ex-ante incentives are applied improperly to types of spend which are unsuitable, it risks creating a time consuming and in efficient review process. In its example of Network Rail, it states that enhancements and larger projects are often difficult to estimate and states that a key lesson learned is that an *"Approach for different categories of expenditure (operations, maintenance, renewals and enhancements) should be considered."*

178. The creation of a more burdensome and inefficient process for capital investment would not be in the interests of consumers. A situation similar to that for Network Rail, which the IFS details effectively saw Network Rail subject to both an ex-ante framework and detailed ex-post review, would increase the level of risk to which Heathrow was exposed through the framework. This would lead to an increase in costs to consumers as Heathrow sought to protect itself by

[67] In paragraph 4.32 on CAP2139 the CAA states: "*In contrast to HAL, we consider that ex ante incentives should be applied to all of HAL's capex in H7. Based on our high-level assessment of the plan, we have not identified any areas that HAL should not be able to properly plan or reasonably control.*"

maintaining higher risk allowances. It would also increase the regulatory burden on Heathrow, further increasing the costs to consumers.

179. To further understand the potential impact of ex-ante incentives, we consulted our internal Procurement and PMO and Infrastructure teams to understand when and how a move to ex-ante incentives could impact our ways of working and project delivery. Under an ex-ante framework with an incentive rate stronger than the current 13%, our threshold for tolerating risk around the G3 estimate would be much lower, which would lead to a change in behaviours and increased risk perception around project delivery. The teams set out four main impacts:

a. **Increase in time before spend transitions from Development to Core:** Where an ex-ante incentive materially higher than the 13% to which we are currently exposed is implemented it would take longer for capital to transition from Development to Core. The extra time is needed to assure ourselves around the cost estimate and the level of risk we were taking. While this may lead to more outturn spend being in line with G3 forecasts, it will mean that capital takes longer to deliver, delaying the delivery of benefits to consumers.

   As part of this, we would also seek to carry out more work ahead of capital transitioning from Development to Core to assure ourselves of the cost estimate. Again, while this could lead to more spend being in line with estimates, it does not necessarily indicate efficiency, indeed it could serve to raise costs for consumers by causing more duplicative or abortive spend.

b. **Move away from best practice contracting:** The current framework allows us to employ a best practice approach to contracting based on the delivery of outcomes. Under a framework with a stronger ex-ante incentive or where an ex-ante incentive was applied to an unsuitable scheme, we would be forced to pass this risk down through the supply chain through the use of fixed price contracts. This would allow us to have more confidence in the outturn price compared to the value set as the capital transitioned to Core and therefore allow us to de-risk the implementation of ex-ante.

   A move to a fixed price contract, while providing us with certainty, would mean a higher price for delivery. Suppliers would increase the risk allowances built in through their estimates in order to protect themselves. This would not drive towards a more efficient process, but just to a more cost certain process. The price for this cost certainty would ultimately be borne by consumers.

c. **Increased risk allowances:** In line with the impact on the behaviour of our suppliers, we as Heathrow would also seek to ensure that we had appropriate risk allocations built into our project estimates to offset the impact of stronger ex-ante incentives. This would serve only to increase costs to consumers.

d. **Increased L&L costs:** Leadership and Logistics (L&L) costs are made up of capital costs which are not directly attributable to specific projects and include Heathrow staff costs, design and delivery integration services, and construction related logistics. In Q6, an allowance of 13.4% of all capital expenditure was included in the settlement, consistent with industry benchmarks for similar organisations with major infrastructure development. Over the Q6+1 period, Heathrow has outperformed this allowance, spending only 13.3%. This mechanism incentivises Heathrow to drive efficiencies and reduce overhead costs as no more than 13.4% can be included in airport charges.

   This 13.4% allowance is built on the requirements of the current capital efficiency process. If this process were to change this allowance would need to be reviewed and updated to reflect the requirements of the updated framework. In the event that the new framework is more complex and requires more administration, L&L costs would have to increase. In this case these increased costs would fall directly on consumers.

Even without full detail, the CAA's proposals for an ex-ante capital framework increase reporting and complexity in the capital governance framework, this is particularly case regarding reconciliation. This increased burden would need to be recognised through increased costs in the H7 period.

180. Taken in the round, this evidence shows that, while ex-ante incentives have been successfully applied across regulated infrastructure sectors, the CAA must be careful to ensure that they are applied appropriately. This will ensure that any potential negative impacts are minimised and consumer outcomes protected. It also shows that an ex-ante framework, while helpful for providing cost certainty, isn't always the answer to ensuring efficiency. This conclusion is consistent with the conclusions drawn by Jacobs in their report which states:

Following our assessment, we have concluded that a move to full scale ex-ante for H7 would likely drive unintended consequences that in turn would lead to poorer outcomes for customers as cost uncertainty and risk aversion would result in less maintenance/enhancement projects being delivered in the regulatory period. To avoid this, we recommend a mixed regulatory model where those elements of the capital programme that have available historic benchmarks (and higher degrees of scope certainty) be subject to ex-ante incentives whereas other aspects of the capital programme remain under the existing ex-post arrangements as used in Q6.[68]

Implementing ex-ante incentives: treatment of different capex categories

181. As set out above, in order to manage the potential impacts of ex-ante incentives on consumers, the CAA should consider different treatment of different capex categories. This would ensure that ex-ante incentives are applied where suitable and minimise the impact they could have on the level of risk Heathrow is being exposed to under the framework. This would mitigate the impact of any cost increases or delays in the delivery of capital for consumers, especially on that investment which most needs flexibility and adaptability to consumer needs.

182. We do see that there are a number of similarities between some of Heathrow's capex categories and the types of investment undertaken by in other regulated infrastructure sectors. This is even while we do not agree that all of Heathrow's H7 capital portfolio is low risk, low complexity and therefore suitable for ex-ante incentives. Following on from their work assessing Heathrow's risk profile in comparison to other sectors, Jacobs have developed a set of criteria which allow us to consider where ex-ante would be best suited within Heathrow's capital portfolio. This is based on precedent from application of ex-ante in the sectors reviewed by Jacobs.

Table 6: ex-ante criteria

No.	Criteria	Rationale	Example
1	*Ex-ante* should be considered for capex where HAL has **regular and repeated experience** in development.	Asset classes with a renewal cycle of up to 5-10 years allow regulated companies to build detailed benchmarks and project briefs that can support ex-ante capex forecasting.	• Vertical transport (lifts/escalators) refurbishment • Apron resurfacing

[68] Jacobs, H7 Capital Efficiency, June 2021, Page 19

			(Taxiway and Runway) • Retail shell and core fitout • Asset Refurbishments (under £5m value e.g. toilets)
2	*Ex-ante* should be considered for capex that can be **efficiently contracted** with a high degree of certainty.	Regulated companies can use procurement methods such as work packaging and bundling to achieve enhanced cost control with their supply chains – but only where projects can be efficiently grouped and contracted.	• IT Networks • Airfield Ground Lighting
3	*Ex-ante* should be considered for capex that can be **sequenced** with a high degree of certainty without reducing benefits to consumer.	Projects that have to be delivered in limited time frames (such as possession windows) are inherently more risky and difficult to forecast – this is the case for certain aviation and rail capital interventions.	• Automation: Self-Service Bag Drops, Self Boarding Gates. • EV Charging
4	*Ex-ante* should not be considered for **generational renewals**.	Regulators are using 'conditional allowances' to allow for the efficient development and delivery of large scale 'once in a generation' capital solutions that cannot be assessed in line with more standardised maintenance renewals.	• Heathrow Expansion • Security Transformation
5	*Ex-ante* should not be considered for **complex capex**.	Complex projects require detailed development and inherently are not part of standard asset management plans during a regulatory period. Ex-ante forecasting is not appropriate for projects facing these increased complexities and challenges.	• Baggage systems project • Multiple asset types being delivered in one project (E.g. Kilo Apron Development)
6	*Ex-ante* should be considered for capex that has **limited customer impact**.	Applying ex-ante forecasting requirements to a suite of projects with elongated approvals pathways and limited historic benchmarks will result in increased risk allowances and by extension increased costs to end customers.	• Back of house projects • Commercial and office scope
7	*Ex-ante* should not be considered for capex **that does not have**	A determined management cannot reasonably be held accountable for ex-ante forecasting of projects that are	• Baggage Handling Systems

	sufficient HAL management control.	subject to significant third party influence.	• Technology projects (3rd Party eg NATS) • UKPNS and HhOPCO
8	*Ex-ante* should not be considered for capex that **exhibits unobservable risks**.	HAL will be required to invest in some projects that will by their nature uncover additional scope/compliance requirements during the project lifecycle.	• Contaminated soil (PFAS) Hydrocarbons • Known Asbestos and Legionella

Source: Jacobs, H7 capital efficiency

183. We reviewed our proposed capex categories against these criteria to understand where ex-ante incentives should be applied for H7 and where applying them might lead to the adverse impacts on consumers set out above. This review has led us to rethink some of our capex categories in line with CAA feedback and the appropriate implementation of these criteria. We are proposing to further split a number of capex categories to ensure that the spend within the category has the same level of risk and controllability. These broadly reflect the different investments set out in our capital plan:

   a. Asset replacement programme should be split into asset maintenance activities and generational renewals categories
   b. Commercial revenue should be split into two categories of protecting existing commercial revenue and generating incremental revenue
   c. Efficient airport should be split into two categories of avoiding material opex increases and automation and digitalisation.

184. The below table sets out our initial review of capex categories against these criteria. Where a tick is used this signifies that it meets the criteria to be considered ex-ante, where a cross is used we consider that it doesn't. In summary, this shows that our Asset replacement – asset maintenance, Commercial revenue – protect existing revenues and Efficient airport – avoid material opex increases categories would be suitable for ex-ante incentives. The other capex categories do not meet the criteria set out above:

Table 7: Assessment of Heathrow capex categories against Jacobs criteria for suitability to ex ante

Capex category	% of H7 portfolio	1	2	3	4	5	6	7	8
Asset replacement – asset maintenance	36%	✓	✓	✓	✓	✓	✓	✓	✓
Asset replacement – generational renewals (T2 baggage)	5%	X	X	X	X	X	X	X	X
Regulated security (compliance and transformation)	20%	X	X	X	X	X	X	X	X
Commercial revenue – protect existing revenues	2%	✓	✓	✓	✓	✓	✓	✓	✓
Commercial revenue – Generate incremental revenues	17%	X	X	X	X	X	X	X	X

Efficient airport – avoid material opex increases	2%	✓	✓	✓	✓	✓	✓	✓	✓
Efficient airport – automation and digitalisation	9%	X	X	X	X	X	X	X	X
Carbon and sustainability	5%	X	X	X	X	X	X	X	X
Future ready airport	4%	X	X	X	X	X	X	X	X

Source: Heathrow

185. The above represents an initial view which we will continue to work with the CAA and airlines to develop. Under this structure around 40% of Heathrow's proposed H7 capital portfolio would be subject to the CAA's proposed stronger ex-ante structure.

186. For the capex categories which are not suitable for ex-ante incentives, we propose that the current ex-post approach to capex is retained along with the 13% financing incentive already included in the framework. We would welcome further engagement with the CAA on our capex categories and also on our application of these criteria.

187. For capex categories subject to ex-ante incentives. The CAA must ensure that the incentive rate applied is balanced with the other elements of the regulatory framework to ensure that the framework is both affordable and financeable. It must be commensurate with the levels of risk imposed on Heathrow through the service quality and risk sharing schemes and consistent with the WACC. We will continue to engage with the CAA on the level of this rate ahead of Initial Proposals.

Implementing ex-ante incentives: Delivery obligations

188. The setting of delivery obligations is a key part of the CAA's proposed framework for setting ex-ante incentives. In any ex-ante framework, it is key to ensure that the identified scope has been delivered when assessing whether capital has been delivered efficiently. The CAA's proposals on delivery obligations remain unclear and if not carefully crafted are potentially unworkable.

189. Delivery obligations cannot attempt to measure the delivery of benefits, only the delivery of agreed scope. The airport is an integrated operation with a number of different parties having responsibility for delivering parts of the airport service. This means that attributing benefits to one action taken by Heathrow is almost impossible and that receiving benefit information to verify the delivery of benefits from other parties is difficult and limited by commercial sensitivities.

190. It is also the case that benefits delivered by capex programmes in H7 may not be delivered within the H7 period. Key examples of this are our investments in Terminals 5 and 2 where investment in previous regulatory periods led to increases in service quality and commercial revenues in subsequent periods. While we are able to report on the delivery against forecast benefits through H7, in many cases we will not be able to confirm whether benefits have been fully delivered during the H7 period.

191. Heathrow is also is subject to a robust service quality framework. It will be important to ensure that there is no overlap or 'double jeopardy' between these sets of incentives. This is a particular issue for our asset management investment which is incentivised directly by the rebates attached to our asset availability SQRB metrics.

192. An example of these issues is shown clearly in the CAA's proposed delivery obligation on T2 baggage. The CAA proposes an obligation which sets out a performance target for the new T2 baggage system and the number of bags that can be processed:

a. It is not possible to assess delivery against a target of bags processed per day. This determined by the way the system is used by airlines and their ground handlers, not just the infrastructure Heathrow provides. Airlines can, should and do make choices about bag policies, customer behaviour and the like which change the number of bags

b. We have measures on the performance of our baggage system as part of our service quality framework which are tracked and incentivised there.

193. For the reasons above, it is important that delivery obligations only cover the delivery of agreed scope which is within Heathrow's control. The delivery of benefits, outputs or performance cannot be measured through this framework without exposing Heathrow to performance risk of other parties operating at the airport or creating double jeopardy around the financial incentives Heathrow faces.

194. The CAA's proposals to set delivery obligations at a capex category level are unworkable in their current format. While some capex categories focus broadly on delivering one output, such as compliance with regulated security, others could deliver a wide range of scope and outputs while contributing to the delivery of the same outcome, such as our carbon and sustainability programme. This means that, for some categories, it will be impossible to continually review and manage a delivery obligation set at capex category level and updated as each investment transitions to Core.

195. We welcome further engagement with the CAA on how delivery obligations are set. An appropriate starting point would be to explore the use of the scope agreed between Heathrow and the airline community when capital transitions from Development to Core. This would provide a clear point of agreed scope which is linked to the cost estimate used to set the 'G3 baseline'. Using this agreed scope would avoid the potential for later disagreement on deliverables and would ensure Heathrow is clear about the risk and the expectations for delivery.

196. Key to ensuring the success of delivery obligations will be clarity on how they will be implemented as part of the reconciliation process, discussed below. The CAA will need to have a robust process of valuation of any under delivery against the scope agreed as part of the 'G3 baseline'. In its current proposals, the CAA provides no detail on how this will be carried out but rather just provides illustrations of values being deducted from baselines. Any review of under delivery will have to be detailed and carried out by experts who understand the delivery of the project. Any deductions will need to be well-evidenced and based on expert valuations of the scope not delivered. Without this, deductions are likely to lead to a contentious process, exactly like the one the CAA is trying to avoid in the current ex-post review.

Implementing ex-ante incentives: Reconciliation

197. The CAA's proposals on reconciliation require further consideration and clarification. Under the current description this could be a lengthy process. Over Q6 there have been 668 G3 events. In order to fully reconcile performance against the delivery of scope and outputs for each capex category, the CAA would need to understand the performance of each specific project which transitioned to Core and which underspent versus its G3 baseline. This would be time consuming and burdensome for all stakeholders.

198. The CAA proposes that an annual review against baselines and delivery obligations will be required to monitor the performance of capex categories. This would duplicate our existing process of programme level reconciliation which takes place through our capital governance forums. Performance against the capital envelope set by the CAA at the Q6 settlement and against each of our programme forecasts is jointly reviewed by Heathrow and the airline

community on a monthly basis at CPB. This takes into account spend which has transitioned from Development to Core and new business cases which have been developed at FPG. The CAA is present at both of these forums and has this information. We propose that this process continues to provide the CAA with comfort on the status of the portfolio and performance against capex categories. With this process in place, there is no need for an annual reconciliation process.

Implementing ex-ante incentives: Governance

199. Any changes made to the capital efficiency framework will require a change in capital governance arrangements. As discussed during CE, we will work with the airlines to refresh the capital governance protocols when the CAA sets out its final policy for H7. This is now urgent work to progress given the H7 period will begin in 2022.

200. As set out in the RBP, any future governance arrangements will need to reflect the new normal for Heathrow and the airline community, resource constraints mean that governance needs to be targeted and proportionate. For this reason, we proposed to move governance for programmes subject to ex-ante incentives to a programme level. This would allow Heathrow and the airline community to focus on the key risky, innovative and generational capital programmes while being kept up to date on the progress of programmes which are simpler and more able to be carried out solely by Heathrow without continued airline input.

201. In our response to CAP1951, we also confirmed that we would intend to keep the current governance structures and groups to ensure that the right levels of governance with subject matter experts are retained for programmes where this is required. In addition, we have committed to carrying out further engagement and reporting on the delivery of benefits through our capital portfolio. This will take place through reporting to CPB (Capital Portfolio Board).

202. We also proposed to refocus the role of the IFS to ensure it can provide maximum value for Heathrow and the airline community. We propose that the IFS takes a central role in reporting on Heathrow's delivery at a programme level to assure our delivery against cost estimates.

Chapter 5: Outcomes Based Regulation

203. The CAA's analysis and guidance regarding the implementation of OBR is unclear and flawed. Rather than make clear steps in developing a consumer-focused service quality framework, the CAA again disregards the consumer evidence we have put forward, instead relying on views from airlines that are not substantiated by consumer research[69] and deferring all decision making in the hope that Heathrow and the airline community will agree the right next steps[70].

204. Airlines are not consumers and have vested interests of their own. To the extent that try to represent the views of the travelling consumer they focus their insight programmes on the elements of the journey provided by them e.g. lounges, product on-board the aircraft, and are, therefore, not proxies for the consumer in respect of the CAA carrying out its primary duty which, as a matter of law, relates on the airport operation services. So the value of the airlines' evidence is limited at best. The CAA should not be seeking to rely on information submitted by airlines, which has not been informed by direct consumer engagement, as was the case in the airline community's journey mapping exercise, to make decisions.

[69] In paragraph 5.19 of CAP2139, the CAA takes an airline view on control post measurement, which was derived from an airline brainstorming session, not consumer engagement, and presents this as a challenge to Heathrow which has not been addressed in the RBP without any interrogation of the consumer evidence.

[70] In paragraph 5.29 of CAP2139 the CAA requests that Heathrow and the airlines engage further to *"to build on areas of agreement and narrow areas of disagreement to the extent that this is practicable"* and to submit a joint response to inform Initial Proposals.

205. Outside of speaking to its Consumer Panel, the CAA does not appear to have undertaken any meaningful analysis of the information we have put forward to determine whether or not it is in the interests of consumers. The CAA repeatedly makes the point that our proposed service quality framework appears to *"result in a more generous service quality framework in terms of financial exposure compared to Q6"*[71]. However, the CAA does not appear to have assessed whether the incentive framework we have proposed would actually be in the interests of consumers by incentivising Heathrow more effectively to deliver service and resilience. To reiterate, that must be the test for the CAA, *not* whether a scheme is 'generous' in financial impacts. Consumers are not harmed if Heathrow earns a bonus for example if they get more of what they want at a cost they would bear – in fact they would be harmed if Heathrow did not earn a bonus in such a case. In our RBP we clearly set out the link between our proposals for a sliding scale incentive mechanism and consumer valuations of service improvements and degradations on a unit basis. To consumers, every unit of service matters.[72] The CAA has not engaged with this evidence and focuses solely on its own, high-level views that only a harsher penalty can incentivise Heathrow, calibrated only by comparison with the existing approach. This is a missed opportunity for consumers.

Measures

206. The CAA's assessment of measures is confused and again centres around an assessment of whether Heathrow and the airlines are in agreement, with the CAA taking agreement as a proxy for measures being in the interests of consumers. Key concerns with the CAA's approach include:

a. On the one hand the CAA welcomes the introduction of certain new reputational measures, but on the other states that Heathrow has taken a *"relatively narrow view"* when determining which measures should be reputational or financial. Our approach to determining whether a measure is financial or reputational was based on the key regulatory principle that risk should be allocated to the party best placed to manage it. If Heathrow is unable to control the performance against a measure, it is inappropriate for Heathrow to face a financial penalty for delivery. Therefore, our approach assigns financial incentives only to those measures over which Heathrow has direct control of performance and service delivery. This approach is also in line with that taken by Ofgem when developing its proposals for the RIIO framework, where it specified that all financially incentivised output measures should be within the company's control to ensure that it did not face the prospect of windfall gains or losses.[73]

   However, in line with CAA policy in CAP1540 which sets out that measures should cover the full passenger journey and to ensure that consumers have access to meaningful information about service at Heathrow, we have proposed wider reputational measures which measure the key outcomes consumers expect to be delivered on their airport journey.

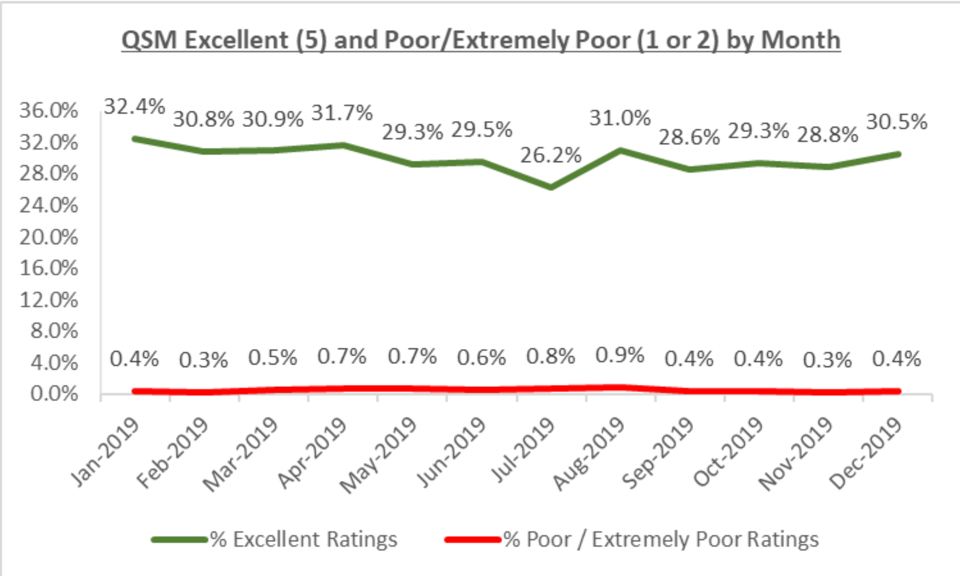
   We urge the CAA to provide clarity on its policy in regard to reputational measures.

b. The CAA asserts that using moving annual average basis masks variability in performance. The CAA needs to accept that there will always be some variability in the data month to month. This is caused by a number of reasons such as terminal congestion, passenger mix, airline and even weather, all of which are very seasonal

[71] CAA, CAP2140, Page 80, Paragraph 5.20
[72] Work undertaken by Systra to understand consumer Willingness to Pay and consumer needs post Covid-19 shows that consumers value every unit of performance. (Systra, *Understanding Consumer Need Priorities in a (Post) Covid-19 World*, November 2020), (Systra, *Heathrow Airport Customer Valuation Research,* November 2018)
[73] https://www.ofgem.gov.uk/ofgem-publications/53835/t1decisionoutput.pdf, Page 3

and subject to variation over time. Using an MAA approach therefore does not mask this variability but allows us to take a meaningful view from the data to ensure we can track the performance of Heathrow to show whether performance is improving or falling over time without being polluted by these standard seasonal variations.

An example of this variability, in this case the seasonal impact can be shown very clearly in our data. While the number of passengers giving negative ratings remains low, the percentage of 'Excellent' ratings caries over the seasons:



Source: Departures QSM Survey Overall Satisfaction

Any target above 4.0 relies on a high proposition of consumers giving Excellent (5) / Good (4) ratings. Evidence shows regular flyers (e.g. Business) state that they are less likely to rate their Heathrow experience as 'Excellent' as they receive the same level of experience each time and so are more inclined to give ratings of Average (3) or Good (4)74. As the proportion of regular flyers alters throughout year the use of moving annual average allows for these seasonal differences in passenger mix to be accounted for.

c. The CAA notes the potential for overlap between some of our proposed overarching measures and the more specific satisfaction measures included within our framework. This is the exact point of our proposals. Following feedback from the Consumer Challenge Board (CCB), suggesting that we ensure that our proposed measures align to our high-level outcomes and that we can communicate performance against delivery of these outcomes in a consumer-friendly way we carried out further consumer engagement to understand how best to achieve this.

We engaged directly with consumers themselves through our future measures research work package to investigate the measures which consumers believed should be used to evaluate performance against each proposed outcome.[75] The key finding from this consumer engagement was that the types of measures consumers are looking for can be categorised into three different levels:

[74] Truth Consulting, Heathrow DNA Integrated Debrief, May 2017
[75] Blue Marble Research, *Consumer Outcomes – Future Measures,* September 2020

- **Overarching Measures**: linked to multiple, or all, consumer outcomes and can allow comparisons with other sectors and businesses;
- **Core Measures**: encompass all or a significant part of an individual consumer outcome; and
- **Diagnostic Measures**: related to a narrow specific aspect or sub theme of an individual consumers outcome.

We took the findings of this research and used it as the foundation for our revised set of measures which included both overarching measures and core measures. Given the nature of the overarching measures is to link all of our outcomes and core measures and provide higher-level information which can allow for comparison against other companies, it is natural that some of these measures may overlap or that outputs from core measures may influence overarching measures. In fact, this is precisely the point of the structure we proposed.

Targets and incentives

207. As set out above, the CAA's assessment of our proposed incentive scheme as being more generous is not relevant. The important issue for the CAA to understand is whether the structure creates the right incentives for Heathrow to provide a level of service that is in the interests of consumers. The CAA has not carried out this work.

208. Our proposed incentive framework was developed on the basis of robust consumer evidence and regulatory precedent across multiple sectors. Appropriately calibrated rewards and penalties align consumer, management and shareholder interests by increasing the focus on improving services and giving shareholders a return for the effort and risk-taking needed to deliver higher levels of service quality. Our consumer insight shows that consumers are willing to pay more for better service and that consumers attach value to improved performance in many areas.[76] It is therefore appropriate to implement the right incentives to ensure that Heathrow is incentivised to continue to develop new and innovative ways of delivering service improvements over and above the baseline service required in order to generate this added value for consumers.

209. This has been recognised in other sectors. 7% of our airport charge revenue is at risk versus an upside potential of 1.44%. While Ofwat's RoRE range for service quality in PR19 has a larger downside than upside for most companies, there is a larger degree of balance than in our current service quality framework. In its PR19 framework, Ofwat specified an expected RoRE range of +/- 1% - 3% for ODI incentives, It also set a symmetrical RoRE range for its C-MeX and D-MeX incentive.[77] Applying Heathrow's current range in comparison would equate to a potential RoRE downside in H7 of -1.74% with a potential upside of only 0.36%. A service quality framework so skewed to the downside does not provide the constructive incentives which reflect the clear value consumers attach to increases in performance.

210. Other sectors have also recognised the value of a sliding scale incentive mechanism. Using a sliding scale mechanism based on consumer valuations has widely been viewed as good practice among other regulators when implementing an outcomes-based framework:

   a. In Water, Ofwat has determined a 'unit rate' for each financial incentive, such that as under- / out-performance increases, the size of penalties / bonuses also increases.[78] This is based on the principle that every unit of performance should count. (This idea

[76] Systra, *Heathrow Airport Customer Valuation Research,* November 2018
[77] https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Aligning-risk-and-return-technical-Appendix.pdf
[78] https://www.ofwat.gov.uk/wp-content/uploads/2017/07/Appendix-2-Outcomes2.pdf

was supported in a Frontier Economics report, prepared for Ofwat, outlining the principles of incentive design) [79]

b. Ofgem also opted for a unit rate approach to setting their incentives for service through its RIIO framework.

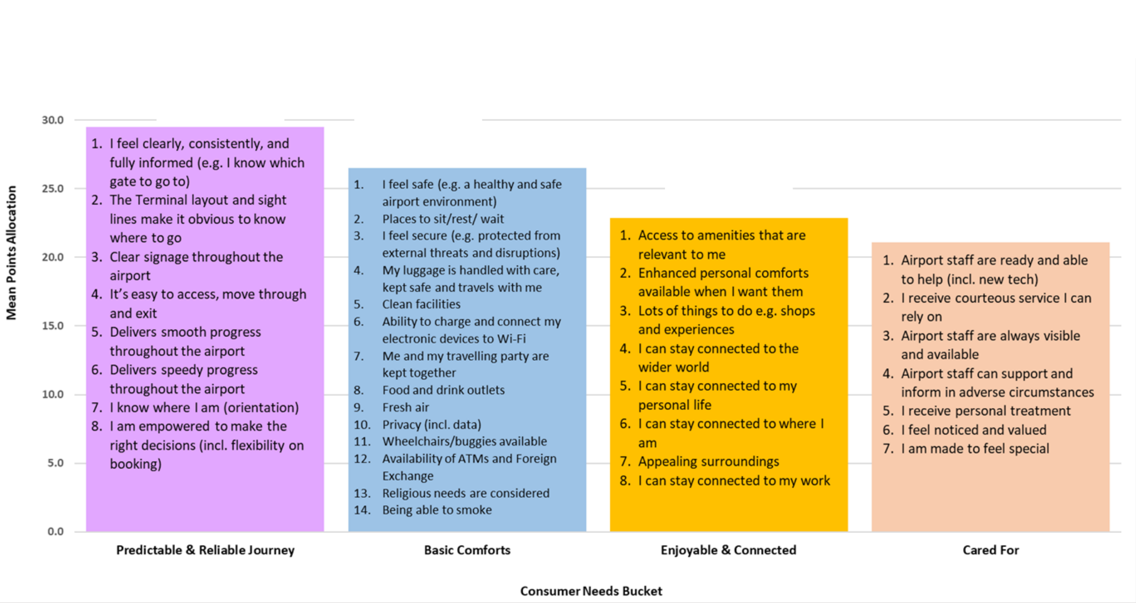
In continuing to pursue a knife edge structure and a balance between rebates and bonuses which is heavily skewed to the downside, the CAA is adopting an approach that is contrary to regulatory best practice.

211. In its position in CAP2139, the CAA also appears to be moving away from its own policy. In CAP1540, the CAA both noted that incentives should be calibrated using consumer priorities and willingness to pay and stated that "*Where practicable incentives should be both positive (reward) and negative (penalty)*"[80]*.* This consultation, in focusing solely on the 'generosity' of the framework rather than ensuring that the incentive design is appropriate, is not consistent with this previous policy*.*

212. Our entire proposed framework is centred around consumer views and ensuring we deliver the outcomes consumers want to see:

a. In order to calibrate our rebates and bonuses, we carried out an exercise to understand the relative importance of aspects of service to consumers. This allowed us to derive a relative importance weighting for each financial measure in our proposed package. We used this to ensure that our potential bonus and rebate exposure was aligned to how important each service aspect was to consumers.

Figure 3: Allocation of priorities



Source: *Systra,* Passenger Priorities Post Covid-19 Research, 2020

b. When establishing which measures should have both rebates and bonuses we reviewed our proposed measures to ensure that our proposals only set bonuses for all

[79] https://www.frontier-economics.com/media/2253/ofwat-report_performance-commitments-outcome-delivery-incentives-pr19.pdf
[80] CAA, CAP1540, Page 23, Paragrah 2.14

areas where these would be appropriate to drive better outcomes for consumers. We are not proposing bonuses on two measures where we judged that a bonus would not be appropriate or incentivise the right outcomes for consumers:

i. Runway Operational Resilience: This measure looks at cancellations and delays caused by congestion on the airfield for reasons under Heathrow's control. A bonus would not be appropriate here
ii. Hygiene testing: Our proposed hygiene safety test measure has a target set at 100% with no opportunity for bonus due to the safety critical nature of the measure.

c. We then applied this relative weighting across the 7% downside exposure which we was agreed by the airline community through CE. From the relative weighting we assigned a unit rate to each measure. This reflects the findings from our extensive consumer research which show that passengers value every unit of increased performance and, also, that they attach a value to every unit of service degradation.[81]

d. To ensure that no drop in service is considered to be 'acceptable' we set our incentive structure so that Heathrow would pay rebates as soon as performance drops below the target set with no deadband. This ensures that Heathrow continues to be incentivised to meet this minimum service level.

e. To ensure that bonuses were challenging to achieve and only paid for exceptional service, well above the level expected and planned for within the settlement, we included a deadband before Heathrow earns a bonus. For satisfaction measures, this is a deadband of 0.25. For asset availability measures, as the service level for the majority of these measures is set at 99%, there was limited scope for bonuses. We therefore set a deadband of 100% performance for these bonuses to be paid. For other measures below 99% we set a deadband of 2% before bonuses are paid.

213. Based on the methodology we have proposed, we do not agree that our incentive structure could be considered to be too generous. It ensures that bonuses are only received where consumers value service improvements and that bonuses are only paid for exceptional service.

214. For this reason, the following statement from the CAA entirely misses the point: *"It is also important that bonuses do not provide double remuneration in areas in which services levels are already being funded through opex and capex allowances."* As we have set out through Chapter 9.2, our targets have been calibrated using our proposed capital and opex plans for H7 and historic performance. Coupled with our proposed deadbands, this ensures we have only proposed bonuses for exceptional levels of service, beyond those which are included within our baseline plans.

215. In regard to our proposals on sliding scale incentive mechanisms, the CAA's document does not provide any detailed feedback on the proposed mechanism in spite of our proposals being set out in detail for the CAA since the publication of our IBP in December 2019. In its document, the CAA notes that, although it sees some potential benefits in using sliding scale incentives, it has the following, high-level concerns:

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[81] Systra, Heathrow Airport Passenger Priorities in a Post-Covid World, December 2020, 20. A smaller-scale survey of current passengers also obtained a priority order of proposed deteriorations in service quality. The most acceptable of the service deteriorations proposed was '7 out of 10 times you will go through security in less than 5 minutes' from a base of 9 out of 10 times. However, this reduction in service would be equivalent to an increase in average fare of 0.9%. The least acceptable deterioration would be '10 out of 1000 passengers' baggage will not travel with them on the same flight' from a current base of 9 out of 1000. This would be the equivalent of a 1.24% increase in air fare.

a. It could be more complex and uncertain
b. Targets must be properly calibrated to ensure there is no trade off between cost and service

216. It is clear to us that moving to a sliding scale incentive structure for H7 is required to transition to a fully outcomes focused framework. The current knife edge structure does not reflect consumer valuations and has bad incentive properties. If Heathrow fails a target, there is no incentive within the service quality framework to continue to deliver the best possible service as the full rebate is payable. While there are obviously a number of incentives on Heathrow to ensure we provide the right levels if service, the service quality framework set by the CAA would not incentivise this. The fact that, under a sliding scale structure, Heathrow would not pay the 'full' rebate for a measure until it had failed the target by 2% rather than as soon as the measure was missed should not be interpreted as more generous. Instead it is correcting the current bad incentive design which does not drive the right outcomes or reflect consumer views.

217. The CAA states that we have not calibrated our targets to reflect a sliding scale mechanism, this is incorrect. As set put above and in chapter 9.2 of our RBP we have calibrated our targets though assessment of historic performance, future investment, consumer WTP, external benchmarking and expert evidence. This process aligns to the evidence base used by Ofwat in its PR19 methodology.[82] We have then calibrated those targets against the downside exposure which it was agreed through Constructive Engagement should be retained for H7 using a consumer focused weighting of the relative importance of each measure. The unit values implemented in order to be consistent with this agreed downside exposure.

218. The CAA notes that moving towards a sliding scale incentive regime could be more complicated and uncertain. We do not agree with this assertion. As in the current scheme, targets will be set for each measure at the start of the period and we will continue to transparently report against these targets through our monthly reports. Underperformance against these targets will continue to be highlighted in red so stakeholders can clearly see we did not meet the target. If a unit rate for each rebate and bonus is then set at the start of the period this can be easily incorporated into our calculation process. This would provide no less certainty or transparency than the process today.

219. The CAA asserts that we have provided limited information on how our targets link to other building blocks and how targets compare to historical performance and performance at other airports:

a. Chapter 10.2 of our RBP clearly shows how alternative opex and capex outcomes would influence our performance against outcomes and service targets. Chapter 9.2 – Measures, Targets and Incentives also sets out the three key areas we will be able to improve in H7 through links to our capital plan and in particular investments in airfield and baggage through our efficient airport and future ready airport programmes. We do, however, acknowledge that further detail on the specific capital investments which will impact service targets will be available as our capital plan develops through the H7 process. As the next step in this process, our RBP update gives more information on our proposed service targets under different capital and opex scenarios using the increased granularity we have on our capital plan following further review and engagement with the airline community.

b. As we discussed in Heathrow's IBP, an Airport Benchmarking Group in 2017[83] was established to provide a platform for major global hub airports to learn from each other

[82] https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Appendix-2-Outcomes-FM-final.pdf, page 45
[83] The group has paused its work since March 2020 given the severe impact of Covid-19

by comparing performance, sharing experiences, and identifying best practices. This group includes nine member airports[84]. The ultimate aim is to achieve improved performance of the participating airports in a way which benefits passengers and the wider public, in areas such as safety, security, quality, environment, productivity and efficiency. One of the key learnings from this group was the challenges of showing comparable data. While, by making sensible adjustments the group found that reasonable benchmarks can be made compared to publicly available numbers, all airports have different regulatory frameworks, ownership structures, complexities driven by geographic location and legislation which make this exercise complex.

The group did not, however, focus on perception KPIs as a wealth of information already exists. Most notably ASQ, which is widely recognised as showing Heathrow performing well against European and other leading airports across the world. This ASQ information is presented in Figure 6 of the RBP which shows how Heathrow performance against other airports in the ACI ASQ passenger satisfaction survey. Further comparative data can also be taken from Skytrax's "World's Top 100 Airports"[85].

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[84] Heathrow, Hong Kong International Airport, Toronto Pearson, Los Angeles Airport, San Francisco Airport, Munich Airport, Aeroports de Paris, Schiphol Airport, and Sydney Airport

[85] https://www.worldairportawards.com/worlds-top-100-airports-2019/

Appendix D: Other aspects of the regulatory framework

1. We welcome confirmation from the CAA that its current intention is to set a five-year price control on a RAB-based single till basis. We agree that setting a price control on this basis will provide stability for stakeholders and provide appropriate efficiency incentives to benefit consumers in the long-run.

2. While we welcome the CAA's confirmation that it will engage stakeholders further on other key changes to the framework, it is disappointing that the CAA has not made further progress on these issues already. Without clarity on the CAA's views on these issues a mere six to nine months before the start of the period, it becomes harder for Heathrow and the airline community to plan for H7.

3. On this basis we will therefore continue to provide our own view on how these elements of the regulatory framework should be treated in H7. This will be set out in full detail in our RBP update which will be published shortly after the response to this document; this will provide an updated view of the regulatory framework in light of further engagement since the publication of our RBP in December 2020.

4. In the points below we set out our position on the topics highlighted by the CAA in Appendix D:

    a. **S-Factor:** In the RBP we proposed that the S-Factor mechanism currently included in the airport charges formula should be retained and amended to include the impact of changes to health and safety policy alongside the current allowances for security. This will ensure that any unforeseeable changes to processes and operations put in place through a formal change to government policy through the H7 period can be accounted for and included within the price control. We have proposed drafting of this definition in Annex 1.

       As part of these changes to the coverage of the S-Factor, we will need to review both the deadband and sharing rate to ensure it maintains the right incentives.

    b. **Uncertainty mechanisms:** In our RBP we set out a number of other mechanisms to manage uncertainty through H7, in addition to our proposals on risk sharing and the S-Factor. These included proposals for the treatment of forecourt charging revenue and an expansion trigger mechanism:

        i. **Terminal Drop Off:** In the RBP we proposed single till treatment of the terminal drop off charge alongside an annual pass through of the revenues against forecast using a term in the price control condition. Following further review of the forecast costs and revenues and discussion with the airline community we have revised our proposals to ensure a more targeted and proportionate approach to managing uncertainties in these revenues.

           Our proposals build on the airline community's request for a 'Notified Items' type approach and agreed principles discussed through governance. Rather than a blanket pass through of revenues to manage uncertainty, our proposals include a consultation provision on potential changes to the level of the forecourt charge above / below a threshold of 10% and a targeted adjustment to the revenues included in the price control if a statutory change outside of

Heathrow's control means that Heathrow is no longer able to enforce the scheme.

We will continue to work with the CAA and airline community to find the right mechanism for H7 and will propose drafting for implementation in due course.

ii. **Expansion trigger mechanism:** Following CAA consultations confirming that the H7 price control should be set on the basis of a two-runway operation we proposed a time bound mechanism to ensure there was a process in place as part of the H7 price control to ensure that expansion could be incorporated into the regulatory framework as required. In our RBP we set out the following milestones and process steps.

Figure 4: Proposed process trigger for the delivery of a framework for Heathrow expansion

We propose that this mechanism is formalised by the CAA through its H7 decision and licence alongside a clear statement on how it will develop and implement a clear policy for early costs.

c. **Changes to the categorisation of ORCs and the ORC recovery mechanism:** This is covered in more detail in our response to Appendix F. In summary, we propose to continue with our revisions to ORCs, including a move towards a marginal cost approach. However, on further review of the potential mechanism for over and under recovery we propose to use the flexibility within the current ORC mechanism rather than our proposed risk sharing mechanism. This follows productive and collaborative discussions with the airline community on how to deal with the current under recovery which have allowed us to maintain separation between the treatment of the airport charge and cost recovery of ORCs. We believe that taking this approach going forward will continue to be the most transparent way of working.

d. **The treatment of cargo revenues:** Again, our substantive response to this issue is dealt with in more detail in response to the CAA's views set out in Appendix F. In summary we propose to continue with the current treatment of cargo revenues, under which cargo revenues form part of the single till in the same way as other commercial revenues. This retains the incentive on Heathrow to grow cargo revenues thereby reducing the airport charge for users.

Appendix E: Assessment of the RBP against the June 2020 Business Plan Guidance criteria

Number	Criteria	CAA assessment	Heathrow response
C01	The RBP should be: • Transparent, and publicly available to all stakeholders; • Supported by a robust evidence base, drawing on industry best practice; • Well-structured and well-integrated between different elements of the plan; • Designed to reflect consumers' views and preferences to the fullest extent practicable; • Based on efficient costs and financing assumptions; • Affordable (including in terms of affordability of charges to airlines); and • Deliverable (including in respect of financeability).	HAL published a full, redacted version of the RBP on its website on 25 February 2021. HAL's plan is overall well-structured and covers the areas and building blocks we expect it to. However, some parts of the plan are not supported by a strong enough evidence base (for example the capex plan). In some instances, we understand some of this evidence is available, and we have been working with HAL to obtain it. We also appreciate that a number of areas within the capital plan for example are still in development, and HAL is currently engaging with airlines on prioritising and developing more detailed plans. As set out in relation to criterion C02, the RBP plan is not well integrated, and specifically HAL has not set out clear relationships between the traffic scenarios and key building blocks in its plan. More detail on the specific criteria is provided in the rest of this table, in relation to specific building blocks.	We acknowledged that some elements of the RBP, in particular the capital plan, are subject to further development as we go through the H7 process. However, the level of detail provided in the RBP is commensurate with that which we told the CAA it could expect in our response to CAP1940 and subsequent engagement. It aligns with approaches, transparency and detail used as best practice in other regulated sectors and the reality of information that actually exists in the current situation in practice. Following the RBP we continued to provide the CAA with information where this became available, in particular in relation to our capital plans. The CAA's assertion that our plan is not well integrated is incorrect. Each of our building blocks is integrated to our passenger forecast. This is set out in: • Our RBP model which provides specific opex and commercial revenue forecasts for each of our passenger scenarios • Chapter 10.2 of our RBP which shows the impact of each passenger scenario on our capex plan and service quality expectations.

<table>
<tr><th>Number</th><th>Criteria</th><th>CAA assessment</th><th>Heathrow response</th></tr>
<tr>
<td>C02</td>
<td>Link revenues and costs clearly to recovery scenarios for passenger numbers, taking account of recent developments including, in particular, the impact of the Covid-19 pandemic. HAL should also clearly identify risk, contingency and efficiency assumptions throughout its plan</td>
<td>The traffic scenarios HAL has developed (low, mid, and high) are not well integrated across the plan. They do not clearly drive differences in scenarios across the building blocks.

For example, it is not clear how the traffic scenarios are integrated with the opex, capex and commercial revenue forecasts. Furthermore, there is no evidence of disaggregation into markets where appropriate (e.g. Commercial Revenues).

The main RBP document is only based on the mid-case forecast. The high and low-case forecasts are only used for high-level sensitivity analysis on the average H7 passenger charge</td>
<td>As set out above and in our response to chapter 3 of the CAA's CAP2139 document, our RBP set out a plan and associated scenarios in which building blocks were fully integrated with all passenger scenarios. The traffic scenarios drive the following differences across the building blocks:
Different traffic assumptions impacted our forecasts for commercial revenue activities and many opex lines as passenger number is the key driver of our driver-based forecasting
<table>
<tr><th>Passenger case</th><th>Opex
(H7 total, £m, 2018p)</th><th>Commercial
(H7 total, £m, 2018p)</th></tr>
<tr><td>Low</td><td>5,268</td><td>3,772</td></tr>
<tr><td>Mid</td><td>5,567</td><td>4,560</td></tr>
<tr><td>High</td><td>5,863</td><td>5,030</td></tr>
</table>
Lower passenger forecasts changed our terminal opening assumptions which also impacted our opex forecasting where the key driver is terminal space. The differences in utilised terminal are can be viewed in the RBP model 'Summary' tab for each scenario selected through the 'Control' tab.
<table>
<tr><th>Passenger case</th><th>Utilised terminal area (000s m2)</th></tr>
<tr><td>Low/ Mid</td><td>2022: 909
2023: 1,031
2024-onwards: 1,117</td></tr>
<tr><td>High</td><td>2022: 1,082
2023-onwards: 1,117</td></tr>
</table>
</td>
</tr>
</table>

Number	Criteria	CAA assessment	Heathrow response
			• The low passenger scenario led to a reduced capital plan from a base of £3.5bn to £2.1bn to reflect a reduced ability to invest These differences can be seen by changing the lead scenario using the 'Control' sheet of the RBP model.
C03	Present all financial, cost and revenue data in the RBP in nominal and real prices, with real values in 2019 prices (or an alternative price base with clear justification provided). HAL should specify what price index it has used (for each item if different indices have been used) to convert data from nominal to real prices. We also require HAL to use a consistent base year when forecasting any quantified elements of the plan. HAL should provide a clear justification and evidence for the choice of base year as part of its forecasting methodology	Overall compliant – HAL has set out what price base is used in the plan and why it has selected this specific price base. We also note that HAL changed the base year for opex and commercial revenues forecasting to 2019 in response to airline feedback. We agree with HAL that this updated approach improves the forecasts because it excludes the significant changes and one-off impacts brought about by the covid-19 pandemic. These can be dealt with more transparently and consistently with a 2019 base year	Heathrow has no further comments on the CAA's assessment.
C04	Ensure its Board reviews and approves the RBP, certifying that it is consistent with the criteria set out in this guidance and fully explaining any divergence from these criteria.	The RBP was reviewed and approved by HAL's board. HAL made a statement in chapter 11 about the status of the RBP document in terms of it not being a formal regulatory submission. We queried this with HAL and they provided an explanation for this statement. In our assessment, we have treated the RBP and supporting evidence as a regulatory submission.	In conversation with the CAA following the submission of our RBP we clarified that the statement in our RBP regarding its status was intended to reflect that: • Although a submission to the regulator, our RBP is a commercial business plan document. • While the RBP is an integrated plan with the outcomes we are planning to deliver being closely linked to the regulatory and policy assumptions we have made, the RBP does not represent the totality of our regulatory

Number	Criteria	CAA assessment	Heathrow response
			policy positions for the H7 period. Since 2016 we have responded to CAA consultations regarding the regulatory framework and policy approach for H7. Through these responses we have set out our view on a wide range of policy approaches and provided evidence for our views. Due to the wide ranging nature of these consultations and the wider, commercial nature of our RBP the RBP document does not present our views on all of these topics. Therefore, the CAA cannot rely solely on our RBP to establish Heathrow's position on the full policy framework for H7. In the case that we have responded to CAA consultations on matters not covered in the RBP, these responses should take primacy. • Additionally, we expect the CAA to continue to consult on and make decisions on regulatory policy following the publication of our RBP. In response to these consultations we may need to update our potion on regulatory policy for H7. In this case, our responses to these consultations will take primacy over the RBP. Given the integrated nature of our plan we would also expect our plan and its deliverables to change to reflect these updated policy positions. We have explored the potential impacts of some key policy changes in our RBP through sensitivity analysis.

<table>
<tr><th>Number</th><th>Criteria</th><th>CAA assessment</th><th>Heathrow response</th></tr>
<tr><td>C05</td><td>Jointly agreed scenarios should take account of the following factors:
Scenarios or forecasts of economic activity, both for the UK economy as a whole and for the economies of the key passenger destinations served by air transport services from Heathrow;
The impact on passenger demand of current and potential future quarantine measures, or other restrictions of movement across borders, by both UK Government and other governments;
The impact of other restrictions in airports or on board aircraft (such as social distancing requirements) on airport and airline fleet capacity.</td><td>Whilst the scenarios in HAL’s RBP were not jointly agreed with airlines, good and constructive dialogue took place during CE, in relation to forecasting methodology and key drivers, and there was an understanding of the significant uncertainty around these.

Given the volatility around the evolution of the pandemic, any agreed scenarios are likely to have become out of date very quickly. With the benefit of hindsight, it appears appropriate that HAL has sought to develop its methodology to better take account of volatility and to develop several scenarios that should aim to capture a reasonable range of possible outcomes, and which can be updated as and when there is more evidence and certainty.</td><td>In its assessment, the CAA assess our RBP as partially compliant with this criterion. However, the CAA’s written assessment acknowledges that our passenger forecasting approach was driven by good engagement with stakeholders and is likely to be the best approach.

We therefore consider that we are compliant with this criterion and the outcomes the CAA was seeking to achieve from it.</td></tr>
<tr><td>C06</td><td>Jointly agreed scenarios should be developed in a way that presents integrated outcomes for passenger numbers, capex, opex and commercial revenues in the RBP at a suitable level of disaggregation. Given the requirements of criterion C05, scenario analysis should be disaggregated, as a minimum, into key geographic markets.</td><td>There is a lack of transparency over how HAL demand forecasts are integrated with the opex, capex and commercial revenues building blocks.

There is no evidence of disaggregation of passenger forecasts into markets where appropriate, for example for use in commercial revenues, where it is noted in the RBP that different passenger markets have a different degree of spend per passenger.</td><td>It is incorrect that there is a lack of transparency in the RBP about how passenger forecasts are integrated with the other price control building blocks.

As the CAA rightly notes, our RBP ‘base case’ was centred around the following assumptions:
A P50 passenger volume forecast;
A Covid-related RAB Adjustment that is made at the start of the H7 price control; and
A five-year length to H7, ending on 31 December 2026.</td></tr>
</table>

Number	Criteria	CAA assessment	Heathrow response
		The RBP is based on a 'Mid' case passenger forecast only. The 'High' and 'Low' cases are used for very high-level sensitivity analyses on the average passenger charge for the H7 period.	In addition to this base case we provided full sensitivities for six alternative scenarios, these included alternative passenger volume scenarios of both a higher (P90) and a lower (P10) passenger forecast. Each of these sensitivities, including the impact of alternative passenger volume scenarios were set out clearly in chapter 10.2 of the RBP: • Table 1 of Chapter 10.2 set out the impact of the alternative passenger volume scenarios on the H7 average charge and forecasts of overall passenger satisfaction through the period. • Table 2 of Chapter 10.2 set out the impact of our 'High' and 'Low' passenger scenarios on the key assumptions of our plan on our capital envelope, WACC and regulatory depreciation assumptions. • Section 10.2.3.1 confirms that the impact of different passenger volume scenarios is reflected in our opex and commercial revenue forecasting through the driver based model • Figures 4 and 5 show the bridge between the average charge in the H7 base case and in the two alternative passenger volume scenarios. • Table 3 provides detail at a programme level on how our capital plan would change in a 'Low' passenger volume scenario. In addition to the narrative and analysis provided in Chapter 10.2, the financial impact of alternative passenger scenarios was also clearly set out in our

Number	Criteria	CAA assessment	Heathrow response
			RBP model and in our alternative PCMs which were submitted to the CAA for each of our sensitivities. We note the CAA's comments regarding market disaggregation and its potential to impact our commercial revenue forecasts. For our RBP update, we will provide additional evidence regarding impact of different passenger mix forecasts on our projected commercial revenues.
C07	HAL should develop an OBR strategy over the short term, recovery period and longer term. As a minimum, this should focus on delivering consumers' and airlines' core needs and priorities so that they continue to receive an appropriate level of service over this time. HAL's focus should be on two areas which must be progressed in parallel: • update the SQRB scheme for the short term and recovery period; and • develop the H7 OBR framework and plan for continuous improvement of the framework over the longer term. Any modified form of the SQRB scheme should be appropriately brought together with longer term work to develop HAL's H7 OBR framework. The H7 OBR framework	HAL has proposed an updated OBR framework and a high-level proposal for continuous improvement. We note that HAL has updated one of its consumer outcomes to reflect new consumer insights. HAL has also made progress since the IBP in proposing a new set of measures that reflect an improved "golden thread" linking to consumer research. Taken together, HAL proposed targets and incentives, would result in a more generous service quality framework in terms of financial exposure in H7 compared to Q6. We also note that limited information has been provided on HAL's proposed targets. Regarding HAL's proposed approach to continuous improvement, we welcome the principle of reviewing and updating the OBR framework during H7. We note that HAL's proposal to escalate areas of disagreement to the Consumer Panel for resolution is not consistent with the Consumer Panel's remit.	As set out in Section 11.6 of our RBP, the RBP focuses on our long term plans for service quality for the H7 period. Discussions regarding short and medium term SQRB changes sit outside of our H7 plans. For this reason we have not included details of the discussions taking place around short-term changes to the SQRB scheme for the iH7 period. Instead, our RBP focuses on the key changes for H7, rather than short-term solutions required only for a matter of months. The CAA's observation that Heathrow's proposed targets and incentives would lead to a 'more generous' service quality scheme is both incorrect and not relevant to the CAA's duties. Our scheme proposes an incentive structure which best reflects how consumers value the service they receive and sets a continuous incentive on Heathrow to provide the right level of service. The CAA has done no meaningful analysis of our proposals to explore whether this incentives structure, used extensively in other sectors and widely considered best practice, is in the interests of consumers. Instead the CAA has relied on an arbitrary assessment that the scheme

Number	Criteria	CAA assessment	Heathrow response
	should be developed to take account of new consumer insights and other developments in the sector so that OBR remains responsive to consumers' evolving needs. See chapter 2 for further explanation of this approach. A section of the RBP should set out HAL's strategy and a methodology for bringing this work together as well as the progress made in doing so.	While HAL and the airlines have invested significant time engaging on SQRB performance and alleviations in light of covid-19, some of this engagement has been challenging. We note that no short-term modifications have been made to the SQRB scheme.	may result in Heathrow paying a lower rebate in some circumstances. The CAA's assessment of our proposals also fails to take into account its own policy guidance in CAP1540 which states that bonuses and rebates should be payable where possible and that incentives should be calibrated using data from consumer valuations. The service quality targets set out in our 'base case' plan maintain and build on current service quality performance, which is amongst the best in the world, and target improvements in the key areas of baggage, punctuality and overall satisfaction. This does not reflect a 'generous' set of service quality targets. Our approach to setting targets is set out in detail in Chapter 9 of the RBP in Section 9.2.3. It confirms that we have used a toolbox of evidence to inform our targets, in line with the approach taken by Ofwat in its PR19 review. After reviewing our consumers WTP information to identify the highest value improvements, we used a mixture of historical performance, expert evidence and comparative data to set our targets for H7. Table 3 sets out our H7 targets in comparison to those set for Q6. The CAA notes that our proposal to escalate any disagreements regarding continuous improvement to the CAA's consumer panel is not consistent with the Consumer Panel's remit. We consider it to be important that the voice of the consumer is strongly represented in any continuous improvement mechanism. We urge the CAA to reconsider the Consumer Panel's remit to ensure the right level of

Number	Criteria	CAA assessment	Heathrow response
			challenge and scrutiny is provided, or to identify an alternative escalation route in the event of the airport and airlines being unable to reach agreement.
C08	In ensuring the RBP is fully informed by consumers' core needs, priorities and preferences. HAL should: • consider which elements of its existing consumer research and engagement remain relevant for the RBP; • refine and build on its existing consumer evidence base with emerging intelligence and, where appropriate and practicable, through new research and engagement; • update its existing consumer research and engagement strategy, setting out how it intends to engage with consumers to understand their core needs, priorities and preferences; • consider airlines' consumer research and insights; and • address relevant findings and recommendations in the CCB's IBP report on consumer research and engagement and continue to follow the CCB's principles of good consumer engagement.	HAL has made a clear effort since the IBP to understand consumer priorities in a post-covid-19 environment, where undertaking research and interpreting the implications for the future are considerably more challenging. There is a clearer attempt at referencing consumer research and linking its plans to consumer outcomes compared to the IBP. While we welcome HAL's efforts, there is scope to better use its research findings within the RBP to support its proposals. Overall while there are some areas of improvement since the IBP, the RBP as a whole still lacks a clear "golden thread" and evidence of value for money for consumers. HAL has undertaken an interim update of its consumer engagement strategy. HAL states that it will undertake a fuller update of its strategy in 2021 which will set out its consumer approach for 2022. We expect the full update of the strategy to reflect feedback from the CAA's Consumer Panel and the CCB's principles of good consumer engagement.	We note the CAA's comments regarding the improvement in our consumer research and its links to our plans. We disagree with the CAA that our plan lacks a clear 'golden thread'. Key examples include: • Our plan prioritises increases in punctuality as this was identified as a core need post Covid-19 due to increased anxiety from consumers about the potential for new, lengthy processes at the airport • Our revised measures, targets and incentives proposal includes new measures on hygiene testing and the ability to social distance to meet consumers' heightened need for cleanliness and a less crowded airport experience. • Our proposal to focus on a decrease in the baggage misconnect rate is directly driven by our willingness to pay work which show that passengers attribute a high valuation to improvements in baggage performance. We disagree with the CAA's assessment that our plan lacks evidence of value for money for consumers. Alongside our RBP we provided the CAA with the outputs of our Willingness to Pay research, including our updated Passenger Priorities Post-Covid work

Number	Criteria	CAA assessment	Heathrow response
	In doing this, HAL should consult the CAA and airlines on its future research and engagement plans and reflect the feedback it receives in its work on the RBP. HAL should also demonstrate how it will manage practical issues on consumer participation and results that may have been distorted by the impact of the Covid-19 pandemic.		package which reviews consumer valuations of service improvements in a post-Covid world. Our plan draws on both of these reports to focus on the key areas of improvement that drive value for Heathrow's passengers, including punctuality, baggage and cleanliness. As set out in Chapter 2, Section 2.3.2 of the RBP we have undertaken further consumer valuation research following the RBP to ensure that our plan, in particular the service received for our proposed charge, is acceptable to consumers. We will provide full detail on this work in our RBP Update.
C09	HAL should consider what the implications of its future scenarios might be for the service quality that consumers and airlines will expect and should receive. To the extent practicable, HAL should demonstrate a clear link between its consumer insights and future plans under the range of scenarios being assessed, drawing on existing consumer insights, new intelligence and research to support these scenarios where possible.	HAL sets out what impact its RBP plans, and other sensitivities will have on the delivery of consumer outcomes at a high level. Further detail on the impact these sensitivities could have on service quality (measures and targets) is not provided in the RBP. We note limited information on the impact some of these sensitivities could have on service quality is set out in HAL's response to CAP2098.	Chapter 10.2 of our RBP sets out the impact of different scenarios on our plans and, consequently, on our ability to deliver against consumer outcomes. We show this for the following scenarios: • High and low passenger forecasts • Covid related RAB adjustment implementation in early 2021 • No Covid related RAB adjustment • 2 Year regulatory period • 7 year regulatory period We are also clear in Chapter 9.2 that, while we would work to maintain current service levels in all scenarios, without the proposed £3.5bn capital plan the following key improvements would not be possible: • Increase Departures Flight Punctuality from 78.4% in 2019 to 80.5% in 2026 • Reduce Baggage Misconnect Rates from 9/1000 in 2019 to 7/1000 in 2026

Number	Criteria	CAA assessment	Heathrow response
			• Increased Passenger Experience satisfaction rating from 4.24 in 2019 to 4.26 in 2026 As the CAA notes, we also provided further evidence on the impact of a lower H7 capital plan on our service quality in our response to the CAA's CAP2098 consultation. We will build on this evidence base in our RBP Update following the further crystallisation of our capital plan.
C10	The RBP should set out capex proposals at a sufficiently detailed level of dis-aggregation. For each project at a sufficiently advanced stage of development, HAL should identify key categories of costs, such as: • leadership and logistics; and • risk and contingency. We will discuss and agree the full list of categories with HAL and airlines in advance of the publication of the RBP.	HAL has proposed a capital plan that is designed around three capital portfolios totalling £3.5bn of spend over H7 (in the central scenario). Each of these portfolios includes a series of programmes; for most of the programmes, HAL has only provided high-level cost estimates. For some of the programmes, the estimates provided are flat over the course of the regulatory period, which is an indication that they have not been derived from bottom-up estimates (e.g. unit costs), but instead from top down allowances. We have subsequently confirmed with HAL that this is the case. The estimates provided in HAL's plan are not disaggregated beyond the programme level, and clear outputs are not specified for most of them. The current plan cannot be meaningfully assessed, and would not allow us to set an overall capex envelope for the H7 price control, or an indicative capex baseline for each capex programme linked to delivery	The CAA's assessment of our capital plan is based on a false view of the information that could have been provided in our RBP. It both fails to take into account (i) our previous statements confirming that we would not be able to provide the level of detail the CAA was requesting in its CAP1940 guidance at the point of publication of our RBP (ii) the increased levels of detail we have provided to the CAA following publication of our RBP through document submissions and airline engagement sessions at which the CAA team were present and (iii) an understanding of how Core and Development capital is developed at Heathrow and the level of development of capital projects at the time of the RBP, particularly given the dramatic change of circumstances for airlines and airport in 2020. Since the publication of the RBP we have continued to engage with the airline community on our plans for capital investment in H7, in particular to agree joint 'Delivery Objectives' for each of the programmes and agree how we will prioritise the pipeline of projects and business cases within each programme. More detail on this will be provided in our RBP update.

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		objectives, to enable us to assess and incentivise capex delivery during H7. Based on discussions with HAL, we understand that the capex plan submitted as part of the RBP is less developed than the other building blocks. HAL is currently working with airlines through governance forums to develop this plan by prioritising programmes and producing more detailed forecasts and business cases for specific projects	The CAA notes in several places that Heathrow has failed to provide the information set out by the CAA in its CAP1940 guidance regarding its capital efficiency proposals. At the time the CAP1940 guidance was published, the CAA's proposals on capital efficiency were not policy and were subject to consultation in the very same document. We set out that we disagreed with the CAA's approach and provided our alternative approach in the RBP. The CAA's constant requests for information to implement its thinking which was not policy at the time is concerning and points to a lack of due process and transparent consultation on these issues.
C11	HAL should clearly identify risk, contingency and efficiency assumptions in its capex proposals, both • at the project level; and • at the overall portfolio level.	HAL's plan did not include a breakdown of risk, contingency or Leadership and Logistics costs. We do not agree that it is necessary for us to have finalised our capex incentives proposals in order for HAL to identify risk and contingency assumptions in its plan.	The CAA's assessment that it is not necessary for capital incentives to have been finalised in order for Heathrow to take a view on risk and contingency and L&L costs is incorrect. The CAA's proposals on capital efficiency could materially change the risk balance faced by Heathrow in the delivery of capital programmes, in particular those which are complex, risky and less controllable. This could have a material impact on how we approach delivery of these investments going forwards. The same is true of L&L costs. The CAA's proposals on the capital efficiency framework, in particular governance and reconciliation arrangements could have a material impact on the cost and time of programme delivery which will undoubtedly impact our L&L costs across H7.

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C12	HAL should identify expected outputs and benefits associated with each project. The RBP should set out how the capex programme delivers value for money, on a whole life cost basis, for customers and consumers during H7. This should include an estimation of measurable benefits.	HAL has presented no details in the RBP on business cases to support its capex plan, even for projects which should be well developed e.g. asset management projects in early H7, of projects which are continuing from the current regulatory period (Ih7). This is a priority area for future business plan updates.	As set out in our response to CAP1951, defining outputs and benefits on a project-by-project basis in the RBP is not workable and would require our capital portfolio to be agreed at the time of the H7 business plan. The impact of Covid-19 has forced us to completely review and redefine our capital plan for the iH7 period. As set out in the RBP, this meant that the majority of the focus of both Heathrow and the airline community at the time of RBP development was establishing a revised capital plan for 2021. Following the RBP publication and the finalisation of the 2021 capital plan, we have continued to engage with the airline community to prioritise specific business cases under each programme. The CAA has also been part of this engagement. Further detail on the output will be provided in our RBP Update document. We have also provided the CAA with additional information on our asset management programme following the publication of the RBP. Again, more detail on the business cases within this programme will be provided in the RBP Update following further engagement with the airline community.
C13	HAL should set out its understanding of our proposed broad approach to capex incentives and how it has taken account of this in the RBP, including any key assumptions.	HAL has set out an alternative approach for capex incentives. Our assessment of HAL's proposal is outlined in Appendix M. As noted in the Appendix, we do not consider that HAL's proposed approach fully meets our RBP criteria or that it addresses all of the issues that we highlighted	Our response to the CAA's assessment of our capital efficiency proposals is provided in Chapter 4 of this response. The CAA's guidance in CAP1940 was based on policy proposals put forward by the CAA which were still under consultation, not on a fully formed policy proposal. Our RBP instead put forward our view of an

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		in the June 2020 Consultation and the August 2020 Working Paper.	appropriate approach to capital efficiency in H7 which delivers the best outcomes for consumers.
C14	The RBP should contain detail on the capex portfolio and, where capex programmes are sufficiently developed, initial views on: • capex categories, and "core" and "development" capex; • delivery obligations ("DOs") and quality requirements; and • any timing incentives.	HAL has presented a top-down capex plan which sets out its proposed capex programmes but has provided limited explanation on why it considers that these programmes reflect appropriate capex categories for the purposes of the H7 incentive framework. HAL did not provide information on the maturity of each capex category i.e. the level of core or development capex, and some programmes are not clear (e.g. opex avoidance, commercial revenue generation). Whilst HAL has included high level delivery objectives for each programme, these lack detail and are at an early stage in development. Limited detail provided on timing incentives for H7. HAL makes reference to changing the existing triggers mechanism so that it has a broader focus but unclear how the timing incentives would change for H7 under this proposal.	As set out above, we are continuing to develop and firm up both the business cases within each of our programmes and associated measures and Delivery Objectives through our engagement with the airline community. More detail will be provided in our RBP Update. The CAA's request for the level of Core and Development spend for each capex category (programme) demonstrates the CAA's continued misunderstanding of how the current process works despite numerous explanations. As we have set out on multiple occasions, capex transitions from Development to Core when it has been agreed with the airline community at the G3 Gateway. Therefore, by definition, most of the capex for the H7 period will be Development until the spend is agreed by the airline community at the G3 Gateway during the period. This is consistent with the status at a similar time before Q6.
C15	HAL should provide details of the proposed governance process to support the capex incentives, including how it will address the issues arising from the Q6	HAL has provided initial thoughts on how governance arrangements could be updated for H7 e.g. programme level review of expenditure for programmes that are subject to ex ante incentive arrangements.	Our proposed governance process builds on the areas of improvement identified by stakeholders and the IFS; we are proposing to move to a more programme-based approach to capital governance

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	arrangements identified by the IFS and CAA.	HAL has not addressed the detailed improvements to the Q6 governance arrangements that we proposed in the June 2020 Consultation.	and refocus the IFS role to provide more technical scrutiny at programme and project level. Given the limited detail provided by the CAA on its proposals for capital efficiency in H7 it was impossible to set out a complete proposal for governance in H7 that aligns with the CAA proposals at the time the RBP was published. We have, however begun working with the airline community and the IFS through IFS Working Group to develop the appropriate capital efficiency measures and governance for H7, following the publication of further detail on the CAA's proposals in the CAP2139 document. We will ensure ongoing engagement with both the airline community and the IFS on this topic through 2021.
C16	HAL should consider whether its forecasting methodology remains appropriate in the context of the impact of the Covid-19 pandemic and the Court of Appeal's judgment. Forecasts should be fully explained, taking account of past performance, the impact of measures to address the impact of the Covid-19 pandemic and expected operational efficiency and commercial revenue generation.	HAL relies on a driver-based forecasting methodology which has been heavily challenged by airlines with a number of additional downside overlays. Covid-19 and other large policy impacts are not fully explained in the RBP narrative in the opex and commercial revenue chapters. Some forecasts are the same as in the IBP (e.g. in relation to input price inflation).	As set out in both our RBP and in Chapter 2 of this response, we continue to believe that our driver-based methodology is the most appropriate forecasting methodology for H7. The CAA's assertion that our methodology has been challenged by airlines, while true, is meaningless as an assessment of our forecasts. We have responded to airline comments regarding our forecasting methodology in Chapters 2.4, 7.1 and 7.2 of our RBP. Airline opinion does not constitute an assessment of the appropriateness of our forecasting methodology. Section 7.1.6.8 of our RBP provides detail on the impact of Covid-19 on our costs, explains our proposed Covid-19 overlay and includes an annual breakdown of our forecast.

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			In Section 7.6.1.1 of the RBP we set out our reasoning for retaining the Input Price Inflation assumptions from the IBP and confirmed that these would be updated : "*It should be noted that all these forecasts were developed before the full impact of the Covid-19 pandemic, which is still on-going. We will update the estimates, reflecting the impact of Covid-19, when new forecasts become available in 2021"*
C17	We expect the RBP to set out consistent historical and forecast data at a level of detail that supports appropriate scrutiny by the CAA and airlines. We expect historical data to cover the Q6 period as a minimum and we expect HAL to ensure that all historical data included in its RBP submission is fully reconcilable to its published Regulatory Accounts.	The reconciliation between the RBP and the Regulatory Accounts was not readily available in the RBP. We obtained some additional detail on this reconciliation in response to our RBP queries. However, it does not provide sufficient information to reconcile the two breakdowns of opex and commercial revenues at a granular level. Historical data beyond 2019 is only set out in the accompanying opex and commercial revenues driver-based forecasting model.	As the CAA notes, full data on historical performance is provided in our supporting RBP model. This information is fully reconcilable to regulatory accounts, as explained and confirmed in Constructive Engagement.
C18	HAL should demonstrate that its forecasts of opex and commercial revenues are integrated with other areas of the RBP: opex forecasts should be clearly linked to anticipated operational activity (e.g. increased use of a particular terminal by passengers) and changes in service quality during the H7 period. HAL should show that its opex and commercial revenue forecasts are	Links between opex and commercial revenues and the capex plan are not well evidenced. The link to reduced terminal utilisation is taken account of through an overlay which is based on estimates that we can't corroborate. There are no details on the optioneering process that HAL has gone through to assess the best options to deliver activities and levels of service in H7 efficiently.	Our RBP sets out a clear link between our forecast of operating costs and the capital plan. This link is based on robust literature of the impacts of capital substitution as set out in Section 7.1.7.2 of the RBP. In regard to commercial revenues, our RBP set out that, as our forecasts were developed using an elasticity which was derived from historical performance data, our forward looking forecasts already included the assumption of equivalent levels of capital expenditure through the H7 period. We will provide more detail on the impact of the capital plan on our commercial revenues in the RBP Update.

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	consistent with planned capital investment. Evidence should be provided to demonstrate that a range of operating and capital solutions have been considered to deliver the activities and levels of service planned for H7 efficiently. The RBP should clearly show how the best and most efficient options have been selected, and how optimum value for money will be achieved.		Operating costs and commercial revenues forecasts are driven by forecasts of available terminal space and passenger volumes meaning that there is a clear link to terminal utilisation in our forecasts.
C19	HAL's proposal for the WACC should be consistent with efficient financing and its assumptions on risks and incentives. HAL should assume a cost of capital for H7 no more than the efficient level necessary to compensate HAL for the business and regulatory risks it faces.	The RBP remunerates tax costs through a pre-tax WACC. The use of a pre-tax WACC is not justified within the RBP. We note that there was some discussion of the issue in the IBP but even that rationale falls short of demonstrating that the WACC is "no more than the efficient level necessary to compensate HAL for the business and regulatory risks it faces" as required in the business plan guidance	The CAA's assessment here is factually incorrect. The CAA has not yet set a policy that the WACC for H7 should be calculated on a post-tax basis and continues to consult on this topic. Therefore, the CAA cannot assess that our RBP represented a WACC which is non-compliant with its business plan guidance. Our plan continues to use a pre-tax WACC which we believe delivers the best outcomes for consumers while maintaining regulatory consistency. We have provided extensive justification for the use of a pre-tax WACC in our IBP and in response to the CAA's consultations.
C20	In estimating the efficient cost of capital for its business plan, HAL should align this with: • recent UK regulatory precedent (including the CMA decisions on RP3 and Ofwat's PR19	HAL's approach is inconsistent with the CMA's position on the PR19 appeal.	Our position on WACC in the RBP takes into account current market data, recent regulatory precedent and precedent from the recent CMA determinations. We disagree that the approach we set out was inconsistent with the CMA's approach. In the WACC

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	determinations wherever available); • market evidence on cost of capital parameters; and • the business risks it faces.		chapter we set out how we had taken the CMA's approach into account for each WACC parameter. The CAA has not yet confirmed its policy for calculating the WACC in H7; in the absence of that we have set out our view on the correct approach which we think best takes into account all available inputs in the context of the challenges Heathrow faces post-Covid. We note that the CAA's criticism of Heathrow's approach not being consistent with the CMA's views in the PR19 and NERL appeal could also be made of the approach taken by the CAA in its document. While the CAA notes the position taken by the CMA it also highlights some limitations and further considerations, such as in its position on calculation of the risk-free rate.
C21	HAL should provide robust evidence that its RBP is financeable and affordable. Analysis of affordability and financeability should be conducted under the same range of planning scenarios as provided in the RBP. This assessment should also be undertaken with reference to the CAA's statements on financeability policy and we would expect HAL to examine the same key metrics. Stress testing is not required for the RBP but will be necessary in 2021.	The assessment of equity financeability was qualitative only and omitted any examination against the range of metrics described in previous CAA consultations. HAL have assessed financeability for a number of sensitivities. Under these sensitivities key model inputs are changed individually. There is no assessment against a range of planning scenarios as required in the business plan guidance.	Alongside our RBP we submitted a range of PCMs for each sensitivity set out in our RBP. This showed the financeability of our plans in each of these planning scenarios. These PCMs formed the basis of our financeability analysis. It should be noted that the CAA does not yet have a policy on equity financeability or a clear approach to how it will test equity financeability; in the absence of clear policy and any understanding of the evidence they have used to reach its conclusion we consider the CAA's criticism that we have not assessed against metrics provided by the CAA invalid.

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C22	HAL should outline what structural and regulatory options and/or changes would best support the credit rating it targets in the RBP, while being consistent with the interests of stakeholders. The assessment of the targeted credit rating for each relevant scenario should consider the net impact of having a higher or lower credit rating.	The assessment of credit ratings focused solely on the strengths of a higher credit rating and the disadvantages of having further downgrades such as higher cost of debt. There was no assessment of the costs related to having to maintain a higher credit rating. In summary, there was no assessment of the net impact of different levels of credit rating as required in the business plan guidance.	A set out in our RBP and in response to Chapter 3 of the CAA's document, ensuring a return to an A- credit rating is vital to ensuring that Heathrow can continue to access cost efficient debt financing. The costs of not achieving an A- rating will ultimately be held by consumers.
C23	HAL should consider the appropriate notional financial structure taking into account the guidance provided on financeability and cost of capital in chapter 4. Analysis should include an evaluation of the advantages and disadvantages of different notional financial structure options developed by HA	The RBP assumed a 60% notional gearing citing the interest of regulatory consistency. There was no analysis provided to evaluate the advantages and disadvantages of different notional financial structures as required in the business plan guidance.	A key reference point for the notional balance sheet is that used for previous determinations (60% since Q4). In the RBP we explained that stability in this assumption was in the interest of consumers.
C24	Analysis of affordability and financeability should include a baseline assessment using the CAA's price control model ("PCM"). If assumptions are not detailed in the business plan itself, a data book detailing the rationale for the assumptions adopted in the RBP should be provided. HAL should discuss with the CAA any structural and formula changes	HAL conducted analysis for its RBP using its own model. To be consistent with the requirements of the business plan guidance HAL had to provide a reconciliation between the PCM and their own model. This reconciliation was provided only in March.	We note the points made by the CAA. Going forwards we will ensure a full reconciliation between our RBP models and the PCMs is provided in a more timely way.

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	required to the PCM in advance of submitting the RBP to agree a version of the PCM for HAL for use in the submission. If HAL uses models other than the PCM in the RBP, they should be accompanied with commentary and analysis reconciling the results to those of the PCM.		
C25	The rationale for any cost reallocation needs to be clear and robust, with the implications for changes in risk and incentives explained. HAL needs to highlight why these changes would be in the interests of consumers.	HAL has provided a clear rationale for its proposals. However, further discussion is needed on whether Business Rates should be recovered as an ORC, including how this changes the incentives on HAL and how the costs and risks should be split between HAL, airlines and non-airline users. More information is needed on why prices are forecast to rise by £50m over the H7 period despite some £56m of annuities and other charges being moved to the airport charge	The rise in ORCs over the H7 period is due to the inclusion of business rates as on ORC. Further detail on this topic is set out in our response to Appendix F of the CAA's document below.
C26	For each ORC, HAL needs to explain the rationale for the proposed treatment of over and under-recovery mechanisms clearly and demonstrate why this would be in the interests of consumers.	HAL proposes to include ORCs in the proposed revenue risk sharing mechanism in Chapter 9.1 but gives no indication of how this would work in practice. Further discussion is needed, through both the ORC and the risk sharing discussions, on whether this is the right solution for ORCs, particularly with the proposed move to a marginal cost approach.	We agree with the CAA that further discussion is needed regarding the recovery mechanism for ORCs. In the RBP we noted that it could form part of the overall risk sharing mechanism to maintain consistency across the price control. Upon further reflection and on receiving the airline community's response to our RBP, we think that it may be more appropriate to retain the over and under recovery mechanism for ORCs within the ORC protocol with the addition of clarity on process for trueing-up ORC under and over recoveries and clarity on the CAA's role in the event of any dispute. More detail on this will be provided in our RBP update.

Number	Criteria	CAA assessment	Heathrow response
C27	HAL should explain how it plans to maintain resilience as passenger numbers increase through H7.	We are supportive of the proposal for a joint resilience plan. We note HAL's plans to pause investment in several High Integrity asset projects and risk of 20-30% of Business Critical assets failing in H7 due to degrading resilience. We will look at this as part of our work on the capital plan prioritisation.	The CAA has misinterpreted our RBP in its assertion regarding asset failure in H7. As stated in the RBP, Heathrow's assets can be divided into three categories: 1. High Integrity assets are those that could cause significant harm to people or non-compliance with legislation or regulation. 2. Business Critical assets are those that are essential for the core operation of Heathrow, where failure would cause significant impact on the operation. 3. Business Operational assets are all assets that are not in either of the two previous categories. For Business Critical assets <u>only</u>, there are a number of assets within this class where a higher risk of failure is assumed. This will not necessarily impact passengers. As explained to the CAA in subsequent engagement on the RBP, risk mitigation takes a number of forms through capex, opex or taking the asset out of service. The service option is normally the last resort to prevent any impact on passengers.
C28	HAL needs to set out its plans for terminal management and accommodating a recovery of passenger numbers over the H7 period.	We note that HAL has agreed with airlines the plans and triggers for reopening Terminals 3 and 4 when passenger volumes recover, although no details of this are provided. We also note the intention to re-establish existing scheduling and capacity limit processes to	We have no further comments on the CAA's assessment here.

Number	Criteria	CAA assessment	Heathrow response
		ensure the operation and resilience are protected and to explore opportunities for further cost savings in relation to T4 consolidation	

Appendix F: Assessment of other elements of the RBP

1. In Appendix F, the CAA raises questions on four specific topic areas, we address those in turn below.

Other Regulated Charges

2. We welcome the CAA's assessment that our RBP provided a clear rationale for changes to ORCs. Our ORC proposals are designed to ensure that the mechanism continues to cover the right services, allows for transparency and collaboration where the biggest differences can be made and ensures that any future over and under recovery in extreme circumstances can be dealt with. For this reason, we propose to continue with our approach to moving fixed costs (annuities and allocated costs) into the airport charge and focusing the ORC mechanism on only the variable costs of providing these services.

3. The CAA notes that there are two areas of focus, the treatment of business rates and the ORC forecasts:

    a. Business rates: In our RBP, we proposed that business rates should be subject to a fuller pass through treatment, building on the business rates factor currently included within the Q6 airport charge formula. This would ensure that the regulatory framework better allocates risk to the party best placed to manage it. Heathrow is not in control of its business rates liability, meaning that a pass through is appropriate. While the airline community is in broad agreement with this, there remains disagreement on whether this pass through is implemented through the airport charge or the ORC mechanism.

    Our RBP proposes using the ORC mechanism as:

    - It provides a clear governance process allowing the airline community to challenge and review the forecasts for business rates, as was requested through the CE process.

    - The ORC governance process which includes robust challenge and scrutiny from the airline community maintains the right incentive on Heathrow to ensure that the business rates bill is as efficient as possible within Heathrow's scope of influence.

    - The ORC process which includes the publication of prices and revenues through the annual General Notice and Trading Statements transparently shows the airline community the size of the rates bill each year, how this will be charged and how it was recovered. This provides transparency for the airline community outside of the airport charges consultation within which business rates may not receive full attention.

    We will continue discussions on business rates with the airline community and CAA to ensure that the right recovery mechanism is in place for H7.

    b. **ORC forecasts:** In the document the CAA notes that, although allocated costs and annuities have been removed from ORCs, the forecasts for ORCs in H7 have increased for H7 in comparison to Q6. This is due to moving business rates from the airport charge to the ORC forecast.

    ORC costs have been forecasted using the same driver-based opex forecasting methodology as all other costs within our cost base using a 2019 baseline. We are happy to work with the CAA and provide further detail on our forecasts where available.

4. In addition to the points above, following our RBP we have reviewed the points previously raised by the CAA. on the appropriate treatment of over and under recovery of ORCs, in particular in extreme circumstances as have been seen in 2020 and 2021. We will continue to work with the CAA and airline community to resolve this issue. In the first instance, our proposal to remove the annuities and allocated costs from the ORC mechanism will largely remove the fixed cost base of ORCs, which contributed to the significant challenges caused by under recovery in 2020 and 2021. The airlines agreed that this proposal would help avoid future under recoveries of the size seen in recent years in their response to the RBP.[86]

5. Additionally, following the successful discussions over the last year which resolved issues regarding under recovery through agreement with the airlines, we propose that using the ORC protocol and current governance to develop a mechanism for over and under recovery is the best mechanism going forward. In order to ensure clarity in the process, we propose that this be implemented through:

    a. Agreement with the airline community of a recovery methodology for extreme circumstances as part of the future development of the ORC protocol; and

    b. Development of a clear CAA role in the arbitration of any disagreements regarding over and under recovery through the period.

Resilience

6. In our RBP we noted the step change in resilience over Q6 and subsequent unparalleled impact that Covid-19 has had on the operation of the airport. We noted the impact of deferred investment resulting from Covid-19 may take multiple years to come through and it may require additional investment to keep resilience at current levels. Resilience will remain a primary consideration for us throughout H7 in our operational planning and as we prioritise the capital portfolio.

7. We welcome the feedback from the CAA that we have met its business plan criteria and that the CAA is supportive of joint resilience plans. We also see this as an important step forward in collaborative working among stakeholders across the airport.

8. We look forward to continuing the discussion on resilience and investment as part of the H7 capital plan. In our RBP Update will we set out our continued intention to prioritise investments required so as to never compromise the safety and security of passengers or colleagues, and to prioritise the demands on delivery capability of other capital programmes needed to ensure the safe operation of airport.

Cargo

9. Contrary to the airline view which the CAA presents in CAP2139, revenues from cargo operations are fully included within the price cap. These revenues form part of the single till and help to reduce the overall level of the charge. We welcome confirmation from the CAA that discussions regarding the forecasts for cargo revenue will take place through the commercial revenues workstream.

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[86] Airline Community H7 RBP Feedback – Reg Framework response – "*14.3 As a result of the annuities and allocated costs, ORC Governance had become problematic, as costs uncontrollable to the ORCG formed part of the pricing 14.4. We therefore agreed with HAL that ORCs should take a more marginal cost approach, which would bring the cost base more in line with the costs of the contracts that support those ORCs"*

10. In our RBP update we will continue to include cargo revenues as a separate revenue line, ensuring that our forecast revenues are included within the price cap for the H7 price control. This provides the appropriate incentive on Heathrow to continue to grow cargo revenues efficiently through the period and, ultimately, in the interests of consumers. We welcome further engagement with the CAA on our forecasts.

11. The CAA also notes the importance of ensuring control posts are correctly included within the H7 OBR framework to ensure that high-value, time critical cargo can reach aircraft on time. As is the case in the Q6 framework, we will continue to measure control post performance in H7. In line with the CAA's request to engage further with the airline community on our approach to OBR in H7 in order to produce a joint response on areas of agreement and disagreement, we have begun further conversations around the measurement of control post service levels for the H7 period. We will provide a further update on the outcome of these discussions in our joint response.

Surface access

12. We welcome the CAA's recognition of the importance of surface access to Heathrow's operations and to the consumer interest. As set out in the RBP, surface access will continue to be of vital importance for Heathrow and consumers, in particular in an H7 period of growth following Covid-19.

13. Surface access continues to be a priority area of consumers' airport experience. Our brand tracker survey still shows that, even in a post-Covid world, ease of getting to the airport is still the second biggest driver of airport choice.[87] This is reflected in the retention of our consumer outcome "I am confident I can get to and from the airport". We also know from our survey of consumer priorities post-Covid that consumers still want to see an improvement in the range of surface access options available so they can use Heathrow in the future.[88] Therefore, even in this very different environment, it is important that we do not forget the importance of ensuring that we continue to make improvements in surface access through the H7 period.

14. In the RBP we proposed to retain similar surface access mode share targets as set out in the Airports National Policy Statement (ANPS). It is important to note that, in any scenario, Heathrow would be expected to have targets set by its Area Transport Forum who *"set out targets for increasing the proportion of journeys made to the airport by public transport for both airport workers and passengers"*[89]*.* Therefore, there is no choice regarding whether we have surface access targets or whether these target an increase in public transport mode share, only around the size of the change we are targeting through H7.

15. In light of the impact of Covid-19 and feedback from the airline community we reviewed our surface access targets for the RBP. Based on the data we had from our profiler survey and MAID system data for colleagues along with the clear constraints regarding capital investment across H7, we simplified and revised our surface access targets to the following two areas of focus:

[87] Heathrow RBP, https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/RBP-detailed-plan.pdf, Page 64, Figure 10
[88] Heathrow RBP, https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/RBP-detailed-plan.pdf, Page 64
[89] https://www.gov.uk/government/publications/aviation-policy-framework, page 70, paragraph 4.17

a. **Achieve a passenger public transport mode share of 45% by 2026:** This passenger mode share target keeps us on track to reach the 50% mode share target for 2030 as in the ANPS and our own sustainability strategy. Following the impact of Covid-19 and with a smaller capital plan, we recognise that achieving this target will take innovation, however it will be important for both sustainability and the future of Heathrow Expansion that we continue to pursue our sustainability goals in line with this long-term ambition.

b. Achieve a colleague single occupancy car mode share of 57% by 2026: We have adopted a simplified colleague target measuring the proportion of single occupancy car trips. This allows us to regularly monitor performance of surface access interventions that target specific travel options such as car sharing and active travel.

16. Our surface access strategy will address each of these targets through utilising relatively low-cost interventions in three groups:

a. **Providing improved connections and facilities**, for example integration of the Elizabeth line for arriving passengers through improved signage and wayfinding, and providing a safe active travel route into the CTA with good end of trip facilities for colleagues.

b. **Providing improved awareness of travel options**, for example through better information about ongoing travel connections to passengers (primarily through digital channels) and the creation of a short video for employers to utilise to help colleagues understand all of their options for travel to work at Heathrow.

c. **Managing demand**, for example by implementing demand management strategies to manage the growth of Private Hire Vehicles at the airport, and implementing daily (rather than annual) billing for car park usage to influence colleague and employer mode choice at the point of making the journey.

17. Through our capital investment process, we will work with the airline community to prioritise investment which allows us to deliver on our consumer outcomes. Our surface access ambitions form part of this prioritisation exercise when considering investment as part of our commercial revenue and sustainability programmes. The CAA is present at these discussions.

18. In our response to chapter 2, we outlined the steps we had taken to refresh our surface access modelling to reflect the impact of Covid-19. Further detail on this will also be provided in our RBP update.

Appendix G: Requirements for Heathrow to provide further information

1. We will provide a full response to the CAA requirements for further information in our RBP update which will be published shortly after the submission of this response.

Appendix H: Cost of Change

1. We welcome the CAA's consultation on the Cost of Change proposal. This agreement between Heathrow and the airline community evidences how Heathrow's regulatory framework can flex and adapt to ensure the right outcomes can be delivered for consumers. We welcome the CAA's 'minded to' decision to allow the proposal.

Appendix K: Financial resilience and ring fencing

1. We have considered the CAA's proposals on financial resilience and ring fencing. The consistent theme among the proposals is that the CAA has not clearly evidenced the existence of an issue that needs to be solved, or an intervention that will benefit consumers. We therefore cannot see a justification for the increased regulatory burden the CAA proposes to impose.

2. We have set out below more detail regarding our view of the CAA's specific proposals and we have the following general observations to make regarding the CAA's approach to these conditions. In setting these conditions the CAA must only do so if its statutory duties under the Civil Aviation Act 2012 (CAA12) require it to act. The CAA's general duties under sections 1(1) and 1(2) CAA12 are qualified by section 1(4)(b) CAA12 which holds that "*regulatory activities should be targeted only at cases <u>in which action is needed</u>*" (emphasis added). In addition, section 1(3)(g) holds that regulatory activities *"should be carried out in a way which is transparent, accountable, proportionate and consistent".* Complementary to the statutory position are the Better Regulation principles under which the CAA has rightly identified that regulation should be proportionate and targeted.[90] The need to act in a proportionate manner includes a requirement to consider whether the measure in question is necessary to achieve the aim pursued, and whether there are any other less onerous means of achieving the same aim. Proportionality is particularly relevant in assessing the appropriateness of an onerous proposal that would limit Heathrow's management's flexibility. Further consideration of this is also set out in Section 4 of Annex 2.

3. The CAA states at paragraph 2 of Appendix K CAP2139 that the work on the conditions *"remains focused on managing the risk that consumers would suffer detriment from disruption to services and investment if HAL experienced financial distress"*. We do not dispute the validity of that as a goal, however, we do not agree that the conditions the CAA is seeking to impose will achieve that goal nor has a clear link been demonstrated. We request that the CAA reviews its proposals and properly interrogates whether action is needed rather than taking the apparent approach of saying "low burdens must be acceptable".

Sufficiency of Resources and Resources Certification

4. The first of the CAA's proposals related to sufficiency of resources is to include wording to state that Heathrow is required to act in a manner in accordance with the Licence, and to add the word 'operational' to the resources that Heathrow should make available.

5. The CAA then proposes to separate the current certificate into operational and financial certificates. We cannot see a clear need for this and note that at the time of submission the CAA did not make clear to us that it views the 2020 compliance certificate as having *"relatively little information and insight into the covid-19 pandemic on operational issues…"* compared with financial matters; we think it would have been preferable for the CAA to have provided this feedback at the time the certificate was produced.

6. As noted in our response to CAP1940, Heathrow is subject to an annual going concern assessment which is verified by auditors. This exercise is substantially consistent with the exercise to produce the Certificate of Adequacy of Resources. We therefore consider that there is the potential to align the time horizon of the Certificate of Adequacy of Resources, in its current form, more closely with the Heathrow SP going concern report. This would enable alignment of internal governance and moving towards this model would reduce regulatory burden but still satisfy the core requirement of the Licence condition.

[90] Better Regulation | UK Civil Aviation Authority (caa.co.uk)

7. The going concern assessment has a time horizon of 12 months from the audit opinion signature, for which Heathrow completes an analysis of 18 months from the year end date, this is more than adequate, particularly when combined with Licence condition E2.4, which states that "The *Licensee shall inform the CAA in writing as soon as practicable if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate…".* We think a reduction in time horizon from 24 months to 18 months after the year end date is reasonable, and there may be an element of spurious precision the further out the time horizon is set, particularly in considering unforecastable major shocks such as Covid-19.

8. The final proposal that the CAA has put forward is to require Heathrow to submit information on the traffic and other scenarios used in the preparation of the Certificate of Adequacy of Resources. The requirements to set out a range of traffic scenarios and plausible outcomes are disproportionate, particularly for option (a), where we will not be drawing attention to any factors which cast doubt on the sufficiency of resources. It does not make sense to treat each certificate with the same burdensome information requirements, given they reflect varying expectations, or request Heathrow to provide information that is created solely for this purpose. It should be noted that pre-Covid, we would produce one forecast and the ranges contained in the 2020 and 2021 certificates have only been produced to address current circumstances. We currently have no plans to continue producing a range of scenarios once demand returns to a more stable state.

9. There is also a legitimate question over the CAA's role in requesting and assessing traffic and other scenarios when the CAA requires us to obtain a report from auditors for the Certificate of Adequacy of Resources. If provided, it is not clear to us how the CAA will assess these scenarios, why it feels the need to do so and what the consequences would be if it disagreed.

10. To summarise, we propose that the Certificate of Adequacy of Resources is largely maintained in its current format and do not consider that the proposed changes from the CAA are targeting areas where action is needed. However, we do see merit in aligning the Certificate of Adequacy of Resources, in its current form, more closely with the annual going concern assessment, which includes a time horizon of 18 months from the year end date.

Information Provision

11. As we noted in our response to CAP1940, the CAA already has access to the wide range of information that Heathrow provides to its bondholders under the terms of its financing arrangements. This includes Heathrow's investor reports which are published by the end of June and the end of December each year, as well as consolidated annual audited financial statements and consolidated semi-annual unaudited financial statements of the security group and Heathrow Funding Limited (as bond issuer). These reports and statements provide investors with details of Heathrow's business and its financial performance and outlook. All of this information is made publicly available via Heathrow's website and the Regulatory News Service (RNS) maintained by the London Stock Exchange. We intend to continue operating in a transparent manner and are therefore prepared to add the CAA to the mailing list for our Investor Centre updates so that the CAA can automatically receive updates as soon as they are available.

12. However, we do not consider a Licence condition in the form proposed by the CAA to be necessary or reasonable in order to achieve the CAA's stated objective which, as set out in paragraph 18 of Appendix K, is "*to ensure the CAA has the same information as bondholders to facilitate oversight"*. We believe that this objective can be met through the CAA accessing the substantial amount of information that is already publicly available. We do not consider that the CAA avoiding the need to monitor RNS announcements is a strong basis for targeted regulatory intervention.

13. The CAA's proposed Licence condition as currently drafted is disproportionately broad: "*E2.8 The Licensee shall provide the CAA with all information and notices required to be provided to bond holders and/or the bond security trustee under the Financing platform at the same time that it is due to be provided to bond holders and/or the bond security trustee*." This leaves us unclear as to precisely what information the CAA is looking for beyond that which is already made publicly available and goes against the principle of targeting intervention where action is needed. It would be useful to understand precisely what information the CAA is seeking in addition to that which it already has access, why the CAA is requesting such information and what assessment it intends to undertake in relation to it. It should also be noted that certain information provided to the bond security trustee / borrower security trustee under Heathrow's financing arrangements is confidential and in certain circumstances may comprise inside information for the purposes of the Market Abuse Regulation. It would not be appropriate for such information to be provided to the CAA without safeguards to ensure that disclosure is justified and that confidentiality can be maintained.

Ultimate Controller Obligation

14. The CAA proposes three changes to the ultimate controller obligation. The first is to insert a definition that the ultimate controller is the holding company of the licensee which is not itself a subsidiary of another company

15. The second proposed change is that the ultimate controller and its affiliates should provide Heathrow with information held which the CAA may need on request.

16. The last requirement relates to HAL writing to the ultimate controller for the purpose of an annual reminder of its obligations. The ultimate controller, FGP Topco Limited, is an entity with directors on the Heathrow Airport Limited Board, who are actively involved in Licence discussions throughout the year; the proposed annual reminder is therefore unnecessary and will not have the desired outcome.

17. In respect of the annual reminder, at paragraph 19, Appendix K, CAP2139 the CAA states: "*(t)he benefit to consumers in promoting compliance of an annual reminder of the undertaking to the ultimate controller may, in practice, be relatively small. However, the administrative burden would be insignificant and, therefore, proportionate to the benefit*". We do not agree that this assessment of benefit vs burden demonstrates that the CAA has met the statutory threshold for the imposition of new conditions. We do not think that the correct assessment should be 'how large is the burden' but rather whether the additional burden is strictly necessary in order for the CAA to mitigate an adverse effect on consumers. In addition to failing to apply the correct test we consider the CAA has made assumptions around the burden of additional regulation without interrogating the actual impact. We would expect the CAA to undertake a more considered review prior to imposing any additional conditions.

18. Consistent with the other financial resilience proposals, for all of these proposed changes to the ultimate controller condition we do not consider that the CAA has established a legitimate need and consumer benefit that is commensurate with the proposed increase in regulatory burden.

Appendix O: Heathrow West's cost recovery request

1. We have set out some observations below regarding Heathrow West's claims that it should be allowed to recover the costs it incurred in submitting a proposal to provide a third runway and associated facilities at Heathrow.

2. For the avoidance of doubt we do not consider the request meritorious and request the CAA dismisses it fully. There are two reasons for this:

    a. It is outside the CAA's vires; and
    b. Even if the CAA did have the power, it could not possibly be in consumers' interests.

3. We agree that Heathrow West's request to recover its costs raises two related but separate issues: 1) whether or not Heathrow West has the right to recover costs incurred; and 2) if yes, the method used to recover those costs. We have dealt with these issues separately below.

Right to Recovery

4. As a starting point we consider that allowing recovery of costs for projects unilaterally undertaken by third parties is unlikely to be in the interests of consumers. We note that Heathrow West made a number of claims regarding the interests of consumers being best served by inter-terminal competition and it therefore appears to have proceeded on the presumption that this means recovery of costs is also in the consumers' interest. We consider this does not accurately reflect reality:

    a. There is no evidence that inter-terminal competition at Heathrow would be beneficial to consumers. We remain strongly of the view that inter-terminal competition in fact leads to negative consumer outcomes, as seen at a number of other airports.

    b. Heathrow West seeks to rely on the Competition Commission's statements regarding separate terminal operation and development (STOD) to support its proposition that inter-terminal competition is in the interests of consumers. Notwithstanding that the Competition Commission's findings are now outdated and measured against a counter-factual that no longer exists, they were also theoretical in nature as the legal powers to impose STOD did not exist at the time of the report.[91] A considerably more detailed econometric analysis would clearly need to be undertaken prior to the imposition of such a draconian measure at Heathrow. Heathrow West's attempt to rely on these findings as a guarantee for cost recovery on the basis of consumer interest is therefore misplaced.

    c. Heathrow West does not appear to have consulted with passengers or airlines regarding its proposal to recover costs for a project which delivered no value to consumers. Further, we have seen no evidence that allowing Heathrow West to recover costs incurred so early in its process would be in consumer's interests in the long term. As evidenced throughout our H7 submissions consumers are willing to pay where there are, or will be, demonstrable improvements in service and quality, this is not the case here. Equally, there is no demonstrated case that not allowing cost recovery would result in a future stifling of competition by dampening incentives to compete for any future expansion.

[91] See Appendix 10.1, paras 45ff Competition Commission Report, 19 March 2009 https://webarchive.nationalarchives.gov.uk/20140402212103/http://www.competition-commission.org.uk/assets/competitioncommission/docs/pdf/non-inquiry/rep_pub/reports/2009/fulltext/545_10_11.pdf

d. Heathrow West appears to infer that the CAA's statement that its proposals had reached the threshold test for the CAA to engage in further analysis means that the CAA had concluded that those proposals would deliver consumer benefit. We disagree. We consider the correct interpretation is that Heathrow West had done just enough to create plans which warranted further investigation, not that any conclusions had been drawn on their credibility.

5. It is notable that whilst the CAA left open the possibility for competitive delivery of expansion there is no policy regarding cost recovery by third parties and this was not raised by any third party engaged in the process. Given that Heathrow West has characterised itself as a key challenger in the expansion process we would have expected that, were it not prepared to take on the commercial risk itself, it should have raised the question of cost recovery via consultation with the CAA at a much earlier stage. It of course remains open to Heathrow West to conclude commercial arrangements directly with the airlines it claims so strongly supported its proposals in order to recover its costs.

6. In the event that recovery were to be allowed we would expect that Heathrow West's costs would be subject to the same level of scrutiny that Heathrow's have been. The bar for recovery should necessarily be a high one in order to ensure that consumers are only paying when real value is realised and not for spurious third-party challenges which have delivered no demonstrable consumer benefit. We consider the applicable threshold test would need to be particularly carefully established given that Heathrow West's scheme was not the only third-party proposal relating to expansion.

7. We note that Heathrow West maintains that the CAA should act to allow recovery in the interest of 'fairness' and equality between Heathrow West and Heathrow. This position fails to acknowledge the amount of time and money already invested by Heathrow in going through the Airports Commission process. Heathrow West now wishes to freeride on the considerable investment made by Heathrow, the vast majority of which the CAA has determined is unrecoverable. In the event that the CAA does determine that third-party expansion costs are recoverable we would expect the CAA to undertake a comprehensive review of the impact on Heathrow's future incentives to invest in similar programmes where there is a risk of free-riding.

Method of Recovery

8. Regardless of whether or not the CAA concludes that Heathrow West should be entitled to recover the costs incurred we do not agree with Heathrow West that use of Heathrow's RAB is either a legally permitted route to such recovery or one which is in consumers' interest.

9. We do not agree that the Civil Aviation Act 2012 (CAA12) gives the CAA the power to require Heathrow to put third party scheme costs on its RAB. The whole framework is one which regulates the prices of the operators of airports with market power in the interests of passengers and cargo owners. The recovery of third party costs does not feature in the statutory framework. It is instructive to work through the directly applicable statutory process in detail:

   a. CAA12 states that "*A licence must include such price control conditions as the CAA considers necessary or expedient having regard to the risk referred to in section 18(1)(a)*"[92]
   b. This consideration sits directly before the power to set a price control; a price control cannot be set without the CAA being satisfied that the price control is necessary or expedient with regard to that risk.
   c. That risk, as set out in section 18(1)(a) CAA12, is that Heathrow may "*engage in an abuse of substantial market power*".

[92] Section 19(2) CAA12

10. The power exists, in other words, to protect passengers and cargo owners from excessive pricing, margin squeeze, and other pricing practices prohibited to dominant plyers by competition law.

11. Heathrow West's costs are nothing to do with that risk. Indeed, allowing Heathrow West's costs to be recoverable through Heathrow's price would act to ***increase*** charges for passengers and cargo owners. It would run directly contrary to the statutory intention.

12. In short, as Heathrow has not abused its market power, nor is there any evidence that there is a risk it might, it would clearly be ultra vires for the CAA to attempt to impose a condition on Heathrow to collect money on behalf of Heathrow West.

13. Further, we have seen no evidence to suggest that adding Heathrow West's costs to Heathrow's RAB is in the interest of consumers. Heathrow West proceeded with its attempt to launch a competing bid with no guarantee of cost recovery, indicating competition will not be adversely affected in the event that these early costs for a proposal which had not undergone any detailed development or assessment are not recoverable. Heathrow would also be unnecessarily burdened with administering the complexities of passing any money back to Heathrow West, with the additional costs for doing so also having to be borne by consumers. We anticipate that given the current pressures on the charge at Heathrow caused by the impact of Covid-19 that airlines and passengers would also consider Heathrow West's proposal inappropriate.

14. Heathrow West's attempt to draw analogies with surface access schemes Heathrow has made contributions to fails. Those contributions have been made directly by Heathrow in support of projects which deliver clear benefits to consumers and following extensive review through Heathrow's agreed capex process. Contributions to these schemes are also expressly allowed for through the CAA's surface access policy which sets out how and when Heathrow can recover the costs of these contributions. Heathrow has never previously allowed direct recovery for a third party scheme which ran contrary to the interests of Heathrow and its users.

15. We also note that it is open to the CAA to licence any third party operator at the point at which such operation falls within the scope of the CAA12. At such a time it is our view that the CAA could permit recovery of historic costs incurred by that operator and thus there would be no disadvantage for competing operators at Heathrow in the event that their proposals had demonstrated customer benefits.

16. In light of the above it is Heathrow's view that the CAA should fully reject Heathrow West's request on the basis that it is neither 1) permissible; nor 2) in the interests of consumers and is therefore without merit.