

Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow

CAP 1541



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About this document

This document follows on from our January 2017 Consultation on the priorities and timetable for our programme of work on the economic regulation of new capacity at Heathrow (the January 2017 Consultation).¹ It confirms our priorities and seeks views on our latest thinking on the development of core elements of the regulatory framework for Heathrow Airport Limited (HAL). These core elements also build on our discussion document on Strategic themes for the review of HAL's charges ("H7") (the March 2016 Document).²

This consultation also updates our thinking on the timetable issues discussed in our Guidance for HAL in preparing its business plans for the H7 price control (the April 2017 Guidance).³

Views invited

We welcome views on all the issues raised in this document and, in particular, the issues set out in the Executive Summary and discussed in more detail in chapters 2 to 7.

Please e-mail responses to economicregulation@caa.co.uk by no later than 22 September 2017. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Stephen Gifford (stephen.gifford@caa.co.uk).

¹ See CAP 1510 Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable www.caa.co.uk/CAP1510.

² See CAP 1383 Strategic themes for the review of Heathrow Airport Limited's charges ("H7") A discussion document www.caa.co.uk/CAP1383.

³ See CAP 1540 Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control www.caa.co.uk/CAP1540.

Executive summary

Introduction

1. The CAA has consistently said that increased airport capacity in the South East of England would be in consumers' interests.⁴ Without this, there is a significant risk that consumers will experience detriment from increased fares, less choice, and a less resilient service. This view was endorsed by the Airports Commission, which, among other things, provided calculations of the significant "shadow costs" that would arise to consumers if no new capacity was made available in the South East of England.
2. In October 2016, the Government announced that its preferred option for the expansion of airport capacity in the South East of England was the Heathrow Northwest runway. Soon after this, we set out our expectations of HAL in its engagement with airlines on the design of new runway capacity.⁵ We were also asked by the Secretary of State to advise him about the effectiveness of HAL's engagement process with airlines.⁶
3. Our work in developing the economic regulatory framework for HAL is guided by our statutory duties, including having regard for the principles of better regulation. Broadly speaking this involves the CAA designing through analysis and consultation a suite of modifications to HAL's economic licence, including limits of the maximum airport charges it can levy on airlines. A wide range of stakeholders also have key roles in capacity expansion, including HAL, airlines and the Government. Wider changes will also be necessary for capacity expansion at Heathrow to be a success, including, in particular, changes to airspace to allow airlines to make best use of new capacity. HAL also has key ongoing responsibilities for safety and security at Heathrow.
4. In January 2017, we issued a consultation on our priorities and timetable for developing the economic regulatory framework. We said that the regulatory arrangements for HAL should properly take account of capacity expansion, continue to protect consumers, and incentivise HAL to finance and develop new

⁴ In this consultation, the terms "consumers" and "users" are used interchangeably. See Appendix 1.

⁵ Letter from Andrew Haines to John Holland-Kaye regarding CAA's expectations on the appropriate scope, design and cost of the new runway capacity www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294981598.

⁶ Terms of Reference: Assessment of airport-airline engagement on the appropriate scope, design and cost of new runway capacity:
www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airports/Economic_regulation/Price_control_files/Section%2016%20ToR%20on%20HAL%20engagement%20with%20airline%20community.pdf.

capacity in an efficient way. The four key priorities we identified were that HAL should develop:

1. a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders;
 2. robust cost estimates, which would help us to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way;
 3. proposals for efficient financing, which would enable us to develop the regulatory framework to be consistent with this, affordability and financeability; and
 4. coordinated proposals for HAL's existing operations (i.e. for the H7 price control) alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable.
5. These priorities put effective airport and airline engagement, efficiency, affordability and financeability, and the interests of consumers at the heart of our work to develop the regulatory framework for HAL.
 6. We have set out a two stage approach to our programme to develop the regulatory framework and price controls for HAL.
 7. The first stage of our work involves encouraging, monitoring and reporting to the Secretary of State on the effectiveness of HAL's engagement with airlines. The purpose of this engagement is to give airlines the opportunity to influence overall scheme design so that it is fit for purpose, efficient and affordable. We published a report on HAL's progress with airlines in February of this year, making recommendations as to how this process can be improved and will publish a further report shortly.⁷ We will continue to monitor the process over the coming months, prior to producing a final report for the Secretary of State in November 2017. In order to allow for the testing of affordability and financeability of scheme designs before the Government designates the National Policy Statement (NPS), we also have an important role in developing the broad approach to the economic regulatory framework over the next year. This should allow debate on how the recovery of capital costs can best be smoothed over time, and an appropriate, but early and preliminary, range for the cost of capital and the other key variables that influence affordability and financeability.
 8. The second stage of this work will involve turning this high level framework into proposals for a five year price control and associated outputs and licence

⁷ See

http://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/Files/CA%20letterannex%20Feb%2017%20health%20check%20final%20for%20website%20with%20signature.pdf

conditions, which will require more detail on costs, incentives and the implementation of the broad policy established in stage one.

9. This document is an important part of the first stage of our work. It summarises the responses to our January 2017 Consultation, starts to map out the regulatory framework consistent with our latest views on regulatory priorities, and updates our timetable for developing the regulatory framework and price control.

Stakeholders' views on our main priorities

10. We received 9 responses to our January 2017 Consultation and these have been published on our website.⁸ We are pleased that all of our key priorities for developing the regulatory framework for capacity expansion received broad support from stakeholders, although some responses suggested differences in emphasis, and provided suggestions for additional clarity or further priorities.
11. We discuss stakeholders' views and suggestions in chapter 1. These do not undermine the importance of the four key priorities identified in our January 2017 Consultation and we can confirm that these remain the strategic priorities for our future work on capacity expansion.

Developing the regulatory framework

12. Our initial work on developing the regulatory framework and incentives is set out in chapters 2 to 5 of this document. On the main aspects of the regulatory framework, we set out initial policy and consult on issues around implementation. In relation to incentives and costs, we identify key issues and further questions for consultation. On assessing affordability and financeability, we describe the main issues and note our intention to publish further information on financeability in Q4 2017.
13. Our policy on the regulatory framework confirms the continued use of both:
 - a Regulatory Asset Base (RAB) to promote efficient financing; and
 - a single till to calculate HAL's price control revenues.
14. As we explained in our January 2017 Consultation, the use of a RAB will only be consistent with overall efficiency if there are appropriate incentives for efficiency and the RAB approach does not preclude commercially negotiated alternative delivery arrangements that would benefit consumers. The use of a single till approach to calculate price control revenue, which involves taking account of forecasts of commercial revenues and costs, should lead to a reduction in the level of airport charges compared to other approaches.

⁸ See (<http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/>).

15. The key questions on the implementation of these policies include:
- any further steps we could reasonably take to facilitate (rather than mandate) the use of alternative delivery arrangements, and how comfort could be provided by promoters of any such arrangements to demonstrate that they would clearly be in the interests of all consumers; and
 - whether there are any further safeguards (for example in relation to any particular commercial arrangements) that should be built into the regulatory regime to ensure that the boundary of the single till remains appropriate and sufficiently protects the interests of consumers.
16. In relation to incentives, our overall objective is to encourage the timely delivery of capacity expansion at the lowest overall efficient cost, consistent with HAL providing the outputs that consumers and airlines expect. This will involve weighing up the effect that developing incentives on HAL to deliver efficiently may have on increasing the risks it faces, and which may need to be taken into account in setting the cost of capital. It will also be necessary to balance incentives for cost efficiency with incentives to deliver the outcomes consumers want in terms of service and resilience. Therefore, we need to take care to develop an approach that delivers a balanced overall package of measures consistent with overall efficiency. Part of this balance involves avoiding incentive arrangements that would create undue risks for HAL (i.e. those that it cannot effectively manage) as this could affect its ability efficiently to finance the scheme which, in turn, might jeopardise affordability.
17. The key questions for consultation on incentives include:
- we consider that the key regulatory incentives for HAL are those associated with (i) capital efficiency; (ii) the cost of debt finance; (iii) operating expenditure; (iv) commercial revenues; (v) service quality (including resilience); and (vi) passenger traffic volumes. Do stakeholders agree? Are other incentives equally important?
 - how should we ensure that we have the best forecasts of operational expenditure, commercial revenues and passenger traffic volumes to support our assessment of affordability and financeability later this year and, in due course, to help set the price control?
 - we consider that our starting point should be to retain the existing incentives for efficiency for operational expenditure and commercial revenues. Do stakeholders consider that this is appropriate?
 - we consider that it is reasonable to look again at the incentives we adopt for passenger traffic volumes (in particular, for price control period H8, following the opening of new capacity) and debt interest costs. Do stakeholders agree with this approach?

- should we develop a new licence condition for HAL further to incentivise its development and maintenance of an efficient and resilient airport?

18. In relation to incentives for capital expenditure efficiency, we will look to build on the existing incentive arrangements and, where practicable and appropriate, develop stronger incentives for cost efficiency. Key issues for consultation at this stage include:

- what steps should we take to ensure that we have the best forecasts of costs to inform the setting of price control incentives, for our assessment of affordability and financeability and to develop better incentives for efficiency?
- how should early stage construction costs be treated in the existing capital expenditure governance process and are there additional steps we should take to provide appropriate incentives for efficiency?

19. A key determinant of affordability will be the work HAL does in conjunction with airlines on refining overall scheme design. As noted above, we have been reporting to the Secretary of State on airport and airline engagement on these matters and will continue to do so during the remainder of this year. We are also developing our own affordability and financeability model in conjunction with PwC. We will publish further information on this modelling and our initial views on the cost of capital later this year. Key questions in relation to financeability include:

- what are the advantages and disadvantages of our previous approach to assessing financeability (which focused on metrics attractive to providers of investment grade debt finance), and how might these be best adapted to the circumstances of capacity expansion?
- how can HAL best demonstrate to stakeholders that its proposals for financing capacity expansion provide appropriate assurance with respect to financial stability and resilience?
- do stakeholders support our initial thinking on maintaining Retail Prices Index (RPI) indexation of the RAB while remaining open minded on whether the form of the price control should be in relation to the Consumer Prices Index (CPI) or RPI (i.e. CPI+/-X or RPI+/-X)?

20. Further investment in road and rail access to Heathrow is essential to support capacity expansion and to ensure that HAL can help meet the Government's expectation for greater use of public transport contained within the draft NPS. We are also seeking views in chapter 6 on whether our existing policy in relation to surface access costs remains fit for purpose for the challenges of capacity expansion.

21. In the January 2017 Consultation, we made it clear that the amount of progress we are able to make in developing the regulatory framework would depend on the amount of information that we received from HAL. While HAL has responded in detail to our January 2017 Consultation, it has, to date, provided only limited information on the costs of capacity expansion. This, in part, reflects how early it is in the process of developing a detailed scheme design. However, timely progress of the programme will be dependent on HAL providing us with information on affordability and financeability, assurance around its cost and price path model results, and evidence showing its expected cost levels are efficient, that its procurement processes are robust, and that its financing plans are appropriately resilient.

Next steps

22. As highlighted in the January 2017 Consultation, our processes for the development of the regulatory framework for HAL need to be coordinated with, and take account of, the wider processes associated with capacity expansion. This includes engagement with the airline community and other stakeholders, and the Department for Transport's process to develop the NPS for Heathrow as well as HAL's process to secure planning permission (development consent). The process (and progress) of the engagement between HAL and airline stakeholders is also important in providing information and data that will inform consideration of affordability and financeability. Depending on progress, we plan to consult on issues important to our initial assessment for financeability in Q4 2017, including our early and preliminary thinking on an appropriate range for the cost of capital.
23. Chapter 7 sets out our latest thinking on the overall timetable. There is broad support from HAL and the airlines to further extend the current price control period in order for the regulatory timetable better to align with the wider Government NPS process and HAL's application for development consent. We consider this is in consumers' interests and we set out our position that the existing regulatory period should be extended by at least a further 12 months so that it fits better with the overall timetable for capacity expansion. This means the current regulatory period will expire at the end of 2020 (or after) rather than the end of 2019.
24. There remains uncertainty about the precise timing of milestones for the wider capacity expansion process. Specifically, there is uncertainty about whether an extension of 12 months will be long enough if there are delays in the wider process. As a pragmatic step, we plan to decide as early as practicable in 2018 whether a longer extension is needed, once the position on the timing of the NPS designation is clearer.

25. We note that there is also broad stakeholder support for the terms of the 12 month extension to be kept simple and to avoid distracting from the important work in 2017/18 on scheme design options, while protecting consumers and ensuring that HAL can continue to finance its licensed activities. There is, however, not a consensus on how this can be achieved. This document sets out a number of options on which we would welcome stakeholders' feedback on these matters. We will decide on the way forward as early as practicable in 2018, alongside whether a further period of extension is necessary beyond 2020. The longer the extension, the greater the case for reopening the assumptions underlying the price control to protect consumers and to ensure HAL can finance its activities.

Our duties

26. In developing this consultation we have had full regard to our statutory duties under the Civil Aviation Act 2012 (CAA12), which are set out more fully in Appendix A.

Structure of this document

27. The structure of this document is as follows:

<u>Chapter 1</u>	summarises the themes emerging from the responses to our January 2017 Consultation and sets out the way forward on our key priorities;
<u>Chapter 2</u>	sets out initial policy on the regulatory framework;
<u>Chapter 3</u>	consults on the approach to setting incentives;
<u>Chapter 4</u>	consults on our approach to cost assessment and incentives;
<u>Chapter 5</u>	discusses our approach to affordability and financeability;
<u>Chapter 6</u>	sets out for consultation our policy on surface access costs;
<u>Chapter 7</u>	updates the timetable for developing the regulatory framework and setting price controls;
<u>Appendix A</u>	provides a summary of our duties under CAA12; and
<u>Appendix B</u>	provides more detail on incentives for passenger traffic volumes, commercial revenues and debt market risks.

Chapter 1

The January 2017 Consultation: stakeholders' responses

Regulatory priorities for HAL and capacity expansion

- 1.1 In the January 2017 Consultation, we identified four key priorities that HAL should develop:
1. a scheme design to further the interests of consumers by engaging in a transparent and effective way with airlines and other stakeholders;
 2. robust cost estimates, which would enable us to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way;
 3. proposals for efficient financing, which would enable us to develop the regulatory framework to be consistent with this, affordability and financeability; and
 4. coordinated proposals for HAL's existing operations (i.e. for the H7 price control) alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable.
- 1.2 We received 9 responses and these have been published on our website.⁹ Our key priorities for developing the regulatory framework for capacity expansion received broad support across all stakeholders, although some responses suggested differences in emphasis, and provided suggestions for additional clarity or further priorities.
- 1.3 While it offered broad support for the four key priorities, HAL also emphasised the need for an approach to regulation that is predictable, simple and effective, creates clear commercial incentives rather than using coercion or bureaucracy, and follows a pragmatic and clear timeline. It also said that a key priority was missing – ensuring that new capacity is actually delivered.
- 1.4 Airlines supported the four key priorities, but emphasised the importance of affordability, efficiency and HAL engaging in a meaningful way with airlines on scheme design. There was strong support for the suggestion in the January 2017 Consultation that it should be possible to develop alternative delivery mechanisms with certain assets designed, developed and delivered competitively, perhaps with financing outside the RAB/single till.

⁹ See (<http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Approach-to-economic-regulation-of-new-capacity/>).

- 1.5 Gatwick Airport Limited (GAL) said that airport competition should be a priority.
- 1.6 HAL's comments on predictability and simplicity are broadly consistent with our statutory duty to take into account the principles of better regulation. Our second priority also stressed the importance of efficient and timely delivery for consumers and so we think these comments are consistent with the broad approach set out in our January 2017 Consultation. Similarly, airlines broadly accepted our key priority issues. In respect of GAL's comments, one of the broader benefits of capacity expansion is that it will enhance competition (by starting to relieve capacity constraints) between airports in the South East of England. So we do not see a compelling case to change our priorities to reflect these matters.
- 1.7 These priorities, therefore, provide us with a frame of reference for our work on high level affordability and financeability issues over the next year and the more detailed work that will follow on setting HAL's next price control later in 2018 and 2019.

More detailed comments on the regulatory framework

- 1.8 As well as comments on our overall vision and key priorities for capacity expansion, we received more detailed comments on our initial thinking on the regulatory framework. These are summarised below and then addressed in the following chapters of this document.

Affordability and financeability

- 1.9 On affordability, HAL said it would aim to achieve the lowest possible airport charges, by engaging with airlines, the Government and the CAA on reducing costs. Noting the present cost to consumers arising from the lack of capacity, HAL said an affordability assessment should start from the consumers' perspective. This should provide value for money, but not be at the expense of providing a fair deal to the local community or an environmentally sustainable scheme.
- 1.10 Airlines considered that the primary consideration should be affordability, and that this would determine financeability. Airlines were concerned about the lack of clarity around affordability and reiterated the importance of flat charges. Virgin Atlantic went further to express the view that per passenger charges should fall over time as passenger numbers increase.
- 1.11 On financeability, HAL emphasised the ability to finance a scheme of the size of Heathrow expansion privately is intrinsically linked to the way in which risk is recognised, allocated and valued. HAL also said that acknowledging the increased risk that investors will face throughout the delivery and operation of expansion is the first step in ensuring expansion is financeable. Building on the

strengths of the existing regulatory framework, together with the use of positive incentives, would encourage investors to commit their resources to the project.

- 1.12 As noted above, airlines saw financeability as a subsidiary consideration to affordability.

Engagement and robust governance on cost estimates

- 1.13 All parties agreed that robust cost estimates were central to the delivery of the scheme. HAL pointed to its ongoing activities with airlines and stakeholders and welcomed the role of the new independent Heathrow Consumer Challenge Board (known as the CCB). HAL said the CAA may not have fully appreciated how important it is to HAL's commercial interests to develop robust costs estimates, as these will be essential to delivering capacity expansion. HAL regarded the role of the Independent Fund Surveyor (IFS) as a significant step towards ensuring the delivery of value for money. It was also of the view that any cost recovery framework should be built on well established approaches, with positive and simple incentives that reflect the nature of individual costs and avoid punitive arrangements. It also stressed the importance of getting comfort from the CAA on early development costs (i.e. those costs in addition to planning costs that it would be necessary and efficient to incur ahead of any approval of its Development Consent Order (DCO) application).
- 1.14 Airlines emphasised the importance of them having a key role in the development of scheme design, together with the need for HAL to demonstrate how it was responding to their input with evidence. Suggestions to drive cost efficiency included better use of new technology, rigorous cost benchmarking, building on the experience of constructive engagement from the Q5 and Q6 price control reviews, and a more substantial role for the IFS. Airlines also said *ex post* cost incentives (i.e. a review of expenditure after it has been incurred) may not always deliver the best outcomes for consumers and were complex and difficult to administer. They gave support to *ex ante* incentives (setting firm cost targets), provided that they were supported by robust cost estimates.

Procurement issues and alternative delivery mechanisms

- 1.15 HAL regarded concerns about its procurement as based on perception rather than fact. It said its procurement process was agreed with airlines at the Q6 price control review through constructive engagement, run in accordance with UK and European procurement law, in line with its procurement code of practice required under its licence granted under CAA12 (the Licence), and shown by IFS reports to realise value for money. HAL opposed any blanket prescription on supplier choice and said this would lead to higher costs and poorer quality.
- 1.16 HAL was also critical of suggestions that we should consider Special Purpose Vehicles as alternative delivery mechanisms for certain assets. It said these

proposals could delay and endanger overall delivery and that aspects of the development such as terminal buildings were integrated with the wider development.

- 1.17 AOC/LACC, IAG and Virgin Atlantic said that the procurement issues identified by the CAA warranted a greater degree of scrutiny and would welcome safeguards and a bolstering of competition in the supply chain. They also strongly favoured the option of commercially negotiated alternative delivery arrangements, including involving alternative developers in capacity expansion.

Timetable

- 1.18 HAL expressed concerns over whether the CAA's timetable was workable, as it might not allow sufficient time for HAL to produce a high quality Initial Business Plan (IBP). It suggested a later date for the IBP would be more achievable. It said there were difficulties with the timing of the regulatory update scheduled for the middle of 2018 and that it might be appropriate to consider a further extension of the Q6 price control.
- 1.19 We recognised the issues with our timetable and the need to update it to reflect changes in the wider programme of work to deliver capacity expansion in our April 2017 Guidance and consulted how best to meet the challenges of the capacity expansion programme. The responses to this further consultation in relation to timetable issues are dealt with in chapter 7 of this document.

Other issues

- 1.20 As well as HAL, GAL, airlines and airline representatives, we had a number of other responses to our January 2017 Consultation. Some of these responses raised wider issues, including:
- whether capacity expansion at Heathrow can be environmentally sustainable;
 - the interests of Londoners as tax payers and the advantages of avoiding state subsidies for capacity expansion;
 - concerns over HAL's debt financing arrangements;
 - the need for HAL to make a fair contribution to the costs of surface access projects;
 - delivering capacity expansion as efficiently as possible without breaching promises to its customers, staff and contractors; and
 - whether capacity expansion would be better undertaken across the five main airports serving London rather than focusing on Heathrow.

- 1.21 Our work needs to take account of relevant environmental requirements, including those that emerge from the planning process (including both the adoption of the NPS by Government and the DCO application by HAL).
- 1.22 The regulatory framework is designed to allow HAL to finance its activities from debt and equity markets and not to rely on state subsidy. As with other undertakings, HAL is required to comply with company and wider UK law in relation to the way it raises debt finance.
- 1.23 We are consulting on our policy in relation to the treatment of surface access costs. These matters are discussed further in chapter 6.
- 1.24 While our duties do not enable us to consider employee and contractor interests directly, we are clear that our focus on the efficient development and operation of Heathrow does not mean that we will only be interested in delivery at the lowest possible cost. Rather, we will focus on incentivising both efficiency and service quality (which are best delivered by motivated employees and contractors).
- 1.25 The Government announced in October 2016 that the Heathrow Northwest runway was its preferred location for capacity expansion in the South East of England. This does not preclude improvement in the quality of service at other airports in the South East or improvements in their surface access arrangements.

Chapter 2

Regulatory framework

Introduction

- 2.1 This chapter deals with key elements of the regulatory framework discussed under priority three (developing the regulatory framework in a way consistent with efficient financing) in our January 2017 Consultation. These issues include the use of a RAB to promote efficient financing and the advantages of a single till approach in calculating HAL's price control revenues. Nonetheless, as we also explained in our January 2017 Consultation, the use of a RAB will only be consistent with overall efficiency if there are appropriate incentives for efficiency (which are discussed in the following chapters) and the retention of the RAB does not preclude commercially negotiated alternative delivery mechanisms that would benefit consumers.

Overall approach

- 2.2 In our January 2017 Consultation, we said that developing the regulatory framework in a way that is consistent with efficient financing, affordability and financeability should be a key regulatory priority. We described the advantages of a RAB-based approach to regulation and (if appropriate) how this could be combined with commercially negotiated alternative delivery arrangements. Taken together, these arrangements could support the efficient financing of the capital expenditure necessary for capacity expansion and so support affordability.
- 2.3 We also discussed how investments in the RAB should be best recovered from consumers, and the advantages of profiling returns and depreciation consistent with both affordability and financeability. This would be an evolution of the CAA's recent approach to these matters, which involved allowing a return on capital expenditure when it was incurred and the simple application of return and straight line depreciation from when the asset enters operation.
- 2.4 Taken together, these policies put both affordability and financeability at the heart of the regulatory framework. In general, respondents to the January 2017 Consultation did not provide an alternative to this vision for the regulatory framework, but they did comment on components of the approach and the relative importance of affordability and financeability.
- 2.5 Another key element of the regulatory framework that supports affordability is how commercial costs and revenues generated by HAL at the airport (such as rent from retail outlets) are taken into account in setting the price control. Consistent with previous policy on these matters, we propose to take account of

these costs and revenues in setting future price controls. This approach is known as the single till.

The RAB and regulatory depreciation

Overview and previous policy statements

- 2.6 The RAB is at the core of HAL's present price control, representing the value invested by HAL in the assets at Heathrow on which regulated returns and depreciation are calculated. Our March 2016 Document said that we intend to continue to remunerate HAL's investment through its RAB. The January 2017 Consultation built on this, stating that the current RAB form of regulation was well understood by stakeholders and debt providers, with a long track record of successful use in UK airport regulation and other sectors.
- 2.7 The recovery of capital expenditure is smoothed by the use of the RAB and the way that this is used to calculate allowances for regulatory depreciation and return on capital. In recent price controls for HAL, regulatory depreciation has been applied to individual assets on a straight line basis using the same asset lives as those used in HAL's statutory accounts.
- 2.8 A benefit of straight line depreciation is that it is simple and predictable: the amount of depreciation for each asset is known and does not have to be recalculated for each year. However, it can produce a relatively arbitrary profile of revenue allowances over time and may not be consistent with affordability and/or financeability.
- 2.9 Regarding the timing of revenues, in the January 2017 Consultation, we said that HAL should be allowed to recover returns and regulatory depreciation:
- "to the extent that this is consistent with broader commitments that airport charges should not increase in real terms – and provided that these commitments provide meaningful protections for airlines over the next 10 years as well as the longer term. If HAL were to seek higher charges to support the financeability of its expenditure programmes, then it would need to provide persuasive evidence to us and stakeholders that this would be in the interests of consumers."*¹⁰
- 2.10 This makes clear that we are open to the profile of regulatory depreciation to be varied to help balance affordability and financeability, consistent with consumers' interests.

¹⁰ At paragraph 5.43.

Stakeholders' views

- 2.11 HAL has consistently supported RAB-based regulation and does not consider that there is merit in, for example, an evolution of it that would create a split of the RAB between existing assets and those for capacity expansion. It sought confirmation from the CAA that RAB regulation will be the starting point of the regulatory framework to enable a timely and efficient delivery of the programme, ensuring that it is affordable and financeable.
- 2.12 Airline representatives also considered that a RAB-based approach has the potential to provide an appropriate basis for estimating regulatory revenue and protecting consumers. Nonetheless, they suggested that this approach should be combined with an appropriate allocation of risks between HAL and its customers, incentives for efficient delivery, and that it should be implemented in a way that would avoid market distortions.
- 2.13 HAL said that the approach we adopted at Q6, including the remuneration of assets in the course of construction, could help ensure that capacity expansion was financeable. Airline representatives acknowledged the potential importance of phasing regulatory depreciation. Virgin Atlantic has previously suggested that we consider the merits of unitised depreciation (under which depreciation is calculated on the basis of expected units of output or usage) to avoid existing consumers paying more than future consumers and to address concerns about depreciation profiles.

CAA views and initial policy

- 2.14 We welcome the support given by respondents to the January 2017 Consultation for a RAB-based approach to regulation and note their comments about delivering a balanced overall package of regulatory measures.
- 2.15 Experience across regulated sectors indicates that existing RAB-based frameworks are consistent with attracting low cost financing and promoting resilient financial arrangements. Low cost financing can also help with affordability, but it is important that the regulatory framework includes a balanced package of measures to ensure that consumers' interests are properly protected. To this end, a RAB-based framework can best deliver overall affordability and financeability when combined with:
- appropriate incentives for efficiency (including, where appropriate, the use of alternative delivery mechanisms, as discussed in the section below) to bring overall costs down; and
 - profiling of regulatory depreciation to help ensure an appropriate price path and so help deliver both affordability and financeability, rather than focusing on issues such as pre-funding or the mechanistic application of accounting conventions.

- 2.16 The specific depreciation profiles will be developed alongside our affordability and financeability modelling, on which we will consult later this year. Where appropriate, we will draw on the approaches developed by other economic regulators, including the use of flexible RAB run-off rates and depreciation periods. If capital expenditure is incurred efficiently and in a way consistent with any relevant incentive arrangements (as discussed in chapter 4), we would expect such spending to be added to the RAB as it is incurred.
- 2.17 Our commitment to the continued use of RAB-based regulation depends on HAL being open to it being implemented in a way that helps to improve the affordability and financeability of the expansion programme as a whole.

Alternative delivery mechanisms

Overview and previous policy statements

- 2.18 The January 2017 Consultation noted that alternative mechanisms for delivering infrastructure in other sectors such as electricity transmission and the Thames Tideway project have helped to drive efficiency through greater competition and choice, including where they involve financing outside the RAB of the incumbent infrastructure provider. At the same time, it also noted the limits of our legal powers to require a party other than HAL to undertake all or part of the capacity expansion, but said we would remain open to proposals for separable assets to be delivered through commercial agreements between HAL and third parties. Under such agreements, assets could be designed, developed, financed and delivered by parties other than HAL, and financed either inside, or outside, the RAB/single till.

Stakeholders' views

- 2.19 HAL outlined a number of concerns around separating the construction of particular assets from the main expansion programme, including emphasising how integrated terminal capacity is with the rest of the airport and building programme. In contrast, IAG strongly supported giving third parties, and especially airlines, the ability to invest with other developers (including HAL) in new facilities, as happens at other airports worldwide. LACC/AOC also noted its view that the CAA should not assume that HAL was the sole delivery agent or operator, but that the regulatory regime should be designed for the most efficient delivery and operation of the airport.

CAA views and initial policy

- 2.20 We remain of the view that it is not possible for us to use our existing powers to force delivery of all or part of the capacity expansion programme by a party other than HAL. That said, our regulatory tools could be used to facilitate and encourage airlines or other parties to enter into commercial arrangements with