

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

CAP 1722



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Contents

Contents	3
About this document	6
Update and summary	7
Introduction	7
Airports National Policy Statement	8
Enhanced Engagement	9
Stakeholders' views	11
Main issues raised in this consultation	11
Capacity expansion and scarcity rents	13
Next steps	14
Our duties	15
Structure of this document	15
Chapter 1	16
The overall timetable and the interim price control	16
Introduction	16
The April 2018 Consultation	17
Interim price control and possibility of a commercial deal	18
Overall timetable	19
Views invited	24
Chapter 2	25
Promoting economy and efficiency	25
Introduction	25
Stakeholder views	26
CAA views	28
Developing the licence condition	30
When should this obligation be introduced?	32
Formalising constructive engagement through the licence	32
Views invited	33

Chapter 3	34
Alternative delivery arrangements	34
Introduction	34
Stakeholder views	35
CAA views	37
HAL's Innovation Partners process	38
The Arora Group's proposals	39
Next steps	41
Views invited	43
Chapter 4	44
Introduction	44
The April 2018 Consultation and May 2018 working paper	45
Our overall approach	46
Multi-modal strategies to meet required environmental targets	47
Benefit tests	50
Highway diversions	51
Views invited	52
Appendix A	53
Our duties	53
Appendix B	55
Assessment of a licence condition promoting economy and efficiency against the CAA's duties	55
The CAA's duties in developing licence modifications	55
Analysis of a licence condition promoting economy and efficiency against the CAA's duties	56
Appendix C	65
Assessment of licensing proposals made by respondents	65
Introduction	65
Stakeholder responses	65
CAA views	66
Appendix D	69
Surface Access policy	69

Introduction	69
The CAA’s proposed updated surface access policy	69

About this document

This document follows on from the consultations that we published on the regulatory framework to support capacity expansion at Heathrow airport in January, June and December 2017 and April 2018. It consults further on the development of the regulatory framework and includes:

- an update on our approach to aligning the regulatory timetable with the overall timetable for the development of capacity expansion;
- detailed consideration of a possible new licence condition to further promote economy and efficiency on the part of Heathrow Airport Limited (“HAL”);
- details of our approach to addressing the issues that may be raised by alternative arrangements for delivering new capacity; and
- an update on our surface access policy.

It also complements our September 2018 interim update to the Department for Transport under section 16 of the Civil Aviation Act 1982 on the progress of the “Enhanced Engagement” process between HAL and airlines.

Views invited

We welcome views on the issues raised in this document and, in particular, the issues set out in the executive summary and those highlighted in chapters 1 to 4.

Please e-mail responses to economicregulation@caa.co.uk by no later than 4 January 2019. 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 Robert Toal (Robert.Toal@caa.co.uk).

Update and summary

Introduction

1. 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”. The CAA has consistently stated that additional runway capacity in the south east of England will benefit air passengers and cargo owners. The timely delivery of more aviation capacity is required to prevent future consumers¹ experiencing higher airfares, reduced choice and lower service quality.
2. During 2017, we issued consultations in January², June³ and December⁴ on the core elements of the regulatory framework to support capacity expansion at Heathrow airport. We published a further consultation in April 2018 that set out:
 - an update on the development of our thinking in relation to the overall regulatory framework, including our initial and early assessment of the affordability and financeability of capacity expansion;
 - proposals for HAL to engage further with stakeholders on alternative commercial and delivery arrangements;
 - more information on the process we are undertaking to establish the cost of capital for HAL, and an explanation of our initial work to integrate our preliminary work on incentives with our approach to assessing the cost of capital and shareholder returns;
 - our decisions in relation to an interim price control that will facilitate the alignment of the regulatory processes for setting price controls with the

¹ In this consultation, the terms “consumers” and “users” are used interchangeably. See Appendix A.

² CAP 1510 Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable (the “January 2017 Consultation”). See: www.caa.co.uk/CAP1510

³ CAP 1541 Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow (the “June 2017 Consultation”). See: www.caa.co.uk/CAP1541

⁴ CAP 1610 Economic regulation of capacity expansion at Heathrow: policy update and consultation (the “December 2017 Consultation”). See: www.caa.co.uk/CAP1610

wider timetable for capacity expansion and better protect the interests of consumers; and

- discussion and further consultation on the regulatory treatment of early construction costs and surface access costs.⁵

Airports National Policy Statement

3. On 26 June 2018, following the approval of the House of Commons, the Secretary of State for Transport designated the Airports National Policy Statement (“NPS”) under section 5(1) of the Planning Act 2008.⁶
4. The NPS sets out:
 - the Government’s policy on the need for new airport capacity in the south east of England;
 - the Government’s preferred location for a scheme to deliver new capacity; and
 - particular considerations relevant to any application for development consent to which the NPS relates.
5. The designation of the NPS is a key development in the expansion of capacity at Heathrow airport as it provides the primary framework for taking forward any application for development consent, thus clarifying what is required to obtain planning permission for new airport capacity.⁷
6. The next step in the planning process is for applicants to develop their plans, and then carry out the further public consultation required under the Planning Act 2008 before making an application for a DCO. Any DCO application will be considered through a public examination by the independent Planning

⁵ CAP1658 Economic regulation of capacity expansion at Heathrow: policy update and consultation (the “April 2018 Consultation”). See: www.caa.co.uk/CAP1658

⁶ See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/714106/airports-nps-new-runway-capacity-and-infrastructure-at-airports-in-the-south-east-of-england-web-version.pdf

⁷ Planning permission for the main elements of capacity expansion is expected to be granted by means of development consent orders (“DCO”). More than one DCO may be granted by the Secretary of State to facilitate the development of new capacity, or different aspects of it.

Inspectorate, before a final decision is made by the Secretary of State, or a designated minister, as to whether to grant the DCO.

7. In the meantime, we will continue our work on developing the overall framework for the future economic regulation of HAL to take account of, and address, the issues raised by capacity expansion.

Enhanced Engagement

8. Our work on capacity expansion has been conducted in the context of both:
 - our regulatory oversight of HAL under the Civil Aviation Act 2012 ("CAA12"); and
 - our reporting to the Secretary of State on airport-airline engagement under section 16 of the Civil Aviation Act 1982.
9. The Terms of Reference for the latter asks us to review and provide advice on how well HAL is engaging with, and responding to, the airline community on its plans for capacity expansion at Heathrow airport and whether this engagement is appropriately reflecting the interests of consumers in line with the CAA's general duty under the CAA12.
10. The engagement process began in earnest in December 2016 and gathered further momentum during 2017 and 2018. We provided the Secretary of State with an "initial health check" in February 2017, followed by further updates in May 2017, September 2017 and April 2018.
11. Our most recent update was provided at the end of September 2018 and included our assessment of airport-airline engagement between May 2018 and September 2018.⁸ The key points included:
 - HAL and the airline community had made some good progress, including agreeing the contents of a new protocol to govern the Enhanced Engagement process;

⁸ Our September 2018 letter to the DfT on the progress of the "Enhanced Engagement" process under section 16 of the Civil Aviation Act 1982 will be made available on the [Section 16 page](#) of our website.

- HAL had not yet adequately addressed repeated requests from the airline community and the CAA (most recently in our April 2018 Section 16 report) to provide high quality and comprehensive information on costs and efficiency;
- we noted that HAL is still developing its preferred masterplan so some uncertainty is inevitable given the maturity of the design and that HAL has committed to enhance its cost estimates as it approaches key programme gateways over the next year. Nonetheless, we said that unless there is a significant improvement in this area we would consider whether there are further steps we should take in respect of these matters to support the proper discharge of our statutory duties;
- HAL had recently announced some changes to its overall expansion schedule and now expects to launch its statutory consultation in June 2019. We emphasised that HAL needs to demonstrate to stakeholders that its new timetable is realistic, achievable and allows sufficient time for high quality engagement;
- HAL has introduced its Innovation Partners process to invite potential business partners to enter an expression of interest to develop alternative design, engineering or construction proposals to deliver capacity expansion at Heathrow airport. We noted that the process appears to have merits, but it would be for HAL to demonstrate the benefits for the airline community and consumers; and
- we welcomed the steady progress made by HAL on implementing its consumer research and engagement strategy in response to our previous recommendations. We expect HAL to continue to deliver on this strategy, engage closely and constructively with stakeholders, including the Consumer Challenge Board (CCB) and the airline community, and be responsive to Arcadis' review of the steps HAL is taking to ensure consumers' interests are reflected in its masterplan. We also welcome the focus the new governance protocol places on consumer interests.

12. We confirmed that the provision of high quality information on costs and efficiency in a timely way, together with a realistic and fully integrated end to end schedule, will be fundamental to the success of capacity expansion.

Stakeholders' views

13. We received responses to the April 2018 Consultation from ten stakeholders and these have been published on the CAA's website.⁹ These responses, and our views are summarised in the relevant chapters of this consultation. Where we have addressed respondents' comments in previous consultations, we have not necessarily repeated our views in this document. Where comments are outside the scope of this consultation, they will, where relevant, be addressed in future CAA publications.

Main issues raised in this consultation

14. In chapter 1, we explain that, following the designation of the NPS, it has become clear that there is additional pressure on the overall timetable and that a number of HAL's deliverables have slipped back by a period of up to six months. While HAL is still planning on the basis of receiving a DCO in 2021, if there were to be any more delays, planning consent might not be received until 2022.
15. If these further delays crystallise it may be appropriate for us to set a three year, rather than two year, interim price control arrangement. In setting any such three year interim control it would be important to ensure that the arrangements properly share efficiency gains with, and protect the interests of, consumers. Our initial view is that it may be appropriate to conduct a full reset of the cost of capital for a third year of interim arrangements in addition to the review of the assumptions we have already said that we will carry out to support a two year interim price control. We have not made final decisions on these matters and will consider carefully any representations we receive from HAL or other stakeholders on these issues.
16. Chapter 1 also sets out our views on the possibility of a commercial deal between HAL and the airlines operating at Heathrow airport that could wholly or largely replace the need for an interim price control. There could be a number of significant advantages to a commercial deal (including starting to move the

⁹ See: <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Heathrow-price-control-review-H7/>

relationships between the airport and airlines to a proper commercial footing). Nonetheless, we would need to test whether any such arrangement would properly further the interests of consumers and would reflect the interests of the range of airlines operating at Heathrow airport. Whether any agreement was supported by a wide range of airlines would be an important consideration and if an outline commercial deal emerges we will consult on whether it furthers the interests of consumers.

17. Chapter 2 assesses the case for a possible modification to HAL's licence to further the interests of consumers through a new condition promoting economy and efficiency in the operation, maintenance and timely development of Heathrow airport. It picks up on the themes raised in our consultations since 2014 on this subject, as well as stakeholders' views, and discusses the limits of the CAA's existing regulatory tools.
18. Such a licence condition could be introduced at the start of the interim price control period and would be part of the suite of licence conditions designed to incentivise efficiency. In response to HAL's concerns that such a condition would be too vague, the condition could include a list of areas of focus which could be amended over time, including making efficient and effective preparations for a DCO application and planning for capacity expansion. The condition would not seek to mandate the construction of the wider capacity expansion programme. It would also be broadly consistent with the licence conditions or obligations on regulated businesses in other sectors.
19. Chapter 3 gives a further update on our approach to addressing issues raised by potential alternative arrangements for delivering new capacity at Heathrow airport. In the April 2018 consultation we explained that our intention was that HAL should explore a full range of alternative arrangements, such as third parties designing and building significant elements of capacity expansion and/or developing alternative proposals for financing and delivering aspects of the capacity expansion programme. The aim of this approach is for HAL to exploit competitive forces to a greater extent than its business as usual approach to procurement, with these alternative arrangements being demonstrably efficient, delivered in a timely way and consistent with protecting the interests of consumers.

20. The chapter summarises the responses we received to the April 2018 Consultation and confirms that, to ensure that our efforts in this area are properly targeted, the current focus for our work on alternative delivery will be to consider both HAL's Innovation Partners process and the Arora Group's plans for airport development. We go on to discuss what our next steps should be in relation to these matters before setting out the information we expect the Arora Group to provide before we would be in a position to consider further how best to develop the regulatory framework to take account of its proposals. Nonetheless, any DCO application submitted by the Arora Group would be a matter for the Planning Inspectorate to consider.
21. Chapter 4 deals with our policy on making allowances for surface access costs to support the setting of HAL's next main price control. It proposes specific amendments and clarifications to the drafting of our existing policy to reflect the circumstances of capacity expansion at Heathrow airport and the targets and obligations set out in the NPS.
22. It confirms that we will not determine whether HAL's surface access strategy will meet the targets set out in the NPS as this is a decision for the planning process. Our focus will be on assessing what level of efficient costs are in consumers' interests and should therefore be passed through to airport charges. We also confirm that where road infrastructure (such as the M25) must be moved to allow for the construction of new capacity, we will treat this as a construction cost rather than a surface access cost.

Capacity expansion and scarcity rents

23. In our consultations on capacity expansion, we have consistently noted the substantial costs for consumers associated with significant delays to capacity expansion.¹⁰ The Airports Commission referred to this issue in its final report,¹¹ in particular, identifying "significant scarcity rents accruing to airlines operating at

¹⁰ See, for example, the April 2018 Consultation at paragraph 1.19.

¹¹ See the Airports Commission Final Report at paragraph 6.49:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440316/airports-commission-final-report.pdf

Gatwick and Heathrow".¹² The issue of scarcity rents has been raised by stakeholders in response to our previous consultations.

24. HAL commissioned Frontier Economics to produce a report titled "Competition & choice 2017 – A report prepared for Heathrow" (the "Frontier Report").¹³ This report included an econometric analysis of airline fares and used the results of that analysis to conclude that fares would "decrease by 23% relative to other London airports as a result of removing the capacity constraint". International Airlines Group (IAG) responded with a critique of the Frontier Report and their own assessment of the impact of capacity constraint at Heathrow airport (the "IAG Response").¹⁴
25. The CAA has commissioned FTI to produce a report which assesses the economic rationale and econometric analyses in the Frontier Report and the IAG Response, and identifies areas where additional analysis may be helpful to further illuminate these issues. The FTI report is published alongside this document¹⁵. We welcome further engagement from interested stakeholders on these matters.

Next steps

26. We intend to publish a working paper on the regulatory treatment of HAL's early Category C (construction) costs in November 2018 followed by working papers on Category B (planning) costs, and financial ring fencing early next year.
27. During the first part of 2019, we will focus on setting the interim price control/assessing any commercial deal that emerges between HAL and airlines. Over the remainder of 2019, we intend to complete our work on the broad

¹² A scarcity rent is an excess of price over the cost of supply that arises when there is insufficient supply in a market such that the price must rise in order to balance supply and demand.

¹³ See Competition and Choice 2017 – A report prepared for Heathrow at page 52. This is available on the CAA's website at:

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

¹⁴ See:

https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/Files/IA%20CAP1658%20response%20FINAL.pdf

¹⁵ [FTI Consulting Report to the CAA on Scarcity Rents](#)

regulatory framework for HAL, consistent with it providing a price control business plan at the end of 2019.

28. Further details of the overall timetable for capacity expansion and our timetable for developing the regulatory framework are included in chapter 1.

Our duties

29. In developing this consultation, we have had full regard to our statutory duties under CAA12, which are set out more fully in Appendix A.

Structure of this document

30. The structure of this consultation document is as follows:
- chapter 1 provides an update on our approach to timetable issues and an interim price control to apply after the end of the existing Q6 price control until the full price control for the development of new capacity is in place;
 - chapter 2 consults on a possible new licence condition to be included in HAL's licence to further promote economy and efficiency;
 - chapter 3 describes our current thinking as to how we will approach alternative arrangements for delivering new capacity; and
 - chapter 4 provides an update on our surface access policy.

Chapter 1

The overall timetable and the interim price control

Introduction

- 1.1 In the April 2018 Consultation, we explained our approach to the proposed interim price control arrangements for the two year period of 2020 and 2021. This is the period between the end of the present price control arrangements (31 December 2019) and when we expect our proposals for HAL's next main price control to take effect (1 January 2022). We have said this interim control should be properly coordinated with the overall timetable for capacity expansion. Following the publication of the April 2018 Consultation, there have been two important developments that suggest we should consider further key aspects of these arrangements.
- 1.2 The first development is that we are aware of discussions between HAL and a number of airlines on the possibility of agreeing commercial deals over 2020 and 2021, rather than relying on an interim price control. This chapter discusses our approach to a commercial deal and the work we might do to ensure that such arrangements are in the interests of consumers.
- 1.3 The second development is that, following the designation of the NPS in June 2018, it has become clear that there is additional pressure on the overall timetable and that a number of HAL's deliverables (including selection of its preferred masterplan and the launch of the statutory planning consultation) have slipped back by up to six months. Nonetheless, HAL continues to plan on the basis of making an application for development consent in 2020 and receiving a DCO in 2021, which would then allow the main construction activities to commence. This chapter explores the implications of these changes for our timetable for developing the regulatory framework, including whether a three year interim price control or arrangement might be appropriate.

The April 2018 Consultation

- 1.4 The current regulatory controls on the charges for the services that HAL provides airlines are due to expire on 31 December 2019 and already include a one year extension to the previous Q6 price control. The April 2018 Consultation proposed a two year interim price control to run from the end of the extended Q6 period on 1 January 2020 to 31 December 2021 with a price path of RPI-1.5% for 2020 and a further RPI-1.5% price reduction for 2021 (subject to a financeability test).
- 1.5 In response to stakeholder preferences for an interim control that is proportionate and straightforward to implement, we proposed a top down approach which would update the assumptions used in the Q6 price control for (i) passenger numbers, (ii) operational expenditure and (iii) commercial revenues. We also proposed updating the weighted average cost of capital ("WACC") in relation to new debt costs and the rate of corporation tax.
- 1.6 We said we would reflect the difference between (i) the RPI-1.5% price path and (ii) the underlying revenue allowances calculated by reference to these updated building block assumptions, by making a corresponding adjustment to regulatory depreciation.
- 1.7 Taken together, we considered that this approach would further the interests of consumers as it would be proportionate and targeted and would better align the main H7 timetable with that of the wider programme for capacity expansion.
- 1.8 We noted that our approach is based on an assumption that the current timetable for capacity expansion would not change significantly and that, if a material change were to occur, such as the NPS not being designated during 2018, we could review our timetable and take whatever steps were expedient to protect consumers. These could include bringing forward the main review of HAL's price control or setting a longer interim control on the basis of reopening more of the underlying assumptions.

Interim price control and possibility of a commercial deal

1.9 In response to the April 2018 Consultation, both HAL and airlines have continued to make representations on the approach to the interim price control that we consulted on in December 2017. For instance, HAL has expressed concerns about the adjustments to regulatory depreciation and the cost of new debt. Airlines have expressed concerns about price profiling and the possible addition of early Category C costs to the regulatory asset base ahead of HAL receiving consent for its DCO. We considered these issues in formulating the April 2018 Consultation, and remain of the view that the policy summarised in the section above is appropriate.

1.10 Nonetheless, as noted above, we also understand that HAL has been in discussions with airlines about the possibility of a commercial deal that would wholly or largely replace the need for an interim price control. In principle there could be a number of advantages to a commercial deal between HAL and airlines, including that:

- it would provide an example of how more commercially driven arrangements could reduce the need for the economic regulation of Heathrow airport, in the same way commercial arrangements have emerged at Gatwick airport and to a significant extent reduced the need for economic regulation;
- it could build confidence in the ability of HAL and airlines to reach agreement on difficult issues and boost confidence in the discussions supporting capacity expansion;
- if such arrangements could be concluded quickly, they could allow all parties (HAL, airlines and the CAA) to concentrate on the important matters relating to capacity expansion, which would be very much in the interests of consumers; and
- agreement on commercial terms should mean that any such arrangement reasonably reflects the interests of both HAL and airlines.

1.11 We would need to test whether any such commercial deal properly reflected the interests of a range of airlines operating at Heathrow airport (including a mix of

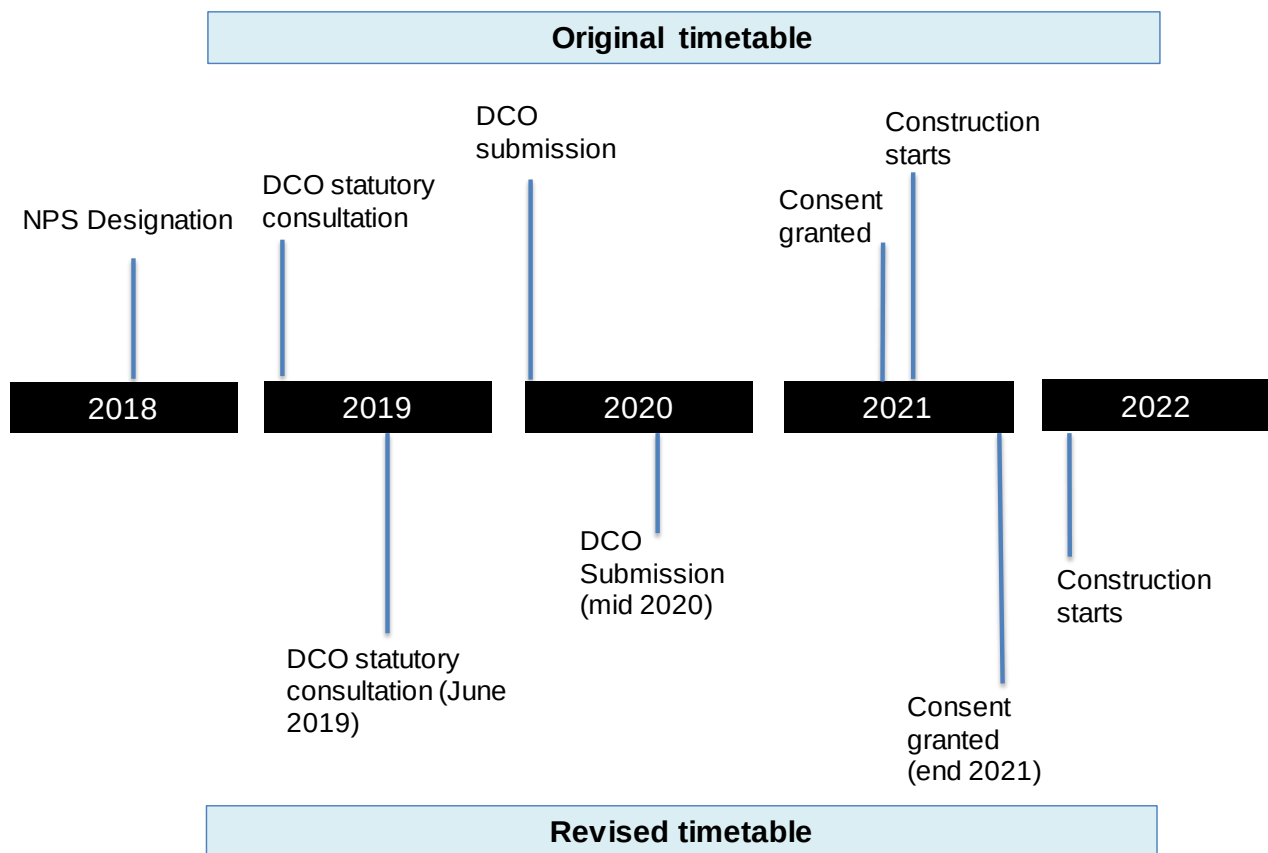
bigger and smaller airlines, a mix of those operating predominantly short and long haul and a mix of ownership) and furthered the interests of consumers. If we found that the commercial deal were to treat all airlines on a broadly equivalent basis and there were to be no compelling objections from airlines, we could then focus on consulting on whether any commercial deal furthers the interests of consumers.

- 1.12 If a commercial deal were to emerge and we found it to be in the interest of consumers, we would not need to undertake the interim price control review on the basis we currently envisage. However, we may still need to modify HAL's licence later in 2019 to ensure that its price control arrangements are properly consistent with the commercial deal and to make any other appropriate changes to HAL's licence (including the licence condition discussed in chapter 2).

Overall timetable

HAL's revised timetable

- 1.13 HAL has recently confirmed to us and to airlines that a number of factors are putting pressure on its timetable for capacity expansion, including:
- the NPS being designated later than it anticipated;
 - additional complexity with the masterplanning process; and
 - delays with the land referencing process.
- 1.14 As a consequence, HAL has undertaken a review of its proposed schedule. It recently announced changes to the time when it will select its preferred masterplan for capacity expansion and when it will issue the statutory consultation ahead of its application for development consent.
- 1.15 HAL's next public consultation, scheduled for January 2019, will focus on future airspace design options. This will be followed by a statutory planning consultation in June 2019, which will seek views on the preferred masterplan for expansion and how HAL will manage and mitigate the effects of its growth on local communities. In overall terms, we understand the impact of this revised schedule is likely to be a delay of around six months as shown in Figure 1 below.

Figure 1: Timeline showing original and revised key milestones

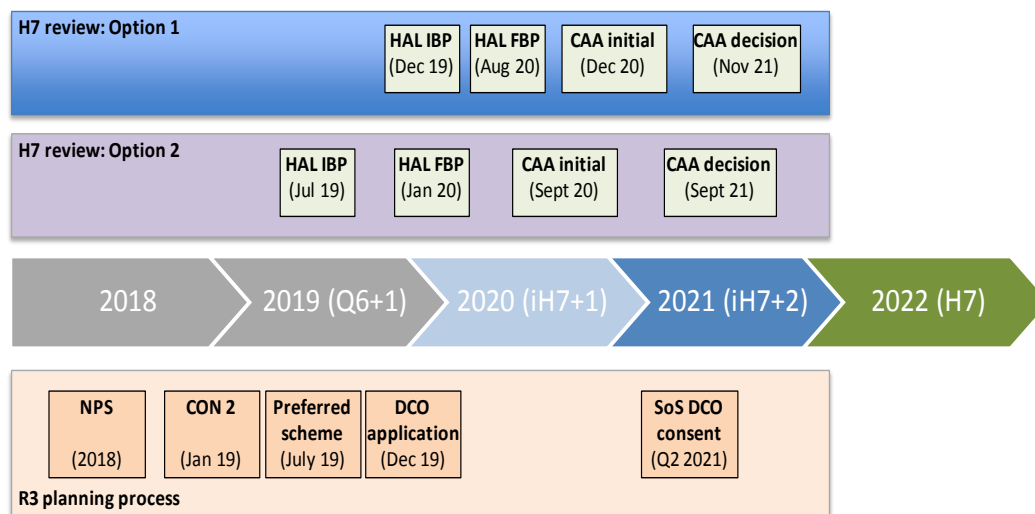
Source: CAA analysis of information provided by HAL

- 1.16 In a submission to the CAA on these matters dated 28 September 2018, HAL has said that it believes the schedule to be robust but the complexity and consultative nature of the process could result in further changes to the schedule. It hopes that any further changes will be relatively minor. It has also said that it will continue to review and update this plan at regular intervals.

Implications for the regulatory timetable

- 1.17 We have previously set out the advantages of aligning the timetable for the development of the regulatory framework with the wider programme for capacity expansion. The April 2018 Consultation set out the following timetable options for developing the regulatory framework.

Figure 2: Options for milestones for the H7 review under a two year interim price control



Note: “iH7” refers to the “interim price control”

- 1.18 We also consulted on the timing of HAL’s price control business plan, with the suggestion that HAL’s initial price control business plan might either be provided in the middle or at the end of 2019.
- 1.19 The delay in HAL’s expansion schedule means that a price control business plan will not now be practicable by the middle of 2019 so we are confirming that the business plan should be provided by the end of December 2019. We have also considered whether there should be a final price control business plan or whether HAL should update information on a more flexible basis in response to constructive engagement with airlines and other stakeholders. Our present view is that one high quality business plan with information updated on a flexible basis would be most consistent with a proportionate, targeted and focused approach to regulation. HAL would need to provide this updated information on a timely basis to facilitate the CAA to set its price control for HAL in a timely manner, taking into account the legal requirements the CAA must follow when modifying the licence.
- 1.20 It is important that these changes enhance rather than diminish the role of constructive engagement. We expect HAL to consult carefully with airlines throughout the masterplanning and business plan processes to ensure that these plans appropriately reflect the views of airlines. Following the publication of the

business plan, there would be further opportunities for airlines to comment and HAL to modify and update its plans in response.

- 1.21 In light of the above considerations, we have developed the revised timetable for developing the regulatory framework for HAL as set out below.

Figure 3: Timetable for developing the regulatory framework

Q4 2018	Working paper on Category C costs
Q1 2019	Working papers on Category B costs and financial resilience and ring fencing
	Publication of consultancy studies on the H7 WACC and the WACC for RP3
	Initial proposals for Interim Review (or consultation on commercial deal)
	Further consultation on the regulatory framework for capacity expansion
Q3 2019	Final decision on Interim Review / commercial deal
	Updated consultation on the regulatory framework for capacity expansion including update on affordability and financeability
Q4 2019	Interim review licence modifications
	HAL regulatory business plan (December 2019)
Q3 2020	CAA initial proposals for H7 review
Q1 2021	CAA updated proposals for H7 review
Q3 2021	CAA's statutory notice proposing modifications to HAL's licence
Q4 2021	CAA's decision modifying HAL's licence
January 2022	New price control and licence conditions come into effect

Implications for the interim price control/commercial arrangements of further delays

- 1.23 We based our approach in the April 2018 Consultation on the assumption that the current timetable for capacity would not change significantly and that, if a material change were to occur, we could review our timetable and take whatever steps were expedient to protect consumers. The changes that have been