

Economic regulation of Heathrow: policy update and consultation

CAP 1940



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About this document

This consultation follows on from our April 2020 Update on our programme for the development of the economic regulation of Heathrow Airport Limited (“HAL”). It deals with the following main issues:

- the responses we received to the April 2020 Update and our approach to protecting the interests of consumers;
- requirements for HAL’s revised business plan (“RBP”), which it is due to publish in the autumn of 2020;
- improving the efficiency incentives and capital expenditure governance arrangements for the H7 price control period; and
- further thoughts on our approach to assessing HAL’s financeability and setting the cost of capital for the H7 price control period.

HAL has paused its work on capacity expansion at Heathrow airport. We also address the regulatory treatment of expenditure incurred to date on expansion.

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 those highlighted in chapters 1 to 4.

Please e-mail responses to economicregulation@caa.co.uk by no later than 18 August 2020. 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 Jon Clyne (jon.clyne@caa.co.uk).

Executive summary and introduction

Introduction

1. In the April 2020 Update¹ on the economic regulation of HAL, we explained that recent developments were having a fundamental impact on Heathrow airport and the aviation sector more widely. The position now remains broadly similar to that in April: in its response to the April 2020 Update, HAL noted that passenger numbers at Heathrow have fallen by around 97%.
2. Prior to the full impact on traffic of the covid-19 pandemic being felt, the Court of Appeal had delivered its judgment that the NPS had not been lawfully produced.² This judgment removed the underpinning under the Planning Act 2008 which HAL was using to support an application for planning consent for expansion. This judgment is, however, subject to an appeal by HAL to the Supreme Court and any review of the policy set out in the NPS that may be carried out by the Government.³
3. These developments have caused us to refocus our work on the economic regulation of HAL. In particular, the April 2020 Update outlined our proposal to continue work on HAL's next price control ("H7"), but with a focus on a "two runway" airport, with the intention of having a new price control in place from 1 January 2022 on the expiry of the existing regulatory arrangements.
4. We noted in the April 2020 Update that the challenges created by the impact of the covid-19 pandemic will present significant difficulties, and it would not be realistic to think of the work we should do to set new regulatory arrangements as a "business as usual" process. Instead, we outlined how we are seeking to respond to these challenges, including through:

¹ References to previous CAA consultations, and definitions of terms used in this consultation are set out in the glossary at Appendix B.

² See: *R (Friends of the Earth) v Secretary of State for Transport and Others* [2020] EWCA Civ 214

³ We note that HAL has obtained leave to appeal from the Supreme Court. See:

<https://www.supremecourt.uk/news/permission-to-appeal-decisions-07-may-2020.html>

- changes to the regulatory programme and timetable;
- the use of scenarios to help explore how the present uncertainty might start to crystallise in the likely future path of air traffic volumes, and airport costs and revenues; and
- a more flexible and interactive process and timetable, but with a continuing emphasis on the importance of the CE process between HAL and its airline customers.

Main issues raised in this consultation

5. This consultation deals with the following main issues:

- the responses we received to the April 2020 Update and our approach to protecting the interests of consumers;
- requirements for HAL's revised business plan ("RBP"), which it is due to publish in the autumn of 2020;
- improved efficiency incentives and capital expenditure governance arrangements for the next price control period; and
- further thoughts on our approach to assessing HAL's financeability and setting the cost of capital for the H7 price control review.

6. Bearing in mind the pause in the expansion programme, we also address a number of issues that were raised in our previous policy consultations but where policy had not yet been finalised, including:

- the regulatory treatment of the early costs of expansion (i.e. the costs that HAL has already incurred in respect of expansion);
- licence conditions relating to financial resilience and ring fencing; and
- the regulatory treatment of the alternative arrangements for expansion proposed by Heathrow West.

Responses to the April 2020 Update and our high level approach to protecting the interests of consumers

7. Respondents to the April 2020 Update broadly supported:

our assessment of the impact of the covid-19 pandemic on HAL and the aviation industry; and

our suggestion that we should refocus our work on a two runway price control.

8. Airlines stressed the importance of affordable airport charges and that HAL should be held accountable for developing both a high quality engagement process and a high quality revised RBP. HAL emphasised the importance of simplifying and streamlining the regulatory framework, but also of providing comfort as soon as practicable on both early costs and the incentives for longer-term investment.
9. We deal with these responses in more detail in chapter 1 and explain further how we will take forward our work on the H7 price review in the difficult circumstances that the sector is currently experiencing. In particular, we will:
 - remain focused on delivering the best outcomes for consumers;
 - expect HAL to work to refine (and, if necessary, extend) the information it already has available to it from its extensive work on consumer engagement to inform its RBP. It should consider whether there may be particular benefits to consumers from providing enhanced or different levels of service or resilience, such as new services and processes that may be appropriate given the impact of the covid-19 pandemic;
 - continue to encourage HAL and airlines to work together, including on the development of scenarios to inform its RBP, to help ensure that the regulatory arrangements we develop are robust and protect consumers in a relatively wide range of circumstances;
 - consider whether any continuing uncertainty about traffic levels and passenger numbers should be dealt with through other uncertainty mechanisms, such as price control “reopeners” or traffic risk sharing arrangements; and
 - seek to develop price control arrangements that provide for the efficient financing of HAL and affordable airport charges for airlines and consumers. Reconciling these objectives may be challenging if the recovery in

passenger numbers happens relatively slowly. In these circumstances, we would seek to use maximum flexibility to develop price control arrangements that deliver these twin aims.

Business plan guidance

10. HAL will need to rework its Initial Business Plan (“IBP”) substantially focusing on how best to serve consumers, given the pressures lower passenger volumes are likely to create for financeability and affordability. The CAA will play an active role in CE as part of an iterative process to help develop, and encourage the timely delivery of, a robust RBP by HAL that reflects the importance of delivering the right outcomes to further the interests of consumers. As noted above, HAL will need to work with airlines on the development of scenarios and consider whether to carry out further targeted consumer engagement to support its approach. We provide more detail of our guidance for HAL on its RBP in Chapter 2 and Appendix E.

Efficiency incentives

11. A key objective of our policy for the H7 price control is to create appropriate incentives for HAL to make capital investments efficiently. This remains a priority even with our focus on a two runway airport as the present difficult circumstances of the sector mean that getting value for money from capital expenditure will be even more important. Chapter 3 explains our approach to these matters. We will build on the approach taken in the Q6 price control, while making improvements where appropriate. We intend to work closely with stakeholders in developing these incentive arrangements.

Financeability and the cost of capital

12. We noted in the April 2020 Update that dealing with any short term liquidity issues created by the impact of the covid-19 pandemic is primarily a matter for HAL, its shareholders and other providers of finance. Looking forward to H7, chapter 4 explains that the challenges for HAL’s financeability have changed significantly. As a result, we are no longer focusing on the financing of the very significant amounts of capex required for expansion. Instead, we need to

develop price control proposals consistent with an efficiently financed licensee continuing to access debt markets on cost effective terms, so that HAL's:

RAB can be efficiently financed; and

airport charges are no higher than is necessary.

13. As for the cost of capital, much has changed since we last addressed this in the January 2020 Consultation. We have commissioned work from Flint Global ("Flint") to help update our thinking on the cost of capital to take account of both our new focus on a two runway airport, and the "Provisional Findings" of the CMA on NERL's price controls. However, a considerable amount of further analysis and monitoring of market developments will be needed to understand the full impact of the covid-19 pandemic on debt and equity markets. We will continue with our work on these matters over the coming months.

Early costs

14. We deal with a number of legacy issues in the appendices to this document. Given that early costs have been of considerable interest to stakeholders, we summarise key elements of our policy here, as well as setting out further detail of our policy in Appendix C. In the light of HAL's decision to pause its work on expansion, we plan to simplify our policy on early costs as a number of aspects of our previous policy proposals no longer appear appropriate. These include recovery caps, enhanced reporting requirements and a new licence condition on governance arrangements.
15. Risk sharing arrangements also no longer seem appropriate, as these had been designed to encourage HAL to make a high quality planning application. Therefore, we propose that the regulatory treatment of the early expansion costs that HAL has incurred up to the end of February 2020 (which are in the region of £500 million) is consistent with the established regulatory principle that costs should be added to HAL's RAB unless there is evidence of inefficiency or misallocation. We intend to complete our work on reviewing the efficiency and allocation of these costs over the coming months. We also intend to make an allowance for financing costs up to the end of 2021. It is important to note, however, that the recovery of regulatory depreciation and allowed returns on

these early costs will not start until 2022 and will be subject to affordability and financeability tests.

16. If the expansion programme recommences at some point in the future, we would expect HAL to consult on detailed, evidence based, robust and properly costed budgets for both early costs and the wider programme.

Other matters

17. We also note that HAL made the following comment in response to the April 2020 Update:

“Through the Q6 process, the CAA clearly set out that the price control could be reopened in the event of ‘extreme circumstances’. We are developing our thinking on how a reopener might best work to deliver consumer benefits.”

18. If we receive detailed representations from HAL on these matters, we will consider them in the light of our statutory duties and consult stakeholders on the most appropriate way forward.

Next steps

19. We will be hosting an online seminar to present the key issues arising from this consultation and discuss with stakeholders the best approach to engagement at 11am on 1 July 2020. If you would like to attend, please contact economicregulation@caa.co.uk.
20. Comments are invited on the issues raised in this consultation by 18 August 2020.
21. We will also issue working papers to support our development of policy as appropriate, including papers later in the summer on capex efficiency incentives and our initial assessment of the efficiency of HAL’s capital expenditure during the Q6 price control (as extended).
22. The initial phase of CE between HAL and airlines commenced in early June 2020 and will run until the end of that month. Following this, HAL intends to issue updated information on the regulatory building blocks for a two runway airport.

The second phase of CE will consider these issues further during August and September 2020, ahead of HAL issuing its RBP in the Autumn of 2020.

23. The CAA will issue a further paper setting out the way forward for the H7 review early in 2021.

Views invited

24. Views are invited on any of the issues raised in this document and, in particular, on:
- the key elements of our approach to developing the H7 programme, as set out in the summary of chapter 1, including our proposed approach to furthering consumers' interests;
 - how we can best continue to engage with HAL and other stakeholders to ensure that HAL has the best opportunity to develop a meaningful and high quality RBP;
 - the criteria and broad approach to capex incentives identified in chapter 3;
 - how best to improve capex governance arrangements;
 - the approach adopted by Flint and summarised in chapter 4 for estimating cost of capital for H7 prior to the impact of the covid-19 pandemic being felt; and
 - how we should best take account of the impact of the covid-19 pandemic on HAL's cost of capital.

Our duties

25. 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

26. The structure of this consultation document is as follows:
- chapter 1 discusses the responses we received to the April 2020 Update;
 - chapter 2 considers our requirements for HAL's RBP;

- chapter 3 addresses capex efficiency incentives and governance arrangements;
- chapter 4 considers our approach to assessing affordability and financeability and setting the cost of capital for H7; and
- the appendices primarily cover issues that were raised in our previous policy consultations but where policy had not yet been finalised, including the treatment of early costs.

Chapter 1

Developing the H7 Programme and responses to the April 2020 Update

Introduction

- 1.1 The April 2020 Update explained how we intend to react to HAL's decision to pause its capacity expansion programme and the unprecedented impact on Heathrow airport, and the aviation sector more widely, arising from the covid-19 pandemic.
- 1.2 This chapter deals with the responses to the April 2020 Update on our overall approach to the H7 price control review. In the light of these responses, we set out an updated way forward.
- 1.3 In particular, this chapter:
- briefly summarises the broad approach outlined in the April 2020 Update;
 - discusses the responses we received to that consultation;
 - sets out our views on the matters raised by respondents; and
 - explains how we expect to take forward the H7 price control review in the interests of consumers, taking account of latest developments and the responses to the April 2020 Update.

The April 2020 Update

- 1.4 We noted that, given HAL's decision to pause its capacity expansion programme and the impact of the covid-19 pandemic, it would be appropriate to focus on a price control for a two runway airport. If circumstances change in such a way that HAL resumes work on expansion, we retain the option to deal with it by adjusting or resetting HAL's price control. We said that:

- given the new strategic context, scenarios could help explore how the present uncertainty might start to crystallise, and illuminate possible future paths of air traffic volumes, airport costs and revenues;
- we would consider a range of options for the form and duration of the price control to help deal with any remaining uncertainty when we set it in 2021; and
- a more flexible process would be appropriate, but with a continuing emphasis on the importance of CE.

Responses to the April 2020 Update

Broad approach

1.5 HAL's comments on the April 2020 Update's broad approach included that:

- expansion is still in consumers' interests and remains a key part of HAL's long term strategy. The regulatory framework should provide flexibility to allow for the possibility of expansion resuming;
- the current framework is not well calibrated. This is demonstrated by the impact of the covid-19 pandemic, and HAL requires greater protection from risk in the future. HAL also suggested that it has failed to earn the cost of capital set in a regulatory settlement for two decades;
- the CAA should take steps to support HAL's financeability in the short term, including by providing clarity on the treatment of early costs;
- the CAA should set out a clear plan for ensuring that both HAL's plans and the H7 price control will properly protect consumers, building on the good work of the CCB; and
- now might be a good opportunity to allow the industry to work together to find a more commercial solution to the current issues and future challenges.

1.6 Airlines agreed with HAL that the sector faced an unprecedented crisis, but took a different view of the approach set out in the April 2020 Update:

- there was general support for focusing on a two runway airport and an emphasis on the importance of airport charges being affordable in the future to support the recovery of passenger traffic;
- BA/IAG suggested that HAL, airlines and the CAA should work collaboratively to find mechanisms to deal with the issues raised by uncertain future traffic volumes;
- there was support for our position that Heathrow airport retains market power and that the CAA should continue to regulate HAL;
- VAA supported the CAA continuing work on H7, noting that the scale of the change that has occurred since the Q6 price control decisions were taken in early 2014 means that a further extension of the Q6 price control would not be in the best interests of passengers; and
- the AOC/LACC said that they did not support any move to a “light touch” form of regulation such as that seen at Gatwick airport.

Use of scenarios

- 1.7 HAL agreed that understanding potential scenarios can help it better to understand the potential impact of the covid-19 pandemic on its forecasts and plans for H7. It also said that engagement should focus on the delivery of outcomes for stakeholders linked to the scenarios, not the scenarios themselves. It said it should continue to use its “driver-based” method to estimate future passenger volumes, costs and revenues, and that a “bottom up” approach to estimating these elements would be inappropriate.
- 1.8 BA/IAG said that the value in developing the framework for such scenarios is in ensuring key building block elements are logically tied together. Operating costs, commercial revenues, capital plans and other areas all need to be linked to a form of scenario, and an appropriate price control outcome needs to result from them. AOC/LACC agreed that the development and use of meaningful scenarios, incorporating iterative engagement from airlines as well as HAL, is a pragmatic and flexible approach for developing the H7 price control.
- 1.9 The LAANC said that, in the interests of respite for local communities, any scenarios should respect existing planning rules.

Uncertainty mechanisms

- 1.10 HAL considered that both risk sharing mechanisms and trigger mechanisms could help to mitigate many of the risks associated with setting a price control in an uncertain environment. It stressed the need for a mechanism to manage larger shocks. An adjustment mechanism could also provide clarity on when the CAA would step in to review the price control.
- 1.11 Airlines also supported work to consider measures to address the current uncertainty. They agreed that we should consider potential trigger mechanisms, although in the case of traffic risk sharing, several airlines cautioned that any such mechanism should not seek to “de-risk” HAL completely.
- 1.12 There was less support for other possible measures. Respondents only supported a shortening of the price control period if there was a clear case for change.

Process and the timetable for the price review

- 1.13 Most respondents to the April 2020 Update agreed with our proposed approach, and there were suggestions for further changes to our processes:
- HAL agreed with a more streamlined process, expressing a desire for further details from the CAA particularly in relation to the consultations that will be issued in 2021. It stressed a need to reduce the regulatory burden and avoid complex new processes;
 - BA/IAG said that stakeholder engagement is critical to an effective regulatory process, and supported more workshop-based discussions to gather evidence for the price control;
 - VAA supported greater informal stakeholder engagement, also observing that airline resources are currently severely constrained so that the level and depth of airline engagement may be lower than previously;
 - AOC/LACC supported the overall approach including more use of feedback and ‘workshop’ sessions. They highlighted the importance of agreeing “principles of engagement” so that all parties are aware of the expectations and requirements upon them; and

- the HCEB encouraged the CAA to gather views from the all stakeholders, including local communities and the wider public.

CAA views

Building on our broad approach

- 1.14 Consistent with the views of stakeholders, we intend to retain our focus on a price control for two runway airport. In relation to expansion, we note that stakeholders have a range of views and, at this stage, we intend to retain the option of dealing with these matters by adjusting or resetting HAL's price control.
- 1.15 We note comments from HAL on the potential use of a "commercial deal", under which CAA could step back from its current regulatory role and allow HAL and the airlines to use to develop an agreed framework for H7. We also note that airlines and airline representatives are sceptical about the introduction of a lighter touch approach to regulation. As we have previously explained, the lighter touch arrangements at Gatwick airport first emerged in parallel with the development of price control proposals (towards the end of the price control review leading up to Q6). Bearing this in mind, we do not see our work on HAL's price control preventing the emergence of a more commercial approach, if HAL and airlines were to agree a suitable way forward.
- 1.16 HAL has made a number of comments about the need for the regulatory framework to address risk and reward appropriately and for greater certainty on the regulatory treatment of early costs. As we explain below, we will consider adapting the form of the price control to deal with uncertainty differently. We will also seek to ensure that we adopt a balanced approach to risk and reward in designing the regulatory arrangements, including our approach to assessing financeability, setting incentives and the cost of capital. These matters are discussed further in chapters 3 and 4. We also deal with the regulatory treatment of early costs in Appendix C of this document.
- 1.17 More broadly, as noted in the Executive Summary, if HAL makes representations that we should reopen the regulatory arrangements that support the existing

commercial deal that is in place for 2020 and 2021, we will consider them carefully.

- 1.18 Airlines commented on the importance of airport charges being affordable and supporting the recovery of passenger traffic. We support these comments but note that it is also important that HAL can be efficiently financed. As indicated in the April 2020 Update, if the recovery of passenger traffic is relatively slow, there may be significant challenges in reconciling these objectives. In these circumstances, we would seek to use maximum flexibility to develop price control arrangements that deliver these twin aims.
- 1.19 We note HAL's comments on the importance of having a clear plan to ensure both HAL's plans and the price control will properly protect consumers. We consider it is timely for us to set out more information on our approach to these matters, and this is discussed further below.

Furthering the interests of consumers

- 1.20 The April 2020 Update stated that we would continue to put the interests of consumers at the heart of our work pursuant to our statutory duties under CAA12. This section expands on our approach to these matters, taking account of our decision to conclude the work of the CCB following its helpful report⁴ on HAL's IBP.
- 1.21 Our established policy and continued focus will be on ensuring that the regulatory regime responds to, and delivers on, the core needs, priorities and preferences of consumers. This will mean building on the success of the SQRB scheme, so that it:
- continues to meet the needs of consumers and airlines; and
 - facilitates the smooth introduction of OBR.
- 1.22 HAL's approach to its RBP and OBR will need to be driven by a robust understanding of what consumers value and reflect suitable levels of service and

⁴ See the CCB's report on HAL's Initial Business Plan:
https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Consumers/20200226%20CB%20Report%20on%20IBP_REDACTED_20200521.pdf

resilience. At the same time, it will also have to reflect the greatly changed circumstances in the sector and provide appropriate support for the recovery of passenger numbers.

1.23 The CCB played an important role in providing independent scrutiny and challenge to HAL on the development of its IBP, its approach to consumer research and engagement, and OBR. It is important that we find a way forward that reflects both the importance of this role and the broader challenges that both HAL and the sector in general face. We propose the following approach to ensure consumers remain at the heart of the regulatory process:

- HAL's approach to OBR and its RBP: HAL should develop a strategy to deliver an appropriate level of service to consumers and airlines that reflects their core needs and priorities both (i) in the short term and during the recovery period; and (ii) over the longer term so that HAL can fully develop its approach to OBR;
- Approach to consumer research and engagement: in ensuring the RBP is informed by the needs, priorities and preferences of consumers, HAL should refine, and build on, its existing consumer evidence base with emerging intelligence and, where appropriate, through new research and engagement that will assist HAL in developing an RBP that is consistent with providing the outcomes that consumers expect;
- Airline insights: it will remain appropriate for HAL to try and lever on airlines' extensive consumer insights and intelligence and, where practicable, this information should be used to support the development of OBR. This insight should be used to supplement any new research and engagement undertaken by HAL to ensure that the RBP is consistent with providing the outcomes that airlines expect for the consumers they serve;
- Stakeholder engagement: we will broaden our approach to stakeholder engagement and develop a better understanding of the perspective of the PSG;
- The CCB's report on the IBP: we expect HAL to address the findings and recommendations in the CCB's report on the IBP where relevant. In particular, HAL should address the CCB's key finding on the need for a

clearer link and “golden thread” between its consumer research, future plans and OBR proposals; and

- CAA consumer advocate role: we will provide scrutiny and challenge of HAL’s plans to ensure that they are grounded in robust consumer insight and reflect consumers’ core needs and priorities. In doing this, we will be assisted by expert advice from the CAA’s Consumer Panel acting as our “critical friend”. We will consider commissioning further external support and assistance if it is necessary to support our work on OBR and/or assessment of HAL’s RBP.

1.24 While we recognise the important role that airlines play in understanding the views and interests of their customers, direct research and engagement is important to gain further insight into consumers’ priorities and preferences.

1.25 Chapter 2 and Appendix E sets out further information on our expectations for HAL’s RBP to reflect these matters.

Scenario analysis

1.26 Given the uncertainties arising as a result of the impact of the covid-19 pandemic, we view the development of meaningful scenarios as a fundamental starting point for the development of “joined up” outcomes in respect of capex, opex and commercial revenues in the RBP. Given this, we disagree with HAL’s view that engagement should focus on the delivery of outcomes for stakeholders linked to the scenarios, but not the scenarios themselves. There would be advantages in a consensus view of the scenarios between airlines and HAL as a starting point for the development of the RBP.

1.27 We expect HAL to work with airlines to develop appropriate scenarios, with this engagement starting as soon as practicable and allowing for the evolution of views. These agreed scenarios:

- should deliver outcomes consistent with consumers’ needs and priorities; and
- provide the basis for an effective, integrated RBP.

- 1.28 Our detailed guidance and requirements for scenario analysis are set out in Appendix E.

Form of control

Traffic risk sharing

- 1.29 The outlook for passenger traffic at Heathrow airport is likely to remain uncertain as we develop the H7 price control. For this reason, our current view is that there may be a strong case for including some form of traffic risk sharing mechanism in HAL's price control. Such mechanisms have operated for an extended period at a number of other major European airports.
- 1.30 A traffic risk sharing mechanism would directly address one of the key sources of uncertainty for the H7 review. As well as affecting HAL's revenues from airport charges, changes in passenger volumes will also have implications for opex and commercial revenues. By carefully calibrating any traffic risk sharing mechanism, we could take account of the likely impact of traffic changes on all of the regulatory "building blocks".
- 1.31 We agree with the airlines that any new mechanism should not aim to protect HAL from all traffic-related risk. It is important that HAL continues to bear some risk and will, therefore, be incentivised to facilitate a rapid recovery in traffic levels. Nevertheless, by reducing, rather than eliminating, HAL's exposure to traffic risk in H7, we can reduce the risks and avoid unnecessary upward pressure on the cost of capital.
- 1.32 We will discuss with HAL and airlines the potential role of a traffic risk sharing mechanism and the principles that could be applied. Before such a mechanism could be introduced, detailed work would need be required on the design of the mechanism and the degree of risk sharing. This could vary, for example, depending on the degree of divergence between forecast and actual traffic levels.
- 1.33 One potential disadvantage of some traffic risk sharing mechanisms is that they could lead to higher charges for airlines and customers at a time when they are already dealing with the consequences of lower than expected demand. We are open to considering ways to mitigate such disadvantages, such as the use of RAB adjustments rather than immediate increases in airport charges.

Price control reopeners

- 1.34 HAL has suggested that we consider the introduction of “price adjustment triggers”. We are aware that some other regulated companies have specific “reopener” provisions associated with their price controls. One example is the provision for Ofwat to carry out a “substantial effect determination” if an unforeseen circumstance has an impact equal to at least 20 per cent of a company’s turnover.
- 1.35 A specific reopener for HAL’s price control could provide additional certainty about when a change to an existing price control might be appropriate. Nonetheless, there are issues about how such provisions might operate in practice. For example, the use of rigid materiality thresholds can distort incentives, fail to reflect important aspects of the underlying context and the operation of these provisions can prove contentious.⁵
- 1.36 As a possible alternative way of providing additional certainty, rather than introducing a new reopener provision, the CAA could consider providing policy guidance on the types of circumstance that might justify a reopening of an existing price control. Such guidance could provide a more nuanced description of CAA’s likely approach under a range of different situations, avoiding some of the rigidities associated with specific licence conditions.
- 1.37 A further important consideration is that the role of any reopener or policy guidance would depend on the nature of any traffic risk sharing mechanism, since a risk sharing mechanism may help to mitigate the impact of events that might otherwise need to be dealt with by reopening the price control.

Other options

- 1.38 Our current view, similar to that of several respondents, is that it would be premature to consider shortening the duration of the H7 price control at this stage.

⁵ For instance in 2008 Ofwat decided against amending Sutton and East Surrey Water’s price control even though it agreed that the materiality threshold had been satisfied (and this decision was upheld following an appeal to the Competition Commission).

However, this is an option that we could consider in future if it became clear that a five year price control might not be in consumers' best interests.

Regulatory programme and approach to engagement

1.39 We welcome the feedback received we have received on our approach to process and timetable. We intend to take forward these matters by:

- hosting a webinar for all interested stakeholders shortly after the publication of this consultation, as highlighted in the Executive Summary . If feedback on this suggests we should, we will consider holding further events at strategic points in the H7 review;
- being proactive in CE, with a particular focus on ensuring this process takes account of the interests of consumers;
- augmenting our contribution to CE with a series of targeted workshops and less formal sessions on key regulatory issues, particularly those which receive less focus as part of CE;
- streamlining our documents and consultations so that they focus on key issues and use working papers where appropriate;
- seeking to understand more the views of the PSG/HCEB and other stakeholders that represent consumers; and
- noting HAL's desire for further details of the process during 2021, we propose to clarify the key stages of the final period of the H7 review following our assessment of HAL's RBP later this year, when we expect that some of the present uncertainty will have reduced.

Summary

1.40 We reaffirm key elements of the vision set out in the April 2020 Update:

- our focus will be on a price control for a two runway airport (with the option of dealing with capacity expansion by adjusting or resetting HAL's price control);
- scenarios should be used to help explore possible future paths of air traffic volumes, and airport costs and revenues;

- we will consider traffic risk sharing mechanisms and price control re-openers to help us deal with remaining uncertainty in setting the H7 price control in 2021; and
- we will adopt more flexible and agile process to setting the price control, but with a continuing emphasis on the importance of CE.

1.41 Taking account of the responses to the April 2020 Update and our evolving thinking, we will further build on the above key elements as follows:

- we will develop processes to ensure that the interests of consumers remain at the heart of the regulatory process; and
- we will consider how best to deliver a price control consistent with efficient financing arrangements for HAL and affordable charges for airlines that best supports the recovery of passenger traffic at Heathrow airport.

Views invited

1.42 Views are invited on any aspect of the issues raised in this chapter and, in particular, on:

- the key elements of our approach set out in the summary of this chapter; and
- our proposed approach to furthering consumers' interests described above.

Chapter 2

Developing HAL's revised business plan

Introduction

- 2.1 The IBP was published in December 2019 on the basis that expansion was proceeding. Given the changed circumstances, the IBP is substantially out of date and HAL has committed to producing an RBP in the Autumn of 2020.
- 2.2 This chapter summarises our guidance for the RBP and builds on and modifies the Updated Business Plan Guidance we produced for HAL's IBP. Although the present level of uncertainty and the difficulties that the sector faces will create real challenges for HAL in producing its RBP, it is essential that the RBP is as robust and informative as practicable and reflects consumers' core needs and priorities for a two runway airport. It should also capture:
- the outcomes of CE;
 - HAL's latest thinking on traffic scenarios and efficient levels of costs; and
 - HAL's views on the form and duration of price control arrangements best suited to dealing with any remaining uncertainty.
- 2.3 This Chapter:
- summarises key features of the IBP and views on it, and the issues from this that are relevant for the RBP;
 - describes our priorities for the RBP;
 - provides further information on how HAL should progress its work on consumer engagement and OBR; and
 - invites views on key issues.
- 2.4 Further detail of our RBP guidance is set out in Appendix E.

Summary of the IBP

2.5 We assessed HAL's IBP against the Updated Business Plan Guidance. We also took into account the views of airlines and the CCB.⁶ Once the circumstances changed, we paused our work on the IBP, but summarise below key features of the IBP, views on it and the implications of these views for the work HAL needs to undertake in preparing the RBP.

Key features of the IBP

2.6 Our preliminary view was that the IBP covered all the main areas necessary to support the price control review. Its key features and elements included:

- strategic choices (an option for prioritising savings and an option for prioritising services);
- an investment/capex plan focused on the delivery of expansion and two other portfolios of projects: "Create Capacity" and "Maintain and Improve". Investment in the existing asset base fell into the latter portfolio;
- a "top-down" forecasting method for opex and commercial revenues which projected opex and revenues forward from a base year using estimated elasticities for passenger growth, rather than the "bottom up" approach used for the Q6 price control. HAL said its base year level of opex was efficient and, therefore, that it would start H7 with an efficient level of opex;
- a continuation of the existing "core" and "development" capex governance framework and related processes; and
- OBR proposals, including six consumer outcomes in the context of four wider stakeholder outcomes, twenty-six measures and a set of alternative measures. Its "prioritising savings" targets were mainly based on maintaining existing Q6 price control service performance levels. Its incentive design was informed by the Q6 price control and cross-sector

⁶ See footnote 4

precedents, consumer insights and whether or not performance was wholly within HAL's control.

- 2.7 We do not currently expect construction for expansion to restart during H7. If expansion restarts, we will treat it as an add-on to the price control. This, and the impact of the covid-19 pandemic on traffic volumes, means that several key assumptions used to construct the IBP are no longer appropriate. These include assumptions on traffic forecasts, the capex plan, financing and financeability and several other key building blocks.
- 2.8 HAL provided initial views on the requirements for its RBP in response to the April 2020 Update. It said that its IBP method for estimating opex and commercial revenues remains fit for purpose and it intends to provide a "Building Block Update" in July 2020 on this basis. We understand this will update many of the assumptions in the IBP, but may use the same or similar models and/or approaches to make forecasts, while taking account of the current circumstances. This update would be more useful for consumers and stakeholders if it also were to address the validity of HAL's underlying models and approaches, especially given the radically changed circumstances of the sector.

Feedback on the IBP from key stakeholders

- 2.9 In response to our request for key stakeholders' feedback on the IBP, the airline community and the CCB provided formal feedback. Since then, the airline community has developed its thinking on requirements for the RBP, providing further views in response to the April 2020 Update. This section summarises airlines' feedback. The CCB's feedback is discussed later in this chapter.
- 2.10 On opex and commercial revenues, the airline community generally did not support the forecasting methodology used in the IBP, considering HAL's approach to using "top down" "drivers" and forward-looking elasticity assumptions⁷ for opex not to be appropriate for robust forecasting. Instead, they

⁷ For example, HAL's opex forecasts accounted for growth using top down elasticity assumptions for passenger volumes and terminal size.

said that the RBP should identify key “bottom up” cost and revenue drivers, linked to planning scenarios. Furthermore, airline feedback was that analysis should be widened to include efficient comparators other than airports, such as other transport modes, or shopping centres. For commercial revenues, forecasts should incorporate benefits derived from capital investment projects, such as valet parking.

- 2.11 On capex and the capital planning framework, airlines were keen to see the capital plan analysis linked to agreed scenarios. They also suggested:
- the evolution of the capex governance process, for example, by reviewing the current “gateway” process; and
 - improved analysis of benefits, including “benefits realisation” analysis to show how far estimated benefits of a project have been delivered.
- 2.12 Airlines considered that HAL's approach to consumer engagement in the IBP had been used to justify unnecessary increases in investment. They considered the Q6 SQRB scheme should remain in place for H7, with adjusted measures and metrics to benefit the consumer interest further. They remained opposed to bonuses for outperformance and said OBR should focus only on the regulated entity.

Overall approach and priorities for the RBP

HAL's overall approach to the RBP

- 2.13 The RBP is a key opportunity for HAL to provide robust information and evidence that will support the price control process for H7 and influence the design of the regulatory regime. It should also:
- provide a positive, integrated plan for stakeholders;
 - improve the scope and depth of stakeholders' engagement; and
 - improve HAL's business planning and delivery for H7 period.
- 2.14 We expect HAL's RBP to address consumers' and industry stakeholders' current and future requirements in the context of the current highly uncertain conditions. Where appropriate, it should draw on good practice from other regulated sectors.

2.15 To be effective 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 consumer views and preferences to the fullest extent practicable;
- based on efficient costs;
- focused on addressing both the financeability and the affordability of airport charges in the context of the challenging circumstances that the sector is likely to face during H7; and
- deliverable.

2.16 While our initial assessment of the IBP was that it went some way to satisfying some of these objectives, the RBP can, and should, go further.

2.17 We intend to facilitate development of an effective RBP by taking an active role in CE discussions on the detailed form and content of the RBP. To support HAL in delivering an effective RBP, we have produced updated guidance at Appendix E. This aims to strike a balance between:

- the need for HAL to provide high quality, transparent, disaggregated information to inform medium term planning for Heathrow airport; while
- avoiding unreasonable burdens on HAL, for example, by aiming to minimise requirements for HAL to collect new data, or to develop entirely new approaches to its planning.

Priorities for traffic, costs and revenues for the RBP

2.18 Our assessment of traffic, costs (both capex and opex) and commercial revenues in the IBP provided insights which remain important for the RBP. These building blocks are critical to business planning and intrinsically connected: passenger volumes drive commercial revenues directly, and have a significant impact on both opex and capex levels.

- 2.19 Our requirements aim to build on HAL's existing planning and forecasting approach, for example, in providing for a reasonable disaggregation of traffic, cost and revenue estimates. For instance, we expect that opex forecasts for H7 should be capable of reflecting significant changes in the levels of staff between terminals and activities. We also note that HAL's Regulatory Accounts include opex at a more disaggregated level than in the IBP. We expect the RBP, therefore, to contain opex estimates for each planning scenario at a level of detail that facilitates understanding of changes in relevant activities, and supports the objectives and principles above.
- 2.20 Nonetheless, the current uncertainties around future traffic volumes mean that very detailed "bottom-up" forecasts of traffic, costs and revenues are unlikely to be useful for consumers and stakeholders in the short term. If uncertainty reduces during the rest of 2020 and 2021 such that the range of scenarios under consideration can be narrowed, we would then expect HAL to provide more detailed information to reflect stakeholders' reasonable needs and expectations. We will engage with HAL and key stakeholders during CE to assess the scope and benefits of such an approach.
- 2.21 We are also of the view that HAL's approach to planning for costs and revenues should be integrated and closely linked to passenger volume scenarios. For example, if a particular scenario assumes that a terminal will remain closed for a significant period of time, we would expect that, for that period:
- opex estimates will reflect the present significant reduction in operational activity, such as material reductions in staff and utility costs for that terminal;
 - commercial revenues from that terminal will be at, or close to, zero, as all retailers and most other revenue generating assets will be closed; and
 - the capex plan will show that no investment is planned in that terminal, unless it is required for refurbishment or otherwise in advance of reopening it.
- 2.22 The RBP should provide scenario-based estimates for traffic, costs and revenues at a suitable level of disaggregation such that the estimates can reflect variations in demand responses and cost drivers for each scenario. If a particular scenario assumes that some geographic markets recover more quickly than

others, the estimates of commercial revenues for the recovery period should reflect variations in the return of revenue between geographic markets.

2.23 Effective capex planning requires an effective process for “sifting” and prioritising potential projects, to ensure that HAL makes the best use of its resources. While HAL already carries out business case analysis on capex projects during its project development process, we agree with the airline community that this process should be enhanced. For each individual business case, HAL should:

- identify expected outputs and quantified benefits (including any incremental revenues and operating costs) to allow monitoring of actual benefits; and
- provide an explanation of how the project or portfolio delivers value for money for customers and consumers during H7, recognising that consumer needs and preferences may well have changed as a result of the impact of the covid-19 pandemic or other factors.

2.24 HAL's RBP should also demonstrate the impact that a particular level of traffic has on operational resilience for that scenario. We expect that HAL's analysis of operational resilience will be linked to the method it uses to estimate those operating costs that relate to operation of its infrastructure.

2.25 In summary, for traffic, costs and revenues, the RBP should:

- apply an integrated approach to planning and estimating volumes;
- present key elements of a flexible framework for medium term planning for H7 that takes account of variations in demand responses and cost drivers for individual scenarios;
- present an approach to capex planning that takes account of expected project outputs and estimated benefits for customers and consumers; and
- demonstrate the impact of traffic levels on operational resilience.

2.26 Nonetheless, we recognise the need for all RBP requirements and guidance to be proportionate and not unduly difficult to implement. We have engaged in initial discussions with HAL on the main principles underlying key requirements and guidance set out in this chapter and Appendix E. We will discuss further the detail and content of the RBP with HAL and airlines during CE.

Consumer engagement and OBR in the RBP

- 2.27 In 2017, we set our OBR policy and appointed the CCB with the intention of moving towards a more consumer focussed approach to service quality in H7. Since then, HAL has undertaken a significant consumer research and engagement programme to inform its approach to OBR, with challenge and insight from airlines and the CCB. HAL set out its approach to consumer engagement and OBR in the IBP.⁸
- 2.28 In February 2020, the CCB provided its report on HAL's IBP. The CCB considered that HAL had undertaken extensive consumer research and engagement, and commended HAL's ambition to produce an IBP based on consumer insights. However, it considered the IBP was deficient in translating this engagement into proposals which reflect consumer preferences. The CCB expressed particular disappointment with the OBR proposals because the "golden thread" between outcomes and consumer insights was not reflected in HAL's proposed measures, targets and incentives. We broadly agree with the CCB's key findings on these matters.

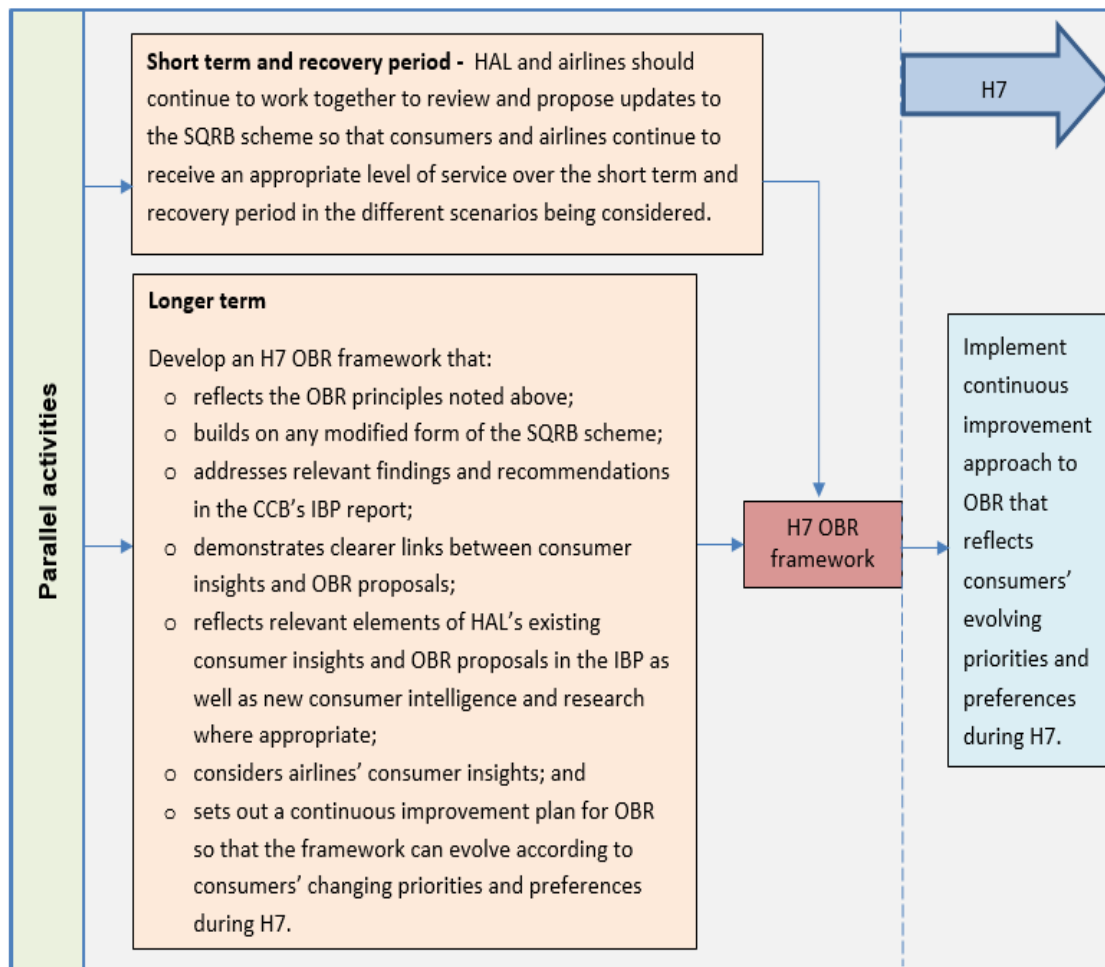
Impact of the latest developments

- 2.29 The covid-19 pandemic is likely to have an impact on consumers' future priorities and preferences, with a greater focus on safety, health and cleanliness. Public health requirements, such as social distancing and health screening, are also likely to have an impact on the passenger journey to and from the airport as well as on operational and service quality processes at the airport.
- 2.30 While it is not clear how consumer priorities will change over time, HAL and the airlines are working to review and propose updates to the SQRB scheme (with CAA support) so that consumers and airlines receive an appropriate level of service over the short term and recovery period in the different scenarios being considered.

⁸ See paragraph 2.6 above.

Guidance for the RBP

- 2.31 It continues to be in consumers' interests for HAL to develop its approach to OBR based on the principles below. HAL's approach should:
- be informed by robust consumer insights in delivering for consumers (i) reflecting their priorities and preferences, (ii) drawing on existing insight and (iii) building on this with new research where appropriate;
 - include 'outcomes', 'measures', 'targets' and 'incentives';
 - build on any updated form of the SQRB scheme over the short term and recovery period (see above); and
 - include performance reporting targeted at consumers.
- 2.32 We do not agree with the airlines' suggestion that the SQRB scheme should be the focus of licensed based regulation in H7. OBR remains central to delivering for consumers, although the SQRB scheme may have a role in supporting OBR and in incentivising HAL to deliver services to support its airline customers. The short term review of the SQRB scheme will also be an important input into supporting airlines in the short term and recovery period as well as in setting a direction of travel to support the future shape of OBR.
- 2.33 In adapting to the new challenges raised by the impact of the covid-19 pandemic, HAL will need to understand and reflect consumers' evolving needs and priorities in its business plan and approach to OBR to help rebuild consumer confidence. In doing this, HAL should both:
- update the SQRB scheme for the short term and recovery period; and
 - develop the H7 OBR framework and plan for continuous improvement over the longer term.
- 2.34 This work should be undertaken in parallel, and a modified form of the SQRB scheme should be appropriately brought together with HAL's work to develop the OBR framework. This approach is illustrated in Figure 1.

Figure 1: OBR strategy and methodology

2.35 Figure 1 refers to a “continuous improvement” approach to OBR that reflects consumers’ evolving priorities and preferences during H7. This broad approach was proposed in HAL’s IBP and should be adapted to meet the challenges of the new circumstances that the sector is facing.

2.36 We summarise below the three requirements for consumer engagement and OBR that we expect HAL to focus on for inclusion in the RBP:

- 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 (see Figure 1 above);
- HAL should consider which elements of its existing consumer research and engagement remain relevant for the RBP. HAL should refine and build on