

Economic regulation of Heathrow Airport Limited: working paper on capital expenditure efficiency incentives

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About this document

This working paper follows on from the June 2020 Consultation and provides further details of our proposed approach to capital efficiency incentives for Heathrow Airport Limited (“HAL”), including:

- a recap of our previous work in this area, including the initial views of stakeholders;
- our proposed criteria for developing new incentives; and
- further details on our broad approach to developing capital efficiency incentives.

Views invited

We welcome views on any of the issues raised in this working paper.

Please e-mail responses to economicregulation@caa.co.uk by no later than 9 October 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 Elly Shafran (elly.shafran@caa.co.uk).

Executive summary

Introduction

We explained in the June 2020 Consultation that we would focus on setting a price control for HAL that covered the operation of the existing two runways. This, combined with the impacts of Covid-19, means that we expect that less capital investment will be needed during the H7 price control period than previously anticipated. Nevertheless, a key objective of our policy for the H7 price control remains to create appropriate incentives on HAL to deliver capital investments efficiently. The difficult circumstances the aviation sector is facing means that that getting value for money from capital expenditure will be even more important. In this context, we have proposed an evolutionary approach to capital efficiency incentives and we intend to build on the approach used during the Q6 price control, including the “core and development” framework, while making improvements to it and setting clearer *ex ante* incentives for efficiency.

We recognise the stretch on resources that HAL, airlines and other stakeholders are experiencing. This working paper includes a significant amount of background information on our proposed approach. While this ensures a high level of transparency in our approach we recognise that some stakeholders may lack the resources to be able to absorb and comment on all of this information. Bearing this in mind we are happy to present our approach to stakeholders and explain key issues. Please contact elly.shafran@caa.co.uk if you would find it helpful to discuss the material in this working paper. We will also engage further with HAL and airline stakeholders to help further develop our approach to incentives during the remainder of 2020 and 2021.

1. This working paper sets out further details of the broad approach we intend to adopt for capital expenditure (“capex”) incentives for HAL’s next price control period (“H7”) which will begin on 1 January 2022. It follows on from earlier consultations on this issue.¹
2. The June 2020 Consultation highlighted that a key objective of our policy for the H7 price control is to create appropriate incentives for HAL to make capital investments efficiently. We consider that this remains a priority even with our focus changing to a two runway airport as the difficult circumstances that the aviation sector is experiencing as a result of the impacts of Covid-19 mean that efficiency and value for money will be particularly important.
3. Recognising the changed context since our earlier consultations on capex efficiency incentives,² we consider that an evolutionary approach is appropriate. Our proposal builds on the approach used during the Q6 price control period, including continuing with the “core and development” capex framework, while making targeted improvements for areas where particular issues have been identified.
4. In developing this approach, we have considered both the changing circumstances at Heathrow airport (including the pausing of capacity expansion and the impact of Covid-19 on the airport and airlines) and stakeholder responses to our recent consultations, as well as initial feedback from recent engagement with HAL and some airlines. We intend to continue to work closely with stakeholders to develop these incentive arrangements for H7.

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

² HAL decided to pause its expansion programme during March 2020 so our earlier consultations outlined our thinking on a capex incentive framework in the context of expansion at Heathrow airport. We have not considered expansion capex in this working paper. If expansion were to restart, we would need to consider appropriate efficiency incentives for expansion related capex.

Existing arrangements

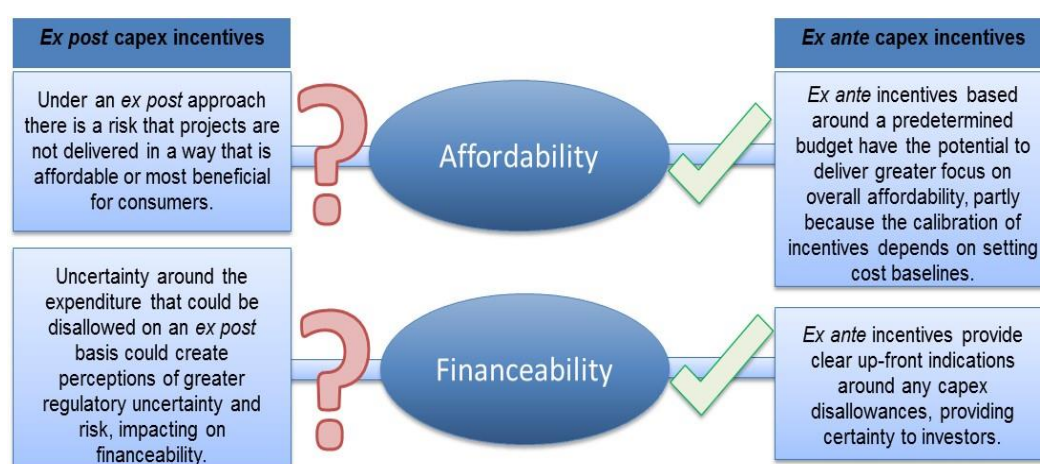
5. In setting HAL's Q6 price control, we relied on a number of mechanisms to encourage capital efficiency. These included:
 - the classification of capex as core or development spending, which allowed the price control to be flexible to the emerging capex needs of the airport;
 - the use of capex triggers which provided an incentive for HAL to deliver new capital projects on time and to deliver the full project scope that was specified;
 - airport/airline governance arrangements to help monitor spending during the price control period; and
 - the scope for *ex post* reviews of capex incurred by HAL, to disallow spending from HAL's Regulatory Asset base (RAB) if there were to be evidence of inefficient spending.
6. A full description of the existing capex arrangements is set out in Appendix C. As part of our ongoing engagement with HAL and airlines on these matters, we have identified scope to further develop and improve these incentive arrangements.

Our proposed improvements

7. We have previously consulted on introducing *ex ante* incentives to strengthen the existing capex efficiency arrangements so that HAL would bear a pre-determined share of any under- or overspend against the capex baseline used to set the price control.
8. The June 2020 Consultation outlined a broad approach to capex efficiency incentives which maintains the flexibility of the existing Q6 framework, and includes some new elements including *ex ante* incentives and improvements to the existing governance arrangements.
9. Building on the existing Q6 capex framework, our broad approach reflects the current uncertain and rapidly changing circumstances facing the

aviation sector, and Heathrow in particular, by being flexible to what the capex programme will look like for H7.

10. Our recent *ex post* reviews of capex to date have shown that assessing the efficiency of capex projects on an *ex post* basis is challenging. Not only is the *ex post* review of projects difficult and contentious, finding and quantifying evidence of inefficiency does not necessarily mean that the remaining expenditure has been incurred with the same level of efficiency that might be reasonably expected from an airport subject to strong competitive pressure. Therefore, we are seeking to further improve incentive arrangements.
11. Our proposed approach for H7 seeks to:
 - create stronger, more consistent and targeted cost incentives on HAL, encouraging greater focus on contract management;
 - place additional weight on project outcomes, creating stronger incentives on HAL to provide clearer scopes; and
 - strengthen and improve the existing capex governance process where necessary, ensuring projects are subject to appropriate stakeholder scrutiny and holding HAL to the agreed costs, deliverables and project deadlines.
12. We will continue to focus on cost efficiency and providing value for money for consumers, particularly given the uncertain times that HAL and airlines are facing. We consider that strong and clear *ex ante* incentives should provide benefits for affordability and financeability compared to an approach that relies heavily on *ex post* efficiency incentives as illustrated in Figure 1.

Figure 1: Supporting affordability and financeability

Source: CAA

Structure of this document

13. The rest of this working paper is structured as follows:
 - chapter 1 provides an overview of work we have undertaken to date to develop capex incentives for H7 and summarises stakeholder feedback to our consultations;
 - chapter 2 provides further detail on the criteria for developing new incentives which were set out in the June 2020 Consultation; and
 - chapter 3 provides further detail on our broad approach for efficiency incentives and outlines this could work in practice. It covers:
 - treatment of the different cost categories and incentive rates;
 - setting delivery obligations and timing incentives;
 - setting the cost baseline and dealing with uncertainty; and
 - reconciliation of incentives.
14. We set out our broad approach to capex governance arrangements in the June 2020 Consultation, that material is not repeated in this working paper.
15. We also set out in Appendix D an evaluation of our broad approach against a set of criteria that we consider are important for developing the H7 capex incentive framework.

Next steps

16. As outlined in the June 2020 Consultation, we will work with stakeholders to develop our broad approach to capex incentives further during 2020 and 2021.
17. Views are invited on any aspect of the issues raised in this paper, both through this engagement process and/or by stakeholders responding directly to this working paper. As noted at the start of the Executive Summary we would be happy to present key aspects of our approach to stakeholders so to facilitate timely and effective feedback.

Chapter 1

Our work to date and stakeholder views

- 1.1 We have engaged with stakeholders through formal consultations and informal discussions to develop our broad approach for capex incentives for H7. This chapter provides a summary of some of the key documents we have published and stakeholders' feedback on our recent consultations.
- 1.2 We have also engaged with HAL and some airlines to develop our approach for capex incentives further in the context of a two runway airport and we will continue to work closely with stakeholders during 2020 and 2021 to develop these arrangements for H7.

The March 2019 Consultation

- 1.3 In 2019, we commissioned CEPA to look at possible ways of implementing *ex ante* efficiency incentives for capex. The CEPA Report set out two main options for a new incentive regime:
- a “regulatory model” in which a single incentive rate is applied across all categories of capex (i.e. the whole capex programme) and measured against a fixed baseline subject to changes in the scope of projects actually delivered; and
 - a “governance model” in which the baseline capex is updated as projects mature, coupled with a strong incentive rate being applied to particular capex categories where appropriate (with other categories subject to *ex post* review or a weaker incentive rate).
- 1.4 In the March 2019 Consultation, we noted CEPA's work and stated that the regulatory model had some advantages over the governance model as the latter may not provide strong enough incentives. However, we also noted that the governance model would build on the existing framework and governance processes so might be easier to introduce.

HAL's Initial Business Plan

- 1.5 HAL proposed that the existing Q6 framework for capex incentives should continue in H7. HAL maintained its previous position that *ex ante* incentives would not be suitable for the expansion programme since this approach would reduce flexibility and could lead to higher, not lower, construction costs. HAL also estimated that *ex ante* incentives could add at least £6 per passenger to airport charges through the “expansion premium” to the allowed cost of capital.

The January 2020 Consultation

- 1.6 The January 2020 Consultation set out our intention to continue to develop the capex incentive framework for H7 and provided an update on our thinking in four key areas:
- the treatment of different cost categories;
 - setting delivery obligations;
 - setting the cost baseline; and
 - reconciliation of the incentives compared to the baseline and delivery obligations.
- 1.7 We had also planned to publish a working paper setting out a more detailed proposal in the spring of 2020. However, HAL decided to pause its work on expansion in March 2020 (following a decision by the Court of Appeal on the Airports National Policy Statement) and it has also had to start to deal with the impact of Covid-19. These factors have led to a significantly reduced capex programme for H7 that reflects the operation of a two runway airport. So, in place of that working paper, we held further informal discussions with HAL and some airlines on what this significant change in circumstances might mean for our broad approach to incentives for the H7 price control.

Stakeholder views

- 1.8 Most stakeholder responses to the January 2020 Consultation focused on a H7 incentive framework in the context of expansion, so we have not summarised all responses here.³ Nonetheless, elements of the responses that remain relevant to informing our approach to incentives in the context of a two runway airport are summarised below.
- 1.9 HAL considered that neither it, nor airlines, had any appetite to introduce new *ex ante* incentives. Instead, HAL said parties should work together to improve the current framework. It suggested that the package of measures should be “holistic” and aim to optimise cost, time and quality, while providing flexibility to adjust to unforeseen circumstances and to meet the changing requirements of consumers, airlines and the airport.
- 1.10 HAL considered that the existing core and development capex framework provides strong, “hard” financial incentives on HAL to deliver capex efficiently, and that these incentives appear underestimated or misunderstood. It set out a stylised summary calculation of the Q6 approach, which it said demonstrated that the existing framework includes an implied *ex ante* financing cost incentive mechanism.⁴ HAL’s example demonstrated that the average incentive rate over Q6 is around 13% because HAL does not recover the financing costs associated with any overspend or underspend against the capex baseline agreed at Gateway 3.
- 1.11 HAL considered that the risks that incentives focus on need to be clearly articulated. It argued that there are multiple distinct risks in capital investment, not all of which can necessarily be incentivised simultaneously.

³ A full set of stakeholders’ responses to the January 2020 Consultation can be found on our website. See: <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Consultations-and-policy-documents/>.

⁴ Discussed further in Appendix C.

- 1.12 HAL also stated that it did not oppose making improvements to the current framework, if this resulted in positive outcomes for all stakeholders and suggested that this should be discussed as part of CE.
- 1.13 VAA said that it would be open to exploring new *ex ante* capex incentives, if there was evidence that this approach could protect consumers from the risks of cost escalation. However, it was concerned that *ex ante* incentives could overcomplicate the regulatory process or lead to regulatory “gaming” by HAL when it initially estimates its capex programme costs.
- 1.14 IAG supported our position that HAL should have a package of measures that allows for efficient financing but that also strongly incentivises HAL to deliver projects on budget. It also said that HAL should be incentivised to deliver projects on time and within a scope that achieves the agreed benefits.
- 1.15 IAG supported strong incentives on HAL to ensure it acts in a commercial way. It considered that HAL’s mismanagement and subsequent inflation of early expansion costs demonstrates that the current mechanisms in place to promote efficient capex are not fit for purpose and are not taken seriously by HAL. It suggested that a mixture of *ex ante* and *ex post* incentive mechanisms would provide the greatest protection to consumers in the future and that a strict governance protocol will be needed to support the incentive arrangements.
- 1.16 Heathrow West considered that the increases in early expansion costs demonstrates that HAL has a weak control of its costs. However, it was not convinced that more regulatory incentives would address this fundamental problem because HAL is rewarded for the capex it incurs and noted that as part of its *ex post* assessment of capex, the CAA has rarely disallowed costs that had been incurred by HAL.
- 1.17 RHC broadly supported our proposed approach. It suggested that it was not unreasonable for airlines and their customers to be required to absorb some risks, such as demand risk, as these are reflected in consumer prices. However, when designing capex incentives, it will be important to

focus on the contingency costs that are included in the capex baseline, and controls for releasing those contingencies as the project progresses.

The June 2020 consultation

- 1.18 In the light of this feedback, we confirmed in the June 2020 Consultation that a key objective of our policy for the H7 price control would be to create appropriate incentives for HAL to make capital investments efficiently. We said that this would remain 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 capex would be even more important.
- 1.19 We provided a high-level proposal of our broad approach for capex efficiency incentives which builds on the Q6 capex framework and includes improvements where appropriate. We said that we will publish further details on our proposal for H7 as part of this working paper.