

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

CAP 2139



Published by the Civil Aviation Authority, 2021

Civil Aviation Authority,
Aviation House,
Beehive Ring Road,
Crawley,
West Sussex,
RH6 0YR.

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA.

First published April 2021

Enquiries regarding the content of this publication should be addressed to: robert.toal@caa.co.uk

The latest version of this document is available in electronic format at www.caa.co.uk/CAP2139

Contents

Contents	3
About this document	5
Views invited	5
Executive summary	6
The Way Forward for the H7 programme	6
Recent developments	6
Overall approach to the H7 control	8
HAL's revised business plan	9
Furthering the interests of consumers	11
Timetable	14
Our duties	15
Next steps and views invited	15
Structure of this document	15
Chapter 1	16
Our Initial Assessment of HAL's RBP	16
Introduction	16
Background	16
Summary of Key Elements of the RBP	17
Our approach to assessing the RBP	21
Summary of our assessment	22
Our overall approach to developing projections to inform the initial proposals	25
Key issues for consultation	26
Chapter 2	27
Developing projections for the Initial Proposals	27
Introduction	27
Passenger forecasts and scenarios	27
Opex	30
Commercial Revenues	35

Capex	39
Key issues for consultation	43
Chapter 3	44
Financial Framework	44
Introduction	44
Our previous statements and stakeholders' responses	45
Capital structure and the impact of the covid-19 pandemic	46
Determining the allowed return	50
How we will assess debt financeability	52
How we will assess equity financeability	54
Affordability and the profiling of revenues	55
Allowance for corporation tax	57
Key issues for consultation	58
Chapter 4	60
Incentives	60
Introduction	60
Risk sharing mechanisms	60
Capex incentives	65
Key issues for consultation	72
Chapter 5	73
Outcome Based Regulation	73
Introduction	73
Background	73
HAL's proposed approach to OBR	75
Airline views	77
CAA Initial Views	79
Next steps	83

Appendices to support this document have been published separately:

[Appendices to Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward \(CAP2139A\)](#)

About this document

This consultation summarises our broad approach to the remainder of the Heathrow Airport Limited (“HAL”) H7 price control review programme. It provides:

- an update on the timetable and recent developments for the review. Our response to HAL’s request for a covid-19 related Regulatory Asset Base (“RAB”) adjustment is set out in a document published alongside this one;
- an overview of our proposed approach to the form of regulation for HAL, including our intention to set a 5-year price control;
- our assessment of HAL’s revised business plan (“RBP”) including our proposed approach to developing projections for each of the key price control “building blocks” that will inform our Initial Proposals due to be published this summer; and
- an update on our approach to introducing traffic or revenue risk sharing, developing stronger capital efficiency incentives, moving towards outcome based regulation (“OBR”), and our approach to assessing HAL’s financeability and the affordability of its charges.

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 5 as well as appendices H, J, K, L, M and O.

Please e-mail responses to economicregulation@caa.co.uk by no later than 18 June 2021. 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 expire. 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 Rob Toal (robert.toal@caa.co.uk).

Executive summary

The Way Forward for the H7 programme

1. During the last four years, we have published a number of consultations and working papers on the economic regulation of Heathrow Airport Limited (HAL) from 1 January 2022 (the “H7” price control period).¹ This consultation summarises our broad approach to the remainder of the H7 price control review programme, including the changes we are making to accommodate the impact of the covid-19 pandemic.
2. There is significant ongoing uncertainty over the likely pace and strength of the recovery from the very large reductions in passenger numbers caused by the pandemic. In the light of this uncertainty, we are seeking to develop an approach such that the price control arrangements can be set in way that accommodates a range of different passenger traffic scenarios. Nonetheless, the combination of lower passenger volumes, HAL’s large RAB and that some elements of its cost base do not change in proportion to changes in passenger numbers, are likely to put upward pressure on airport charges per passenger. We will take steps to smooth the path of prices over the period of the H7 price control but this is unlikely to fully mitigate the upward pressure on prices created by current circumstances.
3. We will closely monitor developments over the coming months to determine how best to deal with the evolving uncertainty. If necessary, we will make further changes to our approach ahead of our Initial Proposals for the H7 price control (scheduled for publication in the summer of 2021).

Recent developments

The impact of the covid-19 pandemic on passenger numbers

4. The covid-19 pandemic continues to have a very large impact on the aviation industry. Passenger numbers at Heathrow airport over 2020 were 73% lower than they were in 2019. The impact of ongoing travel restrictions, including legal restrictions on travelling and quarantine measures both in the UK and overseas, continues to make the path of

¹ All our consultations on the H7 price control can be found at: <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Consultations-and-policy-documents/>.

recovery highly uncertain, particularly in the earlier years of the H7 control period.

5. HAL has produced a range of traffic forecasts in its Revised Business Plan (“RBP”), with its “high” case reflecting a relatively strong recovery in traffic and its “low” case a significantly slower recovery. We discuss these forecasts further in chapter 1 and chapter 2. As noted above, a key challenge will be setting HAL’s price control in a way that protects consumers across an appropriately wide range of passenger traffic scenarios. Scenarios with lower traffic levels are likely to be particularly difficult with significant upward pressure on HAL’s charges. Dealing with these issues will be central to our approach to setting the price control.
6. We would particularly welcome further views and evidence from stakeholders on the best approach to assessing the affordability of airport charges for H7 and how any such approach would further the interests of consumers, including allowing essential investment in airport services to be reasonably financed. We acknowledge that this is a challenging area given the present uncertainty and will focus on these matters in developing Initial Proposals. Consistent with the approach we have adopted to date we will also continue to consult the CAA Consumer Panel on how we should further the interests of consumers, including our approach to affordability.

HAL’s request for a covid-19 related RAB adjustment

7. In response to the impact of the covid-19 pandemic, HAL made a request to the CAA in July 2020 for a significant upward adjustment to its RAB from 2022 to help protect it from the adverse financial consequences of the reduction in passenger volumes. We have been assessing HAL’s request in accordance with our statutory duties and issued consultations in October 2020² and February 2021³ on whether intervention would be warranted in the context of the current (“Q6”) regulatory settlement and the commercial deal between HAL and airlines for 2020 and 2021.
8. We have published our decision on the RAB adjustment ahead of the H7 price review alongside this document. In this we conclude that we should make a targeted intervention that would provide for a £300 million increase in HAL’s RAB from 2022 to provide more assurance that HAL has the incentive to make investments and spend money to provide good quality consumer outcomes during the recovery. In addition to this immediate

² See: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment (CAP1966) (the “October 2020 Consultation”) <http://www.caa.co.uk/CAP1966>

³ See: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment (CAP1966) (the “February 2021 Consultation”) <http://www.caa.co.uk/CAP2098>

intervention, we have committed to consider whether a further RAB adjustment would be appropriate as part of the H7 price control review. This assessment will be an important component of our work on HAL's financeability, its cost of capital and the affordability of airport charges.

Other CAA consultations

9. In addition to considering HAL's request for a covid-19 related RAB adjustment, we have continued developing the regulatory framework for the H7 period through working papers on:
- capital expenditure ("capex") efficiency incentives;
 - the efficiency of HAL's capex incurred during Q6; and
 - the treatment of early expansion costs.
10. These papers are available on the H7 page of the CAA website.⁴

Supreme court decision on the Airports National Policy Statement (the "NPS")

11. We said in the April 2020 Consultation that work on HAL's H7 price control would focus on a "two runway" airport. This reflected the impact of the covid-19 pandemic and the Court of Appeal's decision that the NPS had not been lawfully produced. In December 2020, the Supreme Court reversed the decision of the Court of Appeal, ruling that the Government's decision to designate the NPS had been lawful. As a result, the legal effect of the NPS was restored.
12. Nonetheless, we consider that a "two runway" approach to the H7 price control remains appropriate and reflects the wider circumstances faced by the aviation industry. Further, HAL has said that it will reflect on the Supreme Court decision and consult with stakeholders before setting out the next steps for capacity expansion. We will consider any regulatory issues related to expansion through a separate workstream should the need arise.

Overall approach to the H7 control

13. We remain of the view that regulating prices and service quality is the most appropriate form of regulation for HAL and is the best way for the CAA to

⁴ [H7 Consultations and Policy documents](#)

further the interest of consumers as we are required to do by our statutory duties. We are currently minded to:

- develop a five-year price control to cover the period from 1 January 2022 to 31 December 2026. The intention to set a five-year price control is supported by HAL and airline stakeholders. We will, however, continue to keep this under review through the rest of 2021 as we understand more about the ongoing impact of the covid-19 pandemic;
- base that price control on the “building block” approach used for the Q6 and previous price controls (including using the existing RAB based approach and a “single till” to calculate the level of airport charges);
- deal with the uncertainty in future passenger traffic volumes by considering (i) a range of scenarios for passenger traffic and the impact of these scenarios on HAL’s costs and commercial revenues, and (ii) developing passenger traffic or revenue risk sharing arrangements; and
- to the extent appropriate and practicable, use conventional regulatory levers (such as the profiling of revenue or regulatory depreciation) to develop a price control that delivers affordable charges for consumers and supports the financeability of HAL’s investment programme.

14. Nonetheless, we are very conscious of the challenges and uncertainties created by the impact of the covid-19 pandemic. Bearing these issues in mind we will keep our approach under review with the aim of protecting consumers and supporting the recovery in traffic at Heathrow airport. If circumstances were to dictate a different approach to the form of the price control (or way we set the control) we would not rule out changing our approach, but we would continue to seek to ensure essential investment by HAL remains financeable and charges to airlines (and so passengers) remain affordable.

HAL’s revised business plan

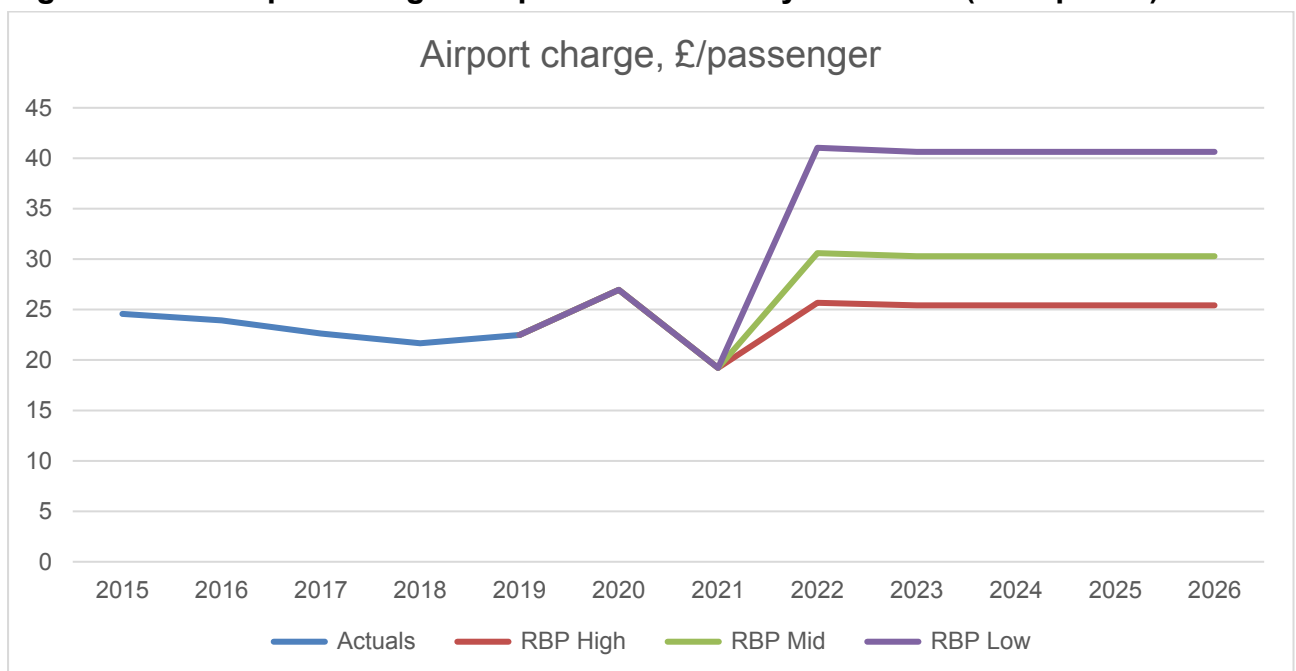
15. In the June 2020 Consultation, we set out key principles and guidance for HAL to produce a high-quality business plan, informed by the needs of consumers and stakeholders.⁵ HAL issued its RBP on 18 December 2020.

⁵ <https://caa.co.uk/CAP1940> Appendix E of the June 2020 Consultation, referred to as “the June 2020 Business Plan Guidance”.

HAL said that the RBP reflects the in-depth consultation with airlines undertaken through Constructive Engagement (“CE”) in 2020.

16. HAL’s RBP “base case” would lead to very significantly increased airport charges compared to the Q6 price control period. HAL’s base case for H7 assumes an average charge of £30 per passenger compared to around £20 in 2021. The RBP “low” case would lead to charges of £40 per passenger and the “high” case £25 per passenger as set out in Figure 1 below.

Figure 1: RBP airport charge compared to last five years of Q6 (2018 prices)



Source: HAL Regulatory Accounts and RBP

Note: Actuals from 2015 to 2019

17. While we recognise that the RBP is an extensive and detailed document and has been developed in difficult circumstances, there are a number of elements of the plan that do not comply with the aspirations set out in our Business Plan Guidance. In particular, the absence of properly integrated alternative scenarios limits the effective assessment of the plan as a whole and the RBP does not fully meet the requirements for a high-quality plan that adequately addresses the needs of consumers and stakeholders.
18. Further, in a number of areas, the plan lacks sufficient detail to enable the CAA and other stakeholders to scrutinise the proposals properly. This is particularly evident in HAL’s estimated capex envelope of £3.5 billion, which is based almost entirely on “top-down” projections rather than on an assessment of the costs of specific projects and programmes supported by structured business case analysis and cost estimates.

19. Nonetheless, we acknowledge the particularly difficult circumstances that HAL has been dealing with, while also developing its RBP. We also recognise the efforts it has made to establish an approach to passenger forecasting that addresses some of the uncertainties created by covid-19. HAL has also already committed to providing more comprehensive information in a number of important areas, including capex.
20. Airlines have also raised concerns with HAL's RBP, stating that it:
 - focuses too much on rewards for shareholders at the expense of consumers; and
 - has failed to reflect the reality of what other businesses within the industry have been required to do in response to the impact of the covid-19 pandemic.
21. In response to these concerns, airlines have provided us with an updated alternative assessment based upon further information from HAL as well as third party consultancy support on commercial revenues, operating costs and the cost of capital. The airline assessment would imply average airport charges significantly lower than those proposed by HAL.
22. Further details of our assessment of the business plans submitted by each of HAL and airlines are set out in chapters 1 and 2 and in the appendices. These chapters also describe our broad approach to building on the work HAL has set out in its RBP to produce the projections of each of the key revenue building blocks that will support our development of Initial Proposals.

Furthering the interests of consumers

23. We are developing the regulatory framework for HAL in a way that is consistent with our statutory duties, so to discharge our primary duty to further the interests of consumers. With that in mind, we are proposing the following developments to the existing regulatory arrangements.

Traffic / revenue risk sharing

24. In the June 2020 Consultation we said that there was a strong case for including some form of traffic risk sharing mechanism in HAL's next price control. We noted that such a mechanism could avoid unnecessary upward pressure on the cost of capital and stated that we would consider possible options for developing such arrangements.
25. Reflecting the current and ongoing difficulties associated with traffic forecasting, we are confirming our intention to introduce new arrangements

for traffic or revenue risk sharing. More work is required over the coming months on the design and calibration of these arrangements, as well as on the interaction with other elements of the regulatory framework (including how such arrangements would prevent undue upward pressure on HAL's cost of capital and level of allowed returns).

Updating our approach to financeability and affordability

26. Chapter 3 on the financial framework builds on the discussion set out in the June 2020 Consultation and explains how we will take account of HAL's financeability and the affordability of its charges in setting the H7 price control. This includes:
- the assumptions we will make on capital structure (i.e. the amount of debt and equity appropriate to finance HAL's RAB) that support both our assessment of financeability and the calculation of the cost of capital;
 - our broad approach to setting the level of allowed return on debt and equity finance (with the overall allowance for the cost of capital important to both the overall level of charges and the incentives of HAL to fund new investment);
 - how we will assess both debt and equity financeability;
 - our approach to the profiling of regulatory depreciation and revenues to support the affordability of airport charges; and
 - how we intend to make allowances for corporation tax.
27. Our work on financeability will also involve considering a number of the issues that HAL has raised in its request for a covid-19 related RAB adjustment. The overall aim is to both support HAL's access to financial markets on reasonable terms so it can finance reasonable levels of investment and set airport charges in a way that is affordable for passengers and the users of cargo services.

Capex efficiency incentives

28. Over the last four years, we have consulted on our approach to capex efficiency incentives for the next price control, with a key objective of creating stronger and clearer incentives for HAL to make capex investments efficiently. This remains a priority for H7, even in the context of a two runway airport.
29. We remain of the view that improvements to capex efficiency incentives are best achieved through the careful introduction of forward looking

incentives. This offers a number of important advantages over the current system of after the fact reviews. These reviews have been challenging to carry out in practice and may not have provided a sufficiently strong incentive for HAL to ensure efficiency across all of its capex programme.

30. Our proposed approach builds on the well-established capex governance arrangements from Q6 including the role of airlines, particularly around the initial selection of projects. HAL's performance will be assessed against baselines that will be updated during the H7 control period to reflect more accurate capex requirements and cost information as it becomes available. We consider that this should provide an appropriately flexible approach and more targeted incentives for HAL to manage the risks that it faces in relation to capex, and so should better serve the interests of consumers.

Outcome based regulation (OBR)

31. The regulatory regime for HAL should incentivise the delivery of the outcomes that consumers value. OBR will contribute to delivering this objective and we are developing the current output-based approach to service quality regulation to provide stronger incentives on HAL to focus its attention on what consumers value.
32. As part of its RBP, HAL developed six overarching consumer outcomes, based on detailed research that it considers should provide the foundation of its business plan and for the OBR framework. HAL also proposed:
- that the OBR framework should include thirty-six service quality measures which include most of the current Service Quality Rebate and Bonus scheme ("SQRB") measures and introduce several new reputational measures; and
 - to focus on maintaining Q6 service levels in H7 and make targeted improvements in areas that HAL considers matter most to consumers.
33. Airlines have also made an OBR proposal based on twenty-five service quality measures and targets, some of which align with HAL's proposals, and which they consider reflect the outcomes that consumers want. The airline proposals are based on a "journey mapping" approach to identify key elements of the passenger's journey through the airport and the operational processes for which HAL is responsible.
34. We very much welcome this focus on consumer outcomes by both HAL and airlines and consider that good progress has been made particularly on measures. We also welcome the principle of reviewing and updating the OBR framework during H7 to ensure it remains agile and can evolve

periodically to reflect consumers' changing priorities and wider covid-19 related developments. Further work is now required over the coming weeks, building on our initial views set out in chapter 5, to develop and improve the existing proposals. We expect HAL to take the lead by engaging with airlines to work towards producing an updated OBR framework and to have narrowed down or eliminated areas of disagreement.

Timetable

35. In light of the impact of the covid-19 pandemic, we have been working with stakeholders to review the timetable to understand whether changes to the timeline we published in April 2020 may be required.
36. To this end, we confirmed in February 2021⁶ that we intend to extend the timetable for the H7 price control review so that our final proposals, and the proposed licence modifications necessary to give them effect, will now be issued in December 2021. Taking this approach should allow:
- sufficient time for the CAA to build a reasonable understanding of how we will address the uncertainty over traffic forecasts;
 - HAL the opportunity to develop and provide updated forecasts based on the evidence emerging during this year; and
 - appropriate time for us to consult stakeholders on our approach.
37. The updated H7 timetable is set out in Appendix C and includes the publication of our Initial Proposals in Summer 2021. In practice, the timetable means that the licence modifications will take effect in March 2022 at the earliest, at least three months after the end of the current Q6 price control. However, our intention is to develop modifications that apply to HAL's revenues for the full year from 1 January 2022.
38. We will keep these timings under close review noting that the continued uncertainty over recovery from the impact of the covid-19 pandemic may require us to make further changes.

Licence modifications

39. The proposed changes to the regulatory framework for the new H7 price control will require us to make extensive changes to HAL's licence to

⁶ [CAA letter to HAL on timing of H7 price control](#)

implement the new arrangements. We will set out more detailed information on licence modifications as part of the Initial Proposals.

Our duties

40. 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.

Next steps and views invited

41. We welcome views on all of the issues raised in this document and, in particular, the issues set out in the set out in the executive summary and those highlighted in chapters 1 to 5 as well as appendices H, J, K, L, M and O.
42. Please e-mail responses to economicregulation@caa.co.uk by no later than 18 June 2021.

Structure of this document

43. The structure of this consultation document is as follows:
- chapter 1 sets out our overall assessment of HAL’s RBP;
 - chapter 2 provides further information on how we will develop our projections of price control building blocks for the Initial Proposals;
 - chapter 3 discusses the financial framework;
 - chapter 4 considers incentives in relation to traffic/revenue risk sharing and capital efficiency;
 - chapter 5 sets out further details on the move towards OBR; and
 - the appendices provide further information on the main issues set out in this consultation.

Chapter 1

Our Initial Assessment of HAL's RBP

Introduction

- 1.1 This chapter covers our approach to the assessment of HAL's RBP for the H7 period, including:
- background to the development of the RBP building on our June 2020 Business Plan Guidance;
 - a summary of the key elements of the RBP and our approach to assessing the plan;
 - our initial assessment of the key issues; and
 - our broad approach to developing our own projections to inform our Initial Proposals for H7.
- 1.2 HAL's RBP is an extensive and detailed document with the published version running to just under 600 pages in length. The plan is supported by 43 annexes which provide further detailed information on many elements of the building blocks. Over the last four months, we have carefully reviewed this material and a summary of the issues most pertinent to economic regulation and the H7 price control are set out here.

Background

- 1.3 In the June 2020 Consultation, we set out key principles and guidance for HAL to produce a high-quality business plan, informed by the needs of consumers and stakeholders. This included guidance for the RBP as a whole, and for each main element of the regulatory framework. We also recognised the need for flexibility given significant ongoing uncertainties on the potential recovery in traffic volumes. We explained that HAL could also develop alternative proposals or solutions in its RBP to meet our requirements, but that these should be properly explained and supported by evidence.
- 1.4 In the light of the impact of the covid-19 pandemic, HAL issued a revised financial forecast and accompanying narrative in July 2020 which it referred to as a building block update ("BBU"). This was intended to update the baseline in its initial business plan ("IBP") to reflect the pausing of expansion and the initial impact of the covid-19 pandemic. The BBU noted

the uncertainty over its forecasts and provided illustrative “high” and “low” scenarios for traffic and other building blocks which implied a range for airports charges over H7 of around £22 to £30 per passenger (2018 prices).

- 1.5 Once HAL issued the BBU, a period of CE with airlines started, which ran between August 2020 and October 2020. CE is the process for engagement between HAL and its airlines customers as part of the H7 price control process. The focus of the CE discussions was on how the BBU could be developed into a robust business plan and included discussions on all key elements of the price control.
- 1.6 In response to CE, in October 2020 airlines provided us with their own "Alternative Business Plan" for H7 that set out their views on the individual building blocks and the overall level of charges. Airlines also noted that their plan was not final and would be subject to change dependent on passenger volumes or as further information became available.
- 1.7 HAL issued the RBP on 18 December 2020 (with a redacted version of the full RBP published by HAL on its website on 25 February 2021).⁷ HAL stated in the RBP that the plan reflects the in-depth consultation with airlines undertaken through CE.

Summary of Key Elements of the RBP

- 1.8 The RBP covers all building blocks and other elements of the H7 price control. The central case (or “Mid”) scenario assumes that HAL can recover the full covid-19 related RAB adjustment that it first requested in July 2020.
- 1.9 The RBP presented three scenarios for passenger numbers through H7, referred to as the “Low”, “Mid”, and “High” scenarios. However, a fully integrated set of cost and revenue estimates and narrative was presented only for the Mid scenario. The basis for these traffic scenarios is described in more detail below (in the sub-section on “passenger numbers”). HAL also set out three types of high-level sensitivities around its Mid plan and sought to demonstrate how these sensitivities deliver on consumer outcomes and affordability compared to the base case. The three sensitivities focused on:
 - the number of passengers;
 - the CAA’s decision on the covid-19 related RAB adjustment; and

⁷ See

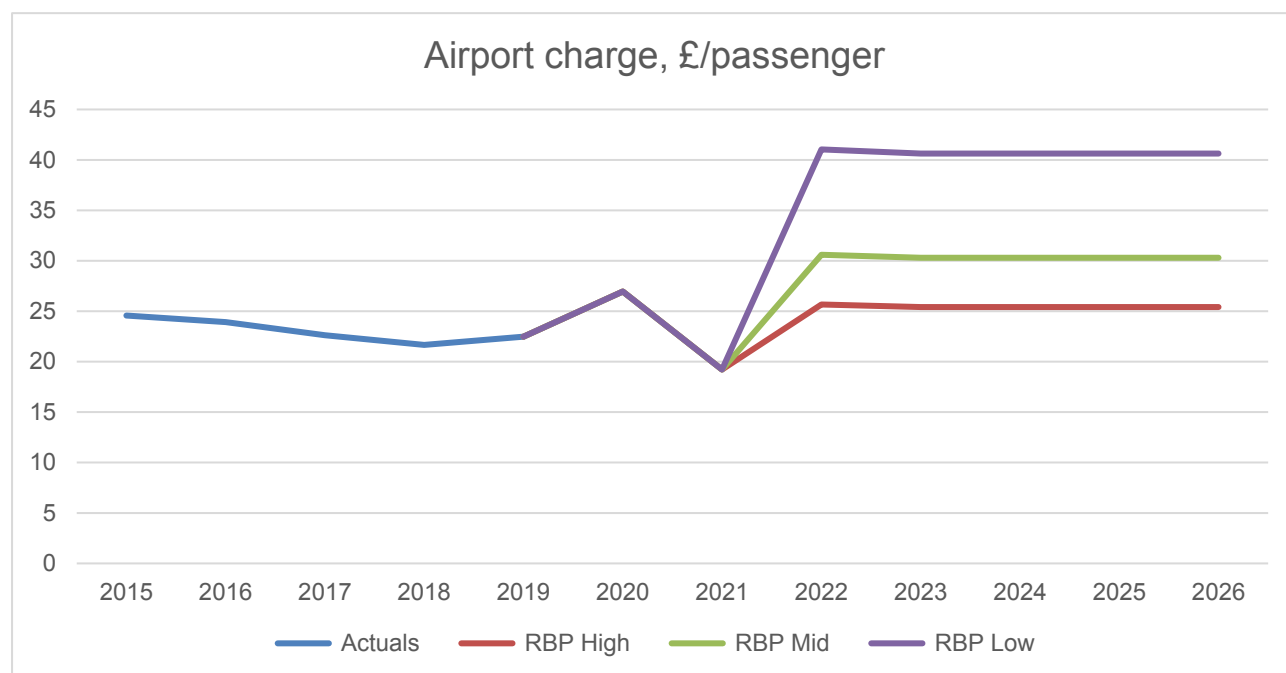
<https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/RBP-detailed-plan.pdf>

- the length of the regulatory period.

Airport charges

1.10 HAL's RBP provides for an increase in airport charges compared to the Q6 and iH7 periods in each of the three scenarios considered (see Figure 1.1).

Figure 1.1: RBP airport charge compared to 2015-2019 (2018 prices)



Source: HAL Regulatory Accounts and RBP

Note: Actuals from 2015 to 2019

1.11 Table 1.1 summarises the key assumptions and estimates which HAL used to construct its Mid case scenario, for the key cost and revenue building blocks and financial parameters/building blocks respectively.

Table 1.1: RBP Mid case building block forecasts 2022 – 2026 compared to Q6 determination average 2015-2018 (2018 prices)

	Q6 (2015- 2018)	2022	2023	2024	2025	2026	H7 Total
Opex	1,162	1,052	1,108	1,150	1,166	1,171	5,647
Depreciation	785	250	237	190	208	228	1,113
Return on capital	873	1,455	1,478	1,513	1,558	1,609	7,613
Total revenue requirement	2,820	2,757	2,823	2,853	2,932	3,009	14,374
Non-aero revenues	1,119	775	884	924	979	998	4,560
Net revenue requirement	1,701	1,982	1,939	1,930	1,953	2,010	9,814
Passengers (million)	73	52	61	67	72	75	326

Source: HAL Regulatory Accounts, RBP

Note: The Q6 column shows the annual average from the Q6 determination from 2015-2018

Note: Figures exclude cargo revenue

Passengers, costs and revenues

1.12 Passenger volumes are a key driver of both costs and revenues. Changes in passenger numbers directly affect the revenue from airport charges and normally:

- result in changes in the expenditure that is required to run the airport effectively; and
- feed through into changes to commercial and other revenues for HAL through spending at the airport or use of HAL services such as rail and car parking.

1.13 HAL's RBP Mid scenario suggested that a full recovery of passenger numbers back to 2019 levels will not happen even by the end of the H7 period. HAL's forecasts in the RBP also suggested that the reduction in passenger numbers will result in significant impacts for the other building blocks in H7. Opex is forecast to reduce by significantly less than the fall in

passenger numbers as a proportion of the 2019 figure, so that opex per passenger will increase. By contrast, non-aeronautical revenues are forecast to reduce by significantly more than passenger numbers, so that non-aeronautical revenue per passenger will be lower in H7 than in Q6.

- 1.14 This partly reflects HAL's RBP assumption that revenues are more variable to changes in passenger numbers than opex. However, the forecast impact on non-aeronautical revenues is also compounded by the estimated impacts of airside tax free shopping policy changes that took effect from 1 January 2021 (as well as other factors discussed further in chapter 2).
- 1.15 HAL has proposed a capital plan totalling £3.5bn of spend over H7. The capex plan is designed around three strategic capital portfolios:
- "Protect the Business" (£2.1bn): the minimum level of investment, in any future scenario, to ensure Heathrow is safe and compliant";
 - "Win the Recovery" (£1.1bn): an amount to respond to near-term challenges presented by the covid-19 pandemic, drive efficiency and cut costs or generate commercial opportunities while also improving the environment for consumers in H7; and
 - "Build Back Better" (£0.3bn): an amount to respond to longer term challenges to Heathrow and the sector, including the need to decarbonise and improve surface access links.

Financial framework

- 1.16 HAL's approach to financial issues is closely linked with the representations it has made with respect to the case for a RAB adjustment designed to provide it with substantial protection from the financial losses it has experienced as a result of the impact of covid-19.
- 1.17 HAL has assumed a RAB adjustment of £2.6 billion and suggests that this will lead to a cost of capital of 8%, in contrast to 9.5% without a RAB adjustment. HAL argues that a RAB adjustment would signal to investors that the CAA will protect it from significant volume downside risk which will lead to those investors requiring a lower return than they might otherwise. It also says that the RAB adjustment will facilitate the profiling of regulatory depreciation in the H7 period, which will keep airport charges lower than they would otherwise be.

Other key elements of the regulatory framework

- 1.18 Other key elements of the overall H7 framework covered in the RBP and dealt with in this document are:

- the overall regulatory framework underpinning the H7 price control including traffic risk sharing and possible arrangements to provide for price control reopeners (see chapter 4 and Appendix D);
- H7 capex efficiency incentives (see chapter 4);
- incentives for HAL to deliver high quality services to consumers, under the OBR framework (see chapter 5); and
- Other Regulated Charges ("ORCs"), surface access, resilience, and cargo: see Appendix F.

Our approach to assessing the RBP

1.19 Since receiving HAL's plan, we have worked to understand the basis for HAL's proposals. Our assessment framework comprised three stages, with increasing levels of granularity:

- a compliance review: on receipt of HAL's plan, we assessed compliance with the June 2020 Business Plan Guidance, with reference to Section 11 of the RBP (Assurance).⁸ Our detailed assessment of compliance for each of the criteria in the June 2020 Business Plan Guidance is summarised in the next chapter and presented in more detail in Appendix E.
- review of the full plan: we have reviewed all sections of the RBP, highlighting any high priority (or "Red Flag") issues; and
- "deeper dive" analysis of the RBP: areas where we have looked in greater detail at the evidence available, including:
 - i. historical data, such as HAL's regulatory and statutory accounts;
 - ii. relevant industry benchmarks or comparative data, for example unit rates for opex for other comparable airports; and
 - iii. submissions by airlines in relation to the RBP.

⁸ See the section "Meeting the CAA's business plan criteria" in Section 11.6 of <https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/economic-regulation/RBP-detailed-plan.pdf>

Summary of our assessment

Summary of compliance review

- 1.20 We recognise that the RBP is an extensive document, which reflects significant work by HAL in partnership with other stakeholders, and the difficult circumstances that HAL has had to deal with while producing its RBP. However, while some aspects of the RBP were consistent with our requirements, several elements of the RBP do not meet our requirements and criteria for a high quality business plan set out in our June 2020 Business Plan Guidance document.
- 1.21 Our assessment of the compliance of the RBP with our June 2020 Business Plan Guidance criteria is summarised in Table 1.2 below for each category of information. This uses a Red/Amber/Green (RAG) approach to show overall compliance for that category. The table shows whether the RBP complies with our criteria for several categories. Specific categories which do not comply with the criteria are highlighted in the table.
- 1.22 Appendix E presents our detailed assessment for each of the criteria. That appendix also provides more details on our assessment for each of the elements of the RBP that we assessed.

Table 1.2: Summary of our compliance assessment

Category	Number of Criteria	Compliance with CAA June 2020 criteria	Summary of key non-compliances	Overall RAG rating
General	4	1 compliant; 2 partially compliant; 1 non-compliant	There is a lack of meaningful integration across different elements of the RBP, and in particular the quantitative building blocks.	
Scenarios for passenger numbers	2	2 partially compliant;	Traffic scenarios are not transparently integrated with other key elements of the plan.	
Consumer engagement and OBR	3	3 partially compliant	HAL has made a clear effort to understand consumer priorities in a post-covid-19 environment, but there is scope to better use the findings from its research as part of its plan.	

Category	Number of Criteria	Compliance with CAA June 2020 criteria	Summary of key non-compliances	Overall RAG rating
			While progress has been made on measures, we note that HAL's proposed targets and incentives would result in a more generous service quality framework in terms of financial exposure in H7 compared to Q6.	
Capex	3	3 non-compliant	The RBP capex plan lacks evidence and required detail. The top-down capex plan does not provide a basis for setting a core capex allowance or baseline for H7.	
Capex Efficiency Incentives	3	2 partially compliant, 1 non-compliant	The RBP does not define delivery objectives or obligations that can be used for the H7 capex incentive framework.	
Opex & Commercial Revenues	3	3 partially compliant	Links between opex and commercial revenues and the capex plan are not well evidenced.	
Cost of Capital	2	1 partially compliant, 1 non-compliance	The use of a pre-tax WACC is not justified.	
Financeability & Financial Modelling	4	4 partially compliant	HAL's assessment of several areas of financeability (e.g. equity financeability, credit rating) was limited. HAL conducted analysis for its RBP using its own model, and a reconciliation to the PCM was only provided in March 2021.	
ORCs	2	2 partially compliant	HAL has provided a clear rationale for its proposals, but more information is needed in some areas, like HAL's forecast and how ORCs	

Category	Number of Criteria	Compliance with CAA June 2020 criteria	Summary of key non-compliances	Overall RAG rating
			would be included in any risk-sharing mechanism.	
Resilience	2	2 compliant	HAL's proposals in this area are overall robust and we are supportive of the proposal for a joint resilience plan.	

1.23 A summary of overarching and other issues arising from our RBP assessment is set out below.

Overarching issues

1.24 HAL's business plan was prepared against a backdrop of significant uncertainty about passenger numbers, revenues and costs. While the RBP does include some information on a range of alternative passenger scenarios, these do not appear to be fully integrated across the building blocks, as required by our guidance. In particular:

- the revenue and cost building blocks are not clearly linked to alternative passenger scenarios within the plan;
- the capex plan is neither sufficiently well developed nor integrated with the rest of the plan; and
- key elements of the plan, such as OBR service performance targets and opex forecasts, appear to be based on the capex envelope of £3.5bn. There is a lack of analysis of the impact of lower levels of capex that might better reflect the circumstances of a central case forecast of relatively low passenger numbers compared to Q6 levels.

1.25 Airlines also consider that the RBP fails to develop integrated scenarios properly, and so continues to be a series of building blocks that do not clearly complement or respond to each other⁹. Specifically, they disagree with HAL's assessment that the RBP addresses requests from both the

⁹ Airlines' views on the RBP are set out in their March 2021 "Initial Comments to Heathrow's Revised Business Plan", shared with the CAA and HAL.

Airline Community and CAA for the development of “scenarios” based on alternative passenger forecasts.

- 1.26 The absence of properly integrated alternative scenarios significantly constrains the effective assessment of the plan as a whole, and results in a plan that does not fully meet the requirements of consumers and stakeholders.

Other issues

- 1.27 **Other Regulated Charges (ORCs).** HAL has made proposals in the RBP for some substantial changes to the ORC framework, such as changing to a marginal cost approach and moving the fixed cost elements to the airport charge. HAL has, for the most part, provided a clear rationale for its proposals for ORCs, which it has developed collaboratively with the airlines. We will need to assess the implications of the proposed changes on the airport charge and the incentives on HAL to ensure the costs are efficient and service quality is maintained. HAL has not adequately addressed its proposed treatment of over- and under-recovery of ORCs in H7.
- 1.28 **Resilience.** Ensuring that the airport is resilient to disruption is an important part of the overall service delivery. We support HAL's proposals for joint resilience plans which should lead to a more collaborative approach to managing disruption and its plans for airspace and runway resilience. Despite the pressures created by the impacts of the covid-19 pandemic, it is important that HAL continues to prioritise resilience and takes appropriate steps to minimise the risk of significant failures in H7 period, such as developing robust asset management plans. We will consider whether any further regulatory steps in relation to these matters are appropriate as part of the capital plan workstream.
- 1.29 **Surface access arrangements.** In the RBP, HAL has said that it intends to retain similar mode share targets to those set out in the ANPS. HAL will need to provide more information explaining this approach and its influence on the prioritisation of capital projects during the H7 period.

Our overall approach to developing projections to inform the initial proposals

- 1.30 For each of the main cost and revenue building blocks, we are currently:

- assessing whether or not the method that HAL proposes in its RBP is appropriate for setting the H7 Price Control, noting that we have the flexibility to consider and adopt different assumptions and scenarios in testing and using these methods;
- considering alternative approaches including:
 - best practice methods for that building block, including approaches implemented by the CAA for previous price controls and assessment by independent experts;
 - the approach proposed by airlines in their response to the RBP; and
 - a combination of elements of these alternatives and HAL's approach.

1.31 We set out more detail on our approach to passenger forecasts, opex, commercial revenues and capital expenditure in chapter 2.

Key issues for consultation

1.32 We welcome the views of stakeholders on any aspect of our approach to assessing HAL's RBP and in particular the conclusions of our initial assessment.