

Setting future price controls – review of approach: Consultation document CAP 2618

Heathrow's response

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Introduction

- 1 This document sets out Heathrow Airport Limited's (Heathrow) response to the CAA's (Civil Aviation Authority) consultation on 'Setting future price controls – review of approach', CAP2618.
- 2 The price control review process that delivers the economic regulation of Heathrow has significant knock-on impacts on the overall success and competitiveness of UK aviation, as well as wider UK economic growth. Inward investment, trade, direct jobs on airport and wider in-direct jobs throughout the supply chain, are all impacted by the decisions that are made during price control review process and the business plan that this process supports.
- 3 Heathrow urges the CAA's leadership to use this review as an important 'reset' ahead of future price control reviews (including with but not limited to the next price control period, H8). This must include a commitment that appropriate lessons from H7 are taken into account and clearly implemented in the planning and delivery of the H8.
- 4 Heathrow's view is that at its heart, the CAA's price control review process should follow the below core principles:
 - *Be fit for purpose through effective and timely decision making;*
 - *Be effective at delivering the right outcomes for consumers;*
 - *Be appropriately and proportionally targeted;*
 - *Create the right incentives for investment and growth.*
- 5 This section summarises Heathrow's main views on the areas of improvement required for future price reviews in order to deliver on the above principles. In the remainder of the document, we respond to the specific questions listed in CAA's consultation.
- 6 Alongside this response, Heathrow has also worked closely with the Airline Community to identify common areas of focus and alignment that both parties believe should be prioritised ahead of H8. These areas are highlighted in the joint letter which has been submitted as part of this consultation but are also noted in elements of Heathrow's response below.
- 7 We look forward to continuing to work together with the CAA and other aviation stakeholders to ensure that H8 and future price controls are conducted in a clear, focused and effective way to deliver for consumers.

Pillars for H8

- 8 **A stable framework and timely decision making:**
 - 8.1 Why?
 - A successful price control review should proceed with stability, predictability and proportionality. H8 and beyond should allow stakeholders to plan and meet obligations effectively. This requires realistic, consulted timetables that help avoid delays and missed deadlines.
 - Furthermore, H8's regulatory framework needs to be consulted and agreed on from the outset, ensuring a smoother implementation of the price control process overall. Regulatory decisions need to be evidence-based, consistent with Better Regulation Principles, and proportionate, with targeted intervention only where this leads to better outcomes for consumers.

8.2 How?

- The CAA should review and consult on a more detailed timetable for H8, including precise dates, provide comprehensive information around its plans and resourcing (including external consultants), how the plans take into account internal decision-making processes, and overlaps with other price control processes in respect to London Gatwick Airport (Gatwick) and NATS (En Route) plc (NERL). This would allow stakeholders to understand if the proposal is realistic and whether any changes are required.
- To help improve and expedite internal governance processes, the CAA could consider establishing a dedicated regulatory board (an 'expert panel') that reports to CAA's Board and is able to make robust and faster decisions where required.
- We expect CAA policy proposals to be explicit about and provide information on: (i) the issues the CAA aims to address; (ii) how proposed interventions will achieve desired goals; and (iii) supporting analysis and evidence, including regulatory impact assessments, quantitative modelling, consumer research.
- The CAA needs to incorporate a stronger assessment element in their work, to evaluate the effectiveness of existing policies whether they have achieved the expected aims. This should be part of and inform the price control process.

9 **Strengthening the role of consumers in the regulatory process:**

9.1 Why?

- Looking ahead to H8, the CAA needs to consider how best to reflect and further consumers' interests comprehensively during the process. Service, pricing, and investment outcomes must be shaped by direct consumer input. A narrow focus on reducing charges alone, risks the delivery of wider consumer priorities.

9.2 How?

- The price review should be built upon, and guided by, a strategic long-term vision that is grounded in a balanced approach, defining and pursuing the full breadth of consumer priorities.
- There must be a provision for independent consumer voices to review the quality of consumer engagement informing the process throughout the process – holding all stakeholders to account, including Heathrow.

10 **Responding to growing demand:**

10.1 Why?

- After the recovery in passenger traffic following the Covid-19 pandemic, Heathrow will hit capacity level during H8 and a major challenge ahead is rapidly mobilising capacity and infrastructure to meet resurgent demand. This is a different challenge from the landscape in previous price control reviews, and the CAA must approach H8 with this context front and centre of their decision making. As a capacity-constrained airport, as well as optimising use of current facilities, Heathrow will need to add new infrastructure to meet the demand of our customers – both current and future – enabling appropriate investment under all capacity scenarios.

10.2 How?

- Forecasting analyses need to be focused and tailored to capacity issues at Heathrow. Currently, external forecasts are not robustly conducted and there is a considerable risk

that an independent approach – without the full range of parameters that impact traffic at Heathrow - would not be an efficient use of CAA planning and resource.

- The Traffic Risk Sharing mechanism (TRS) needs to change to reflect this new reality and the CAA should consider further consulting on its design moving forwards.

11 **Enabling the delivery of the Government, Aviation sector and Heathrow's Net Zero targets:**

11.1 Why?

- Through Heathrow 2.0, Heathrow has a clear plan to decarbonise the airport and support sector-wide emission reductions. By 2030, our goal is that carbon from flights falls by up to 15% from 2019 levels (and our recent sustainably linked bond demonstrates a financial commitment to delivery). This is ambitious, but achievable if there is rapid Government action to scale up sustainable aviation fuels. By 2050, our goal beats the Climate Change Committee's (CCC) target for aviation as successful delivery of Heathrow's decarbonisation plans would mean that our residual emissions by 2050 would be less than half of what the CCC projects. Therefore, the regulatory framework must facilitate Heathrow's role in reaching Net Zero – both transforming its infrastructure meeting future shifts in technology – while protecting and furthering the economic and social benefits of aviation.

11.2 How?

- The CAA needs to develop guidance on how it will review Net Zero investments as part of future business plans, and outline how and why this will help deliver Government policy and Aviation targets which are of clear interest to the consumer.
- Streamlining investment governance for net zero projects is vital. Clear CAA direction on the importance of Net Zero projects for consumers and delivering against Government policy (as well as contributing to the CAA's growth duty) is key to avoid any stakeholder delaying and challenging its overall purpose and relevance.

The process for setting price controls

Market Power

12 As a measure of good regulatory practice, it is important to regularly consider the best approach to how a business or utility is regulated, using updated evidence to support any policy. This is fundamental to ensure regulation is not only relevant for the market conditions as they appear, but also fit for purpose, transparent, accountable, proportionate, consistent, and targeted, in order to effectively further the interests of consumers.

13 The 2014 Market Power Determination (MPD) was the last time the CAA considered the overall approach to Heathrow's framework and overall aviation market dynamics.

14 However, since then major developments have taken place, including but not limited to:

- Major changes in the airline market meaning that the description of airlines at Heathrow as "full-service carriers" at risk of being no longer valid. As a result, the MPD's product market definition possibly needs to be reviewed;
- Heathrow's 3rd runway expansion plan being announced, progressed and then paused;
- Proposals for other airport expansion elsewhere in the London market;
- The continued growth of other hubs in Europe, the Middle East and Asia;

- Expanding low-cost traffic that has profoundly changed short-haul market dynamics;
- Legally binding net zero targets in the UK and industry and policy shift towards it;
- The Covid-19 pandemic and the effective “shutting down” of the Aviation sector.

- 15 Despite the above, CAP2618 states that the CAA’s initial view is that “*a change in this assessment for Heathrow would seem to be highly unlikely*”. Without precluding an in-depth review or setting any specific proposals, it is unclear whether this statement is supported by any CAA analysis or any in-depth study surrounding Heathrow’s market power.
- 16 Given the purpose of this review is learning the lessons of H7 and improving the process for H8, Heathrow seeks clarity on what sits behind this assumption in CAP2618. There may be significant analysis required to understand whether the 2014 MPD considerations are still fit for purpose – for example, and as mentioned above, the MPD defines Heathrow’s product market as service to “full-service carriers” and the geographic market as Heathrow only. These definitions may no longer accurately reflect market dynamics and characteristics – and it is important that to deliver the right consumer protection and benefits for future price controls, the CAA consider whether this remains the case.
- 17 Regulatory ‘best practice’ would also point to a commitment to regular reviews of market power. Ofcom, for comparison, conducts periodic reassessments to ensure the continued effectiveness and proportionality of its regulation. The CAA could consider introducing a similar mechanism for periodic market reassessments and review of regulatory burden. Updated regulatory impact assessments and analysis would provide stronger evidence to evaluate whether benefits of current regulation outweigh its costs and the interests of consumers are being fully furthered.
- 18 Alongside wider market power considerations, CAA’s choice of a single till approach is heavily based on evidence from the Competition Commission’s 2002 report on regulation. The CAA should consider updating its analyses to evaluate whether this approach remains appropriate. Given there has been no investment in the airport boundaries since 2005, there is emerging evidence that in some areas the single till is not delivering the best outcome for consumers.

Objectives

- 19 As outlined above and within the joint Heathrow-Airline Community response, H8 must build on clear strategic vision and goals. It is vital that the CAA consults on and clearly articulates the strategic aims and vision of the H8 review at the outset of the price review.
- 20 This strategic vision needs to be built on the following key pillars:
- *Improved regulatory process with a stable framework and timely decision-making, underpinned by proportionality and predictability.* Heathrow requires ongoing investment to ensure that it can provide the right levels of service for passengers, airlines and cargo operators – continuing to function as the UK’s hub for tourism and trade. To ensure this is possible, regulation must be based on realistic, well-resourced, and aligned timetables, enabling policy and regulatory decisions that are evidence-based and consistent with Better Regulation Principles.
 - *Strengthening the role of consumers.* A more comprehensive and balanced approach to consumer priorities, ensuring that regulation is informed by consumers’ interests both in the short and long run. The CAA must not fail on this duty by adopting a single focus on lowering charges, based on the incorrect assumption that this will automatically lead to lower ticket prices. This does represent and reflect the significant consumer and passenger

insight that has been conducted on the value placed on the right charging levels that also help to deliver investment.

- *Responding to growing demand.* For H8, it is key that the CAA recognises the very different challenges ahead for the UK's aviation sector. Heathrow is operating nearly at capacity, and operational efficiencies and investments to meet the growing demand should be reflected in the price control objectives, even in a two-runway scenario. Consumer demand is not delivered by a continued congestion premium.
- *Enabling the delivery of Government, the Aviation sector and Heathrow's Net Zero targets.* The price review needs to enable Heathrow to deliver on broader government priorities, but most notably, Net Zero. Heathrow has a central role to play through both transforming its infrastructure and driving market-level changes such as uptake of Sustainable Aviation Fuels. Investments to 'operationalise' these future developments need to be streamlined and accelerated.

Proportionate and transparent regulation

- 21 Proportionate and transparent policy interventions should be grounded in clear evidence and rationale. It is crucial that stakeholders can easily access information on and understand: (i) the issues the CAA aims to address; (ii) how proposed interventions will achieve desired goals; (iii) supporting analysis and evidence, including e.g., regulatory impact assessments, quantitative modelling, consumer research.
- 22 Parts of the H7 work on service quality rebates and bonuses were positive in this regard, in particular some of the work carried out by Arcadis to review past performance and the impact of future investment to give a view on potential service quality targets for H7. While the work did not cover the full-service quality scheme, it did provide a rounded view of whether the current investment plan would facilitate the service quality metrics being proposed and provide evidence on how policy decisions might impact the desired outcomes.
- 23 Moving to a more robust policy process, the CAA needs to incorporate a stronger assessment element in their work, to assess the effectiveness of existing policies whether they have achieved the expected aims. This should be part of and inform the price control process.
- 24 Despite this, certain existing framework aspects – like the capital expenditure framework and Other Regulated Charges (ORCs) – need to be reviewed and revised. These do not reflect Better Regulation principles, delivering excessive complexity without clearly evidenced value to consumers. This creates inefficient use of resources by all stakeholders and leads to more polarised views that cause delay. Where guidance is not aligned to the Licence requirements, this can especially create confusion and additional scope for disagreement with airlines – leading to protracted engagement to agree protocols.
- 25 On capital expenditure, the new ex-ante incentives came in to force on 1 March 2024; however, they have already resulted in a substantial increase in process and complexity without clear and defined benefits. A clear example being the protracted discussions with the airlines on the first Delivery Obligation (T2 Security), which took more than two months to agree and was subject to an escalation to the Joint Steering Board, as well as Heathrow and airline CEO's. Heathrow and airlines will need time to develop, embed and learn from the new processes, and further CAA guidance is likely to aid this work.
- 26 Therefore, it is premature and concerning that the CAA considers taking further steps on capital efficiency at this early stage and without understanding the impacts of its implementation first. Furthermore, it is critical that proper consideration is given to the wider

impacts the framework has on other areas, such as delay in benefit delivery to consumers due to a new capital approach slowing down projects or making new or innovative projects unattractive to Heathrow or airlines.

- 27 On ORCs, the framework lacks flexibility and constrains needed investments. The framework drives misaligned incentives, with Heathrow seeing excessive barriers to progress with delivery of key benefits to consumers. It needs to be thought through properly, to identify opportunities for simplification. As part of these improvements, more consideration needs to also be given to non-airline stakeholders.

Constructive engagement

- 28 Heathrow and airlines have a proven and established engagement process. We engage regularly and frequently through several existing forums to address decisions concerning elements of all building blocks before, during and after the regulatory review process.
- 29 As also outlined in the joint Heathrow-Airline Community letter response, Constructive Engagement (CE) builds on the existing discussions with a more direct focus on the Business Plan (BP) for the regulatory period. As such, CE presents an important step in the price control review to map areas of alignment and disagreement early on in the process. It delivers value when focusing on strategic issues. This includes clarifying key choices around the level of ambition for service levels, the pace required to deliver growth, and choices around surface access.
- 30 In H7, CE was helpful to discuss elements like capex expenditure and service targets. It was also an opportunity to explain the BP to airlines in detail and for discussions on some areas of ORCs.
- 31 However, the value of CE diminishes when discussions become overly combative due to polarised views. Arguing the detail of assumptions around security efficiency for example is unlikely to be helpful.
- 32 For CE to realise its full potential, the CAA can help by providing direction, delineating expectations, proposing strategic discussion areas, and moderating when disputes emerge. Whilst CE is and should always be industry stakeholders engaging on Heathrow's BP, the CAA should consider what role it can play to avoid leaving disputes needing to be considered only much later in the price control process.

Timetable

- 33 A realistic, credible and deliverable regulatory timeline is crucial for effective price control reviews. As Heathrow and airlines agree in their separate letter responding to this consultation, delays and missed deadlines in H7 created uncertainty for all, as well as delayed investment and planning.
- 34 For an effective H8 price control period, the timetable needs to be underpinned by the CAA, from the outset, setting clear objectives and strategic vision, as well as defining methodologies, and developing resource planning.
- 35 Critically, the CAA needs to set a firm but realistic timetable and commit to it – and in addition, it is imperative that the CAA informs stakeholders as early as possible if delays occur and plans change, indicating the reasons for the change and any revised timelines. Early and transparent communication is crucial to enable better planning and service delivery, which is in the interest of consumers.

- 36 As such, we welcome the view of an initial proposed H8 timeline; however, we remain concerned over its deliverability. Under current plans, H8 would need to be completed in just over two years – faster than that which took place for Q6. This is especially challenging given the need to finalise this consultation, as well as CAP2980 on H7 outstanding issues only recently published on 20th March 2024. Furthermore, the CAA is also currently procuring an external expert panel to provide views on its approach to setting price controls to be considered as part of its review.
- 37 Going into a new price control process without a renewed approach which stems from the lessons learned exercise or expert advice being sought, as well as with remaining H7 issues not finalised, does not allow for a solid foundation and seemingly goes against the very purpose of this consultation process itself.
- 38 Furthermore, a key milestone in the new timetable is in early 2025, with Heathrow needing to provide an Initial Business Plan (IBP). However, the important capacity and infrastructure decisions that will need engagement, evidence gathering and alignment on beforehand and in development with a range of stakeholders, risks being ‘squeezed’ and diluted just to meet the initial timelines set out by the CAA. As it stands, the plan provides no certainty on when Heathrow will receive guidance from the CAA prior to compiling its IBP (a key factor in delivering a high-quality plan) and allows only limited time for CE, which as outlined above, if done well can help the process work more smoothly.
- 39 Taking lessons from other regulators, OfWat shared its first discussion paper for PR24 in December 2020, before publishing a draft methodology in July 2022, then announcing their final methodology in December 2022 – and business plan submissions in October 2023. This means the process for PR24 was started four years before the beginning of the price control period, and with 11 months between final methodology and business plan submissions. For the indicative H8 timeline the CAA have outlined, the equivalent discussion paper has not been published yet, and the period between final methodology and business plan submission is two to three months only.
- 40 Finally, it is also important that the CAA ensures timetables align with the internal governance required to deliver against them. Too often delays seem to occur due to governance issues – and as such, timelines set out should incorporate and allow time for effective internal governance processes.
- 41 As a next step, it is therefore crucial that the CAA develops a more detailed timetable for H8, including precise dates, comprehensive information around its resourcing plans, and how the plans take into account internal decision-making processes. It should also consider the significant requirements brought by overlaps with other price control processes in respect to Gatwick and NERL.
- 42 Demonstrating the deliverability of the current proposed timetable is essential to allow stakeholders to understand if the proposal is realistic and set out their own resource accordingly. With this current consultation being delayed initially, it is more than likely that the CAA’s timetable will not be met. Given the relevance of getting this key element of the mechanics of the process right, in addition to future CAA consultations on this specific matter, it might also be productive to organise a joint workshop in April 2024 to align and agree on what a revised and improved timetable looks like.

Governance around price controls

Management of process

- 43 We agree that the CAA needs to strengthen price control process management, including through clearer expectations around timely and complete submissions.
- 44 As outlined above, a robust regulatory timeline with precise target dates is crucial for this. Alongside this and as part of this planning, the CAA needs to also avoid running consultations at the same time as publishing the Final Decision, as it was the case in H7.
- 45 Improving internal processes around decision-making, including more agile internal governance – committed to via overall the price control timeline – is also needed to support the running of the price control timely and effectively. As alluded to above, the CAA could consider establishing a dedicated regulatory board that reports to CAA’s Board and is able to make robust and faster decisions.
- 46 Finally, it will be also important for the CAA to develop upfront planning of external resourcing support they intend to use during H8, also providing early visibility for Heathrow to comment on plans, Terms of References etc. These plans should consider the entire review cycle, not just expected peaks – the CAA needs to be adequately resourced on an ongoing basis.

Engagement and taking account of stakeholder views

- 47 Heathrow undertakes extensive consumer research to provide rich insight that guide our service priorities. To further the price review’s emphasis on delivering consumers’ needs and wants, it is important that the CAA likewise engages directly with consumers (both to get analysis on Heathrow’s research and plans but also their own research) and ensures that more weight is placed on consumer evidence.
- 48 This is crucial because taking airlines as the only voice of consumer interests is not an accurate reflection of passenger priorities and severely impacts the benefits consumers can expect. The CAA has itself noted this on more than one occasion: in the Initial Proposals for Q6, it states: “*Airline commercial interests do not fully align with those of consumers, as the CAA has itself noted. Independent validation of consumer priorities should thus inform CAA decisions shaping Constructive Engagement and investments.*”¹ More recently, CAA’s Surface Access Policy highlights that: “*...the interests of the air passenger as a distinct group are likely to be under-represented by airlines on their own...*”²
- 49 Therefore, the CAA needs to strengthen its own consumer research work and deliver on its own previous and correct analysis. during previous price control processes. The input from consumers should define the outcomes the regulator is seeking to achieve both in terms of direct service outcomes, but also in regard to price and investment.
- 50 Furthermore, the CAA needs to consider introducing an independent consumer group/body directly into the process. This body should be involved in the price control process to review the quality of consumer engagement informing the process. Previous work with groups like the Consumer Challenge Board (CCB) demonstrated the value of appropriate consumer engagement. Such panels helped draw attention to possible review weaknesses (e.g., relying on incorrect assumptions), while helping engagement with right audiences. Given the tight timescales set out by the CAA for H8 overall, it is important that a group is

¹ CAP 1027, available at <https://www.caa.co.uk/our-work/publications/documents/content/cap1027/>

² CAP 1847, available at <https://www.caa.co.uk/our-work/publications/documents/content/cap1847/>

established quickly – or that more time is taken through changes to the timetable that would allow for the right group/ forum to be created.

Guidance and information gathering

- 51 Firstly, it is important to note that Heathrow provides high quality information that is available at that time and does not withhold information from the CAA.
- 52 However, greater alignment on expectations around evidence feasibility and standard of information provision on Heathrow would help further improve the price control process. We notice, for example, that CAA requests can reflect unrealistic assumptions of available information and level of granularity in very early stages, for example capital project data. They may also conflate early and not fully formed airline assertions with actual verifiable evidence.
- 53 A key element to allow improvement in this area is ensuring that Heathrow's BP is built upon a defined regulatory framework, set ahead of and serving as a context for, a plan submission. If a BP is required while framework consultations are still going, Heathrow is "hitting a moving target" or being asked to provide information (and therefore mobilising resources) to support policies which may never be implemented or may change.
- 54 Enhanced engagement between Heathrow and the CAA could also support clearer mutual standards. In H7, constructive bilateral forums proved effective, and to further enhance this it would be important that the CAA defines clear dedicated building block owners on their side.
- 55 Stronger CAA commitment to timelines is also crucial in this respect. More effective planning and development of responses to the CAA depend on consultations being published on a date and timetable that has been specified well in advance. Similarly, unclear guidance hampers alignment and information provision as well – the recent ex-ante framework, for example, still leaves uncertainty around Delivery Obligations starting positions, undermining the effectiveness of the process.
- 56 More broadly, CAA engagement can also expand beyond the price review process. Clear involvement in certain aspects throughout a control period would provide the CAA with a better understanding about how certain structures are working, e.g., CAA attendance in Heathrow Other Regulated Charges governance group (ORCG) or Capital fora.

Expert advice and quality assurance

- 57 Different aspects of the governance around the use of consultants by the CAA can be improved to maximise the efficiency and benefits gained from their input. Ensuring early planning and enhanced engagement with Heathrow can help streamline the process and support more consistency across work done in different building blocks.
- 58 As highlighted above, the CAA should outline and share upfront its plans to contract external consultants, including draft Terms of Reference for Heathrow to review. Early visibility enables alignment and coordination while also preventing possible misunderstandings and misconceptions that can delay the process.
- 59 Additionally, prompt engagement once consultants are appointed is also critical, to set expectations and avoid missteps. In H7, for example, CAA consultants developed and published an initial cost assessment before any discussion with Heathrow, resulting in factual errors needing correction which delayed progress.

- 60 It is also important that the CAA strengthens the quality and standards of the work conducted by different consultants. In H7, for example, there was not enough transparency in relation to indices being employed in the economic/financial modelling work. That lack of information affected Heathrow's financial planning and modelling analyses, especially in relation to cost estimates. Further consideration is also required on how the CAA can maintain a consistent approach across building blocks ensuring that consultants come to their assessment and views in a rounded manner taking other building blocks into consideration, whilst maintaining their independence and objectivity.

Approach to key price control issues and building blocks

Passenger forecasts

- 61 Given Heathrow's capacity-constrained reality in H8, forecasting work involves very different considerations when contrasted to H7. Focus should now be placed on making the best use of Heathrow's capacity to meet growing demand. It is now more relevant than before that any forecasting analyses are specifically focused and tailored to capacity issues at Heathrow. However, there are currently no external forecasts that robustly forecast Heathrow specifically.
- 62 Generating an independent forecast for a constrained Heathrow would require taking into account several Heathrow specific characteristics in order to be representative, which is likely to be a complex and cost-ineffective process demanding substantial resources from all sides. To ensure relevance as well as complete transparency on methodologies and assumptions, such forecast would require significant engagement with the experts at Heathrow since the terms of reference stage to ensure appropriate framing and that certain elements of Heathrow's operating environment are not lost.

Service quality

- 63 The Measures, Targets and Incentives Scheme (MTI Scheme) generally works well as an effective incentive mechanism to continuously improve performance. However, as it stands, the framework needs a stronger customer-focused approach.
- 64 First, and as suggested above, direct input from consumers, coming from CAA consumer research, should inform the outcomes of the MTI Scheme. Consumers are as central airport customers as airlines, and the service quality framework needs to embed this.
- 65 Second, the MTI Scheme can be further improved with the introduction of more positive incentives focused on these consumers' outcomes. Both the rebates and the bonus elements play a part in incentives to Heathrow; however, the amounts are currently very disproportionate (7% vs 0.36%). This is a ratio of nearly 20 pounds paid in maximum rebates for each pound earned in maximum bonus. Furthermore, rebates should directly benefit the end consumer – right now, they are paid to the airline community, who may prioritise interests not aligned with consumers' preferences.
- 66 It is also necessary to note that other elements of Heathrow's regulatory framework overlap with the MTI Scheme (elements of the capex incentives). Once these are considered, the MTI Scheme prevents Heathrow from running the airport in a flexible way, especially in relation to asset management.

Traffic risk sharing

- 67 The TRS is an important incentive mechanism. However, as it stands, it is not suitable for H8. Given that Heathrow will be operating at capacity, the risk becomes asymmetric (asymmetric cost function at capacity). The TRS needs to change to reflect this new reality and the CAA should consider further consulting on its design moving forwards.
- 68 A key to ensuring a balanced risk allocation is that different treatments are required for under and over performance. Symmetric demand bands do not provide a fair risk balance across Heathrow and airlines.

Cost assessment

- 69 The H7 Final Decision (FD) has significantly underestimated operating costs and over-estimated commercial revenues, despite passenger numbers having exceeded FD forecast, as shown in Table 1 below.

Table 1: Comparison of Final Decision forecasts and outturn

£m (nominal)	2022		2023		2024		Difference
	FD	Outturn	FD	Outturn	FD	Forecast	
Operating costs	1,281	1,290	1,379	1,489	1,471	1,626	-274
Commercial revenues	822	789	980	968	1,101	985	161

- 70 This discrepancy creates immense cost pressures, especially in a scenario of declining charges (for example, Heathrow has now imposed a hiring freeze). Operating costs have increased as a result of Heathrow choosing to invest in the service customers get as they pass through the airport in order to remain competitive. Reductions cannot be delivered without impacting service, and we do not believe this would be right for consumers.
- 71 Looking ahead to H8, the CAA needs to avoid some of the challenges of H7 that have led to this disproportionate approach:
- As mentioned above, the CAA needs to firstly set a regulatory framework as the context for our business plan submissions.
 - Rather than focusing on individual cost categories, the CAA needs to adopt the adequate regulatory principles of an efficient cost baseline or an appropriate cost allowance for an airport of Heathrow's size and complexity. This means properly considering the regulatory precedent that you do not have to be best in class in every cost category to be considered efficient.
 - The CAA also needs to carry-out effective cross checks. Future settlements need to consider the impact of changes in capex spend, service quality expectations or commercial revenue targets on the appropriate OPEX allowance. H7 did not adequately reflect and consider the realities of the airport in 2022-23 as Heathrow recovered from the pandemic and built back capacity to meet passengers demand, which naturally led to the need to quickly increase people costs.
 - It is key that the CAA engages and adopts the most robust evidence available to develop estimates. In H7, Heathrow commissioned a report by KMPG that compared the airport's historic costs with competitors using a best practice approach of econometric analysis, but

there was not sufficient engagement by the CAA on this information. Moreover, Heathrow provided 2022 forecast on energy costs, but the CAA continued to consider 2021 forecast information within its FD. This shows that there are gaps in approach which need to be addressed prior to H8.

- As highlighted above, engagement between CAA consultants work on cost estimates and Heathrow needs to happen at the initial stage of work to avoid errors and misconceptions which can set back the process.
- It is also key that CAA assumptions and supporting models are made transparent to Heathrow early in the process. This will allow Heathrow to mobilise teams and resources adequately and enable cross-checks in view of the reality of the business.

OPEX and capex incentives

72 We have provided our views on in responses to previous questions.

Contributing to the UK aviation sector reaching net zero

73 The decarbonisation of the aviation sector and the UK economy more broadly, is of vital importance to Heathrow. Government policy recognises the wider economic and social value of aviation (*Jet Zero strategy: delivering net zero aviation by 2050*³) and also stresses airport infrastructure investment as critical to achieving legally mandated decarbonisation targets (*2040 zero emissions airport target*⁴).

74 Therefore, reaching net zero requires ambitious and decisive action from all stakeholders – including economic regulators. The CAA needs to be clear about its fundamental enabling role in this area to facilitate long-term investment in infrastructure and streamlined governance processes.

75 The decades-long capital programs needed for Net Zero, demand regulatory commitment and clarity now on funding investments that span across several regulatory periods. This will require long-term investment on initiatives across several key areas such as climate adaptation, energy resilience, future Aviation technology shifts, and surface access to the airport.

76 In this sense, understanding the scale of change required to meet legal targets is a first key task for regulation. Engagement between Heathrow and CAA needs to be intensified in this area to allow the CAA a clearer view of the value of carbon programmes and a better understanding of the Net Zero challenge ‘on the ground’, and how to best enable change ‘in the air’.

77 Fine-tuning incentives in this area is also important. Consideration needs to be given to ways to facilitate the behavioural change that is needed from all stakeholders in the airport ecosystem, including via closer alignment between NERL’s regulatory framework and Heathrow’s Net Zero ambitions.

78 Critically, allowances alone do not guarantee timely project delivery if airlines are not also committed to Net Zero investments. Heathrow is working to provide Electric Vehicle charging facilities in the Authorised Vehicle Area and the Taxi Feeder Park, but approval at stage G1 of the capital programme governance – not even an investment decision – took nearly one year, from May 2023 to January 2024. Streamlining investment governance for net zero

³ Available at <https://www.gov.uk/government/publications/jet-zero-strategy-delivering-net-zero-aviation-by-2050>

⁴ Available at <https://www.gov.uk/government/calls-for-evidence/2040-zero-emissions-airport-target/2040-zero-emissions-airport-target>

projects is thus equally vital. Clear CAA direction on the importance of Net Zero projects for consumer and delivering Government policy is vital to avoid any stakeholder delaying and challenging the purpose of their delivery.

Inflation indexation

- 79 Government plans to align RPI with the consumer prices index by 2030 means that the transition will occur during H8. It is imperative that the CAA handles this issue sensitively and develops further and more detailed consultations on this matter.
- 80 At a principle level, we expect that any adjustment to the approach to inflation by the CAA will be value neutral to Heathrow, therefore ensuring there's no negative impact on RAB or WACC.

Cost of capital

- 81 The decision on WACC in H8 needs to enable efficient capital planning to meet consumer priorities. Pressures to scale the airport to meet growing demand as Heathrow reaches capacity mean that Heathrow needs to continue demonstrating financial resilience to access capital.
- 82 In this sense, Heathrow does not agree that the CMA's decision as part of the appeals on the H7 settlement, offers the appropriate starting point for H8. In its decision, the CMA did not agree that the CAA was correct – they simply did not find that the CAA was wrong given the huge degree of latitude given.
- 83 As a starting point, there needs to be clear, unambiguous, and agreed parameters at the outset which determine how each constituent part of the WACC is calculated. This would include (although not limited to):
- Cost of Embedded Debt. The CAA should consider using the actual cost of Heathrow debt outstanding at a particular point in time, rather than estimating it using indices and Company specific premiums.
 - Cost of New Debt. This should consider clearly defined choice of index based on the rating and tenor of Heathrow debt, with any premiums/cross currency charges based on evidence from Heathrow specific issuance.
 - Proportion of Index-Linked Debt. The CAA should consider an independent review as to whether 30% is still appropriate, given Heathrow's actual inflation exposure.
 - Treatment of Inflation. The CAA should be clear on the treatment of inflation in the WACC calculation.
- 84 WACC levels should be aligned with evidence from capital markets, as comparisons with other regulated sectors in this area do not offer full alignment. Unlike essential utility services, aviation is a choice service for consumers. Furthermore, Heathrow has a greater proportion of commercial revenues that are subject to price risk as well as demand risk.
- 85 It is important as well to properly balance risks between Heathrow and its customers. The CAA assessments need an improved, well-rounded view of the systematic risks to which Heathrow is exposed, considering intensified airport competition and market dynamics like surging low-cost traffic. Furthermore, the risk mitigation provided by the TRS and the likely benefit on WACC are hugely overestimated – especially as the TRS mechanism needs substantial changes for H8.

RAB and depreciation

- 86 Any new or revised approaches in relation to the regulatory asset base (RAB) or depreciation must be grounded on proper analysis, consultation, and consideration of the wider impacts they may have. The stability of the regulatory regime that is the very foundation of economic regulation at Heathrow, relies on the principles underpinning the RAB. The recovery of efficiently incurred expenditure through regulatory depreciation must be upheld, and delivering the CAA's primary duty relies on companies funding licensed activities through efficient cost recovery. Any deviation from this principle risks unfinanceable outcomes and is extremely harmful to consumers.
- 87 It is therefore concerning that in this consultation the CAA suggests Heathrow's RAB is potentially oversized and whether "further increases are in the interests of consumers", without developing or demonstrating any supporting analysis to this end. Indeed, the size and scale of the RAB can be attributed to the wider and underlying framework of Heathrow's regulation and the impact of depreciation and inflation.
- 88 The element of the RAB at Heathrow that is related to capital spend reflects customer demand for long-haul connectivity, with a significantly higher proportion of front of cabin seats and connecting passengers. As a result, providing a very high level of service such as pier service to meet such demand for passengers and airlines alike, drives significant additional terminal and equipment requirements – both in terms of initial investment and ongoing maintenance.
- 89 Moreover, evidence shows that there is a substantial premium in fares at Heathrow. This premium means that any increases in airport charge will not be passed on to consumers. Therefore, investment to improve service in line with consumer demand and to increase capacity to meet resurgent demand, is clearly in the consumer interest and should be supported via the regulatory framework and the RAB-based model which underpins it.
- 90 As such, the approach to the RAB and regulatory depreciation should be guided by a balanced view that considers the variety of consumers interests, both in the short and long-term. Heathrow continues to be committed to running the efficient airport consumer interests rely upon, but an unbalanced prioritisation of low charges driven by the need to reduce a potentially oversized RAB that is not supported by detailed analysis, is not a correct approach. This cannot and should not jeopardise the necessary investments in infrastructure and services that will actually deliver the consumer benefits expected of a global hub airport. H8 needs to focus on regaining such balance, based on proportionality, stability, and predictability of the framework.

Package of incentives and risk sharing arrangements

- 91 Our views related to TRS, CAPEX, OPEX, and ORCs have been addressed in questions above.
- 92 In relation to commercial activities, the current regulatory framework also does not provide the necessary flexibility to allow Heathrow to invest in response to consumers' demands. This is a missed opportunity and sub-optimal outcome for all stakeholders, affecting the comfort and convenience of consumers, airlines, Heathrow employees and the community.
- 93 Property development, in particular, does not fit well in the current regulatory framework. There is clear evidence of underinvestment in commercial property at Heathrow, with no perimeter development since 2005 and around half of the Central Terminal Area (CTA) mothballed for end of life. The challenge to invest results from the combination of different

elements, including, the short payback period required for commercial investments, a comparatively low return when contrasting the WACC set by the CAA and that obtained in real estate, or misalignments brought by the cross-subsidisation implied by the single till.

- 94 To achieve a more balanced settlement in H8, the CAA should enable more commercial flexibility for Heathrow to invest in areas where underinvestment is clear, allowing the airport to develop non-aeronautical activities in response to consumers' demand, while keeping efficiency incentives are in place.

Financeability

- 95 Heathrow's financeability and growth prospects depend on maintaining solid investment grade credit ratings. This relies on the CAA keeping a transparent, stable and predictable price review process, underpinned by solid evidence-based methodology. However, certain H7 approaches have undermined ratings stability.
- 96 Abrupt inflation methodology changes midway through the review unsettled investors and ratings agencies alike given difficulties in understanding CAA's approach and limited consultation. The short-term spike in inflation has put pressure on credit rating metrics and shifting cost of debt measures from long-term to short-term indices significantly harmed investors' regulatory confidence. H8 needs to take this into account, as even with the CAA's notional company, the spike in inflation would have caused rating pressure.
- 97 To sustainably fund operations and future growth to reflect demand, Heathrow needs a financial framework where the notional company targets at least a BBB+ rating, given its similarities with Heathrow's debt structure. To help enable this, the CAA should consider commissioning independent review to recommend what rating is needed for adequate financing.

Other regulated charges (ORCs)

- 98 We have provided our views on the ORCs framework in questions above.

Broader strategic Issues

Form of controls

- 99 As stated above, and as a measure of good regulatory practice, it is important to regularly consider the best approach to regulating Heathrow, using updated evidence to support any working assumptions. A lessons learned exercise is an opportune moment to consider broad issues – such as market power dynamics and the boundary of the till – and there is relevance in conducting a review of these elements before H8 begins.
- 100 Alongside these elements, the duration of the regulatory cycle is another fundamental component of the current framework that has not been reevaluated for a significant time. There are valid arguments towards transitioning to a longer-term framework to help enable major capital projects that cut across price control periods for their delivery and impact. Longer regulatory periods may also increase stability and investors' confidence amidst constant regulatory churn.

Environmental sustainability

- 101 We have provided our main views on this area in questions above.

Expansion at Heathrow airport

- 102 Heathrow remains committed to long-term sustainable growth to reflect demand and are currently reviewing our plans. The Airports National Policy Statement (ANPS) remains in full effect post legal challenge, providing policy support for our plans for a third runway and the related infrastructure required to support an expanded airport.
- 103 Growth of the airport, however, is not limited to new runway discussions. It is critical that the future framework and decisions on investments and the RAB consider appropriately the optimisations required for Heathrow to also respond to a growing demand in a two-runway airport scenario.

Provision and operation of new infrastructure at Heathrow airport

- 104 It is important to consider mechanisms to facilitate effective and efficient delivery of important infrastructure work needed ahead, to ensure the best use of Heathrow's capacity.
- 105 However, experience from other airports around the world demonstrates that direct third-party delivery of operational infrastructure only delivers significant operational complexity and risks to resilience; a key issue for our airline customers and passengers. The challenging issues that arose during discussions from a third-party delivering infrastructure at Heathrow for expansion would be increased in a two-runway environment, with less ability to separate operating parties i.e. no additional new terminals to support a new runway to build and operate.

Scarcity rents

- 106 The principle that changes in costs of airport charges are passed directly through to consumers is a misconception, especially in the case of a capacity constrained airport like Heathrow.
- 107 The system currently employed for allocating slots for take-off and landing, with most slots originally allocated free of charge to incumbent airlines, means that rents accrue mainly to airlines. Airline scarcity rents arise when potential demand exceeds the physical airport capacity to accommodate airline seat supply, as is currently the case at Heathrow. Airline rents accrue as air ticket prices increase to balance supply and demand and clear the market. Ticket prices are higher than they would be if all demand was accommodated.
- 108 Where there are airline scarcity rents, airfares are unlikely to increase simply because airline costs have increased through any possible increase in airport charges; instead, scarcity rents (and thus fares and yields) will fall. Likewise, there will be no impact on choice and availability of routes. There is indeed substantial evidence demonstrating this e.g., analysis by Frontier Economics on the congestion premium (see Frontier Economics: Slot Scarcity and ticket prices at Heathrow, 1 June 2022, referenced in our Response to H7 Final Proposals Chapter 10 WACC, from 9 August 2022⁵).
- 109 Furthermore, the current context shows ticket prices are soaring despite declining charges (see, e.g., ACI Europe's review published on 14 November 2023 demonstrating that air fares are rising above inflation levels⁶). This only reinforces the view that using airlines as a proxy to directly identify consumers' interests is not the correct approach, goes against views that

⁵ Available at <https://www.caa.co.uk/media/mhpbazy1/46-frontier-slot-scarcity-and-ticket-prices-at-heathrow.pdf>

⁶ Available at <https://www.aci-europe.org/press-release/469-european-air-fares-rising-way-above-inflation-and-airport-charges.html>

the CAA have previously stated in consultations, and severely impacts the benefits delivered to consumers.

Airspace modernisation and new users

- 110 There are a number of elements related to the Airspace Modernisation Strategy where more in-depth consideration is required. Without prejudice of further and more detailed discussions and consultations, we can provide initial views on some of these aspects.
- 111 On airspace funding, centralising charges through en-route fees is an appropriate mechanism. However, careful consideration around cost capitalisation is warranted to prevent regulated airports from bearing disproportionate burdens driven by airspace changes in unrelated regions.
- 112 The NR23 decision on funding mechanism for the Airspace Change Organising Group (ACOG) represents positive progress. This experience highlights lessons and areas for improvement:
- First, clarifying program leadership roles, decision authorities, and governance is crucial for effective program management.
 - Simplifying organizational structures would enable earlier risk identification and proactive mitigation. Complexity inhibits agility in decisions and progression.
 - While the intent is valuable, ACOG's engagement requirements should focus on synthesizing rather than imposing new requirements beyond CAP1616 itself.
 - Consideration could be given to replacing, rather than adding to, ACOG with the Single Design Entity group to streamline coordination.
 - Similarly, integrating responsibilities like Industry Communications for the Airspace Modernisation Strategy (ICAMS) under a combined Single Design Entity (SDE)/ACOG structure may reduce fragmentation and overlapping processes.
- 113 Finally, another important element is ensuring the adequate application of the principles of proportionate regulation to airspace modernisation designs and regulatory processes. The team structures, governance processes, and oversight included in CAP1616 airspace change protocol must consider this and the risk profile of proposed changes.

Charges and Airport Charges Regulations (ACRs)

- 114 It is imperative that Heathrow continues to have flexibility to set the structure of its charges in order to incentivise growth at the airport. Heathrow has a well-established process which ensures compliance with both the ACRs and Heathrow's economic licence. This is complex and any changes should be carefully considered in full and consulted on before being implemented.
- 115 The processes in place ensure that Heathrow is operating in a transparent and accountable manner and at this stage we see no reason for further regulatory intervention. However, if in the future the CAA does provide stronger guidance/chooses to adopt different sustainability principles then we ask that it expressly considers how such guidance might impact Heathrow's continuing obligations under the ACRs.