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British Airways Response to CAP1940: Economic Regulation of Heathrow

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out our views on the issues raised by you as requested as well as providing further comments on both the consultation and wider policy environment.

Executive Summary

The key messages from British Airways in this response are as follows:

- Heathrow continues to demonstrate Substantial Market Power, and continued regulation by the Civil Aviation Authority ("CAA") is required in order to best protect users of Heathrow's services, and ultimately consumers;

- The CAA must focus on the financing duty as set out in the Civil Aviation Act 2012, which "does not require the CAA to ensure the financing of regulated airports in all circumstances. For example, the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions";

- Heathrow Airport Ltd ("HAL") should present a range of scenarios for H7, along with estimates and detail where available covering passenger forecasts, capital and operating expenditures, and revenues to inform the H7 Constructive Engagement process. Without these HAL runs the risk of undermining the process as we are unable to effectively evaluate aspects of their business plan without understanding the full effect of the proposals in differing demand environments;

- In order to receive our endorsement, CAA proposals for ex-ante capital incentives must demonstrably lower overall costs to airlines and consumers, and avoid over-complicating the regulatory incentives that HAL faces: complexity offers further opportunity for potential gaming of the regulatory regime by a regulated business;

- The Flint Global review for the CAA of the H7 Weighted Average Cost of Capital ("WACC") results in a WACC estimate that is too high due to a number of flawed assumptions. Please note that the airline community has jointly commissioned a report on the cost of capital from CEPA, which is appended to the LACC response to CAP1940, to which all our comments on this topic refer;

- Consumers and airlines should not be paying upward of £550 million for Heathrow's failed runway expansion plans –however given the CAA's proposals at the very least the risk-sharing mechanism for scheme failure must be applied to planning costs with a reduced return; and early construction costs incurred by HAL before securing the Development Consent Order for expansion must be paid for by HAL; and

- The CAA should not change the Heathrow price control in H7 to accommodate future Expansion projects: these should be done at HAL's own sole risk.

Developing the H7 programme

Broad Approach

1. British Airways ("BA") supports the CAA's focus on developing the **H7 price control for a two-runway airport**. Whilst we recognise that HAL intends to pursue its appeal against the Court of Appeal's decision regarding the Airports National Policy Statement ("ANPS") later this year, it remains highly unlikely that any re-start of construction Heathrow expansion will be feasible in the H7 period.

2. The CAA states that "we intend to retain the option of dealing with these [expansion] matters by **adjusting or resetting HAL's price control**"[1], however for the avoidance of doubt, we do not support any further adjustments or changes to the underlying price control to accommodate future expansion projects. Having accumulated in excess of £1 billion on the RAB for no consumer benefit on two failed expansion projects to date, we suggest this should be dealt with separately at the time, and possibly remain outside of the existing Heathrow RAB at HAL's risk.

3. HAL refers to the potential use of a commercial deal, however, we must reiterate our view that the underlying price control needs to be set in a robust manner to ensure that Heathrow, as an airport with substantial market power, remains regulated in a manner appropriate to protect users of its services and ultimately consumers.

Regulatory framework

4. We further note HAL's statement of the need for the regulatory framework to "**address risk and reward appropriately**[2]". We do not recognise HAL's assertion that the current regulatory arrangements do not address risk and reward appropriately, and on a simplistic assessment of regulatory operating profit vs average RAB, HAL has outperformed the Q6 settlement over 2014 to 2019 by £840m, and further chose to raise financial risk by raising leverage in subordinated and other debt by several billion whilst extracting significant value in Group dividends over the same period (c.£3.5bn).

[1] CAP1940 para 1.14
[2] CAP1940 para 1.5

5. **Affordable airport charges** will be key to supporting the recovery of passenger traffic. We note that the CAA supports this position but also considers that "it is also important that HAL can be efficiently financed".[3] Q6 was assessed on regulated operations based upon the notional debt to equity structure set in the regulatory settlement. This is distinct from HAL's approach to financing, where further debt exists at levels far above notional, both in regulated entities and at Group level above those regulated entities, and which has been undertaken at HAL's own sole risk.

6. HAL's financing strategy appears to assume that the Regulated Asset Base ("RAB") is ever-expanding, which has introduced potential re-financing risk where the debt maturity profiles may not match the depreciation schedule of underlying assets incorporated in the RAB. This could leave the HAL Group exposed to a declining RAB as capital expenditure naturally diminishes, following a relatively large building programme in Q5 and Q6. **CAA12 specifically "does not require the CAA to ensure the financing of regulated airports in all circumstances. For example, the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions".** The effect of yet further financial leverage is only to magnify the negative financial impact of this decline alongside events such as Covid-19. These effects are distinct from the theoretical question of "financeability" of the RAB to return sunk costs, and we believe debt levels should ideally be more prudent, as was envisaged in the regulatory settlement.

7. Furthermore, BA is firmly of the view that **capital expenditure on the RAB should only ever be undertaken if it is manifestly in the consumer interest**. Following periods of substantial expenditure in Q5 and Q6, the RAB will naturally diminish in size, and this must be anticipated in the financing strategy undertaken by Heathrow's owners. During the recovery period from Covid-19, there is no obligation on the CAA to endorse an inappropriate capital plan to artificially sustain the RAB, as consumers will ultimately pay yet further inflated airport charges through ticket pricing and hinder the ability of airlines operating at Heathrow to compete with carriers based at other European hubs. This is not in the consumer interest and will reduce choice by making routes uneconomic to operate.

Consumer interest

8. We fully endorse the **CAA's focus on ensuring the interests of consumers** are at the heart of the regulatory process. As the impacts of the Covid-19 pandemic on Heathrow, aviation and the wider economy become more apparent, we expect an even greater focus by consumers on price, service and value-for-money.

Scenario analysis

[3] CAP1940 para 1.18

9. BA supports the CAA's position that "the development of meaningful **scenarios** as a fundamental starting point for the development of 'joined up' outcomes in respect of capex, opex and commercial revenues in the RBP"[4] is necessary. In BA's view such scenarios should cater to a range of outcomes and should not be limited to simply producing a "book-ends" around a single range. Furthermore, these scenarios should be developed with an understanding of how they derive from HAL's actual performance to date.

Form of control

10. The CAA highlights the potential for **traffic risk-sharing and other uncertainty mechanisms**. We have previously indicated a willingness to assess such mechanisms. A key determinant in our view of these mechanisms will be the impact on the amount of risk assumed to sit within the cost of capital and on the level of airport charges, which will be particularly critical as we look to restore consumer confidence in the recovery from the Covid-19 pandemic. BA does in general not support the use of the RAB as a mechanism to defer increased charges over the long-term[5]. It is not in the consumer interest to pay for services not received, and any specific proposals will need to clearly demonstrate real consumer benefits.

11. HAL has proposed introducing **price control re-openers for the H7 period**. The CAA draws the comparison with Ofwat's "substantial effect determination" that operates in the event of unforeseen event. A full debate is needed on the appropriateness of adopting such a mechanism, or whether other developments such as traffic risk-sharing or a revised cost of capital offset the need for such a mechanism. We also note that consideration of other sectors' control provisions must be considered in conjunction with all aspects of those settlements – in water for example, this includes limits on debt to ensure appropriate equity capital supports the business.

12. BA agrees with the CAA's position that the **price control length** should be assumed to be five years unless a compelling case emerges otherwise. We believe it is demonstrably in the consumer interest that HAL is subject to economic regulation and that full reviews of the HAL business should be conducted every five years as a minimum. This has not been the case for eight years, and the consumer has not benefited from the scrutiny of HAL that airlines and the CAA can bring to bear.

Constructive Engagement and the H7 review

13. The **CAA's intention to be more proactive** during the second, truncated phase of Constructive Engagement ("CE") is welcome. Clearly the HAL Initial Business Plan and CE has been severely impacted by both the Court of Appeal's decision regarding the Airports National Policy Statement, and further by the Covid-19 pandemic. The task for all parties is to conduct an effective review of HAL in fluid and challenging circumstances and the CAA being more directly engaged in the process will help make best use of the time available.

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[4] CAP1940 para 1.26
[5] CAP1940 para 1.33

14. Whilst BA and other airlines are now engaged in the second phase of CE prior to HAL producing its Revised Business Plan ("RBP") we do not then intend to stop engaging with HAL on issues simply because the allotted time for that has ended. We envisage engaging with HAL through 2020 and 2021 to ensure that the time available to us to achieve the best regulatory outcome for H7 is fully used. We will engage with the CAA throughout as well.

15. The CAA summarises its overall objective for H7 in para 1.41. BA would suggest amending it to better reflect the impact of airport charges on the consumer both now and in the long-term as follows:

    "We will consider how best to deliver a price control consistent with efficient financing arrangements for HAL and affordable charges for ***consumers and*** *airlines that best supports the recovery of passenger traffic at Heathrow airport* ***and supports appropriate efficient capital infrastructure investment****.*

16. Amidst the economic challenge of Covid-19 we should not forget that following record investment at Heathrow, it has become the most expensive airport in the world and any actions taken should continue to facilitate a return to more appropriate levels.

Developing HAL's revised business plan

The December 2019 Initial Business Plan

17. As noted above HAL's Initial Business Plan ("IBP") is now out of date. The **Revised Business Plan ("RBP") will now have a much narrower focus** on the immediate 2022 to 2026 period for a two-runway airport with the capability for 480,000 movements ("ATMs") per annum. Of core importance in this period will be the need to re-build passenger volumes and consumer confidence.

18. BA objected to **HAL's proposals to review its operating costs and commercial revenues** on a top-down driver basis. Now that the focus is on a five-year price control, our view is that reviewing HAL's costs and revenues based on its actual performance is more compelling than ever. The CAA should ensure that HAL's costs and revenues are reviewed on a detailed bottom-up basis to best inform the price control decision. The CAA clearly state that "we expect that opex forecasts for H7 should be capable of reflecting significant changes in the levels of staff between terminals and activities" and "we expect the RBP…to contain opex estimates for each planning scenario at a level of detail that facilitates understanding of changes in relevant activities"[6]. We expect HAL to comply with the CAA's requirements in the development of scenarios during CE that are then included in the RBP.

[6] CAP1940 para 2.19

19. BA agrees with the CAA's expectation that construction for **expansion would be unlikely to re-start in the H7 period** and that if it returns it should be added to the core H7 price control. Further views on expansion are detailed below.

Development of scenarios for H7 planning

20. BA fully endorses the **CAA's approach on H7 scenarios**, requiring HAL to:

"provide scenario-based estimates for traffic, costs and revenues at a suitable level of disaggregation such that the estimates can reflect variations in demand responses and cost drivers for each scenario"[7]

21. We agree with the CAA that "very detailed 'bottom-up' forecasts are unlikely to be useful…in the short-term"[8]. However, the development of scenarios does not depend on detailed forecasts of passenger numbers, capital expenditure, operating costs or commercial revenues. Rather the focus should be on building likely scenarios covering a range of passenger forecasts overlaid with different approaches to capital expenditure, and operating modes, so as to determine different levels of operating costs and commercial revenues. In the recent HAL Building Block Update there are only two scenarios presented as "book-ends" around a passenger forecast range of 60-80 million passengers per annum ("mppa") with three terminals open (T2, T3 & T5) at 60 mppa and all four terminals open at 80 mppa.

22. **HAL's apparent approach to H7 scenarios does not therefore appears to be heading towards what the CAA has asked for in the RBP**. CAP1940 refers to "individual scenarios"[9] and assumptions around different geographic markets recovering more quickly than others[10]. HAL should develop several high-level scenarios that speak to different outcomes as requested by the CAA, particularly as the shape and timing of any Covid-19 economic recovery is unknown.

23. The CAA's support for **enhanced business case analysis** on capital expenditure projects is welcome. BA and other airlines would like to see increased monitoring of the business case benefits that capital expenditure projects deliver in H7, so we are better able to understand whether or not business case benefits have been realised. This is critical to ensuring that capital expenditure realises benefits to consumers envisaged at the planning stage, and that charges reflect delivery of those consumer benefits.

24. Understanding **operational resilience** that is assumed within each H7 scenario will be important for airlines. HAL's more simplistic "book-ends" approach may not fully consider the operational resilience pinch-points. Even when not near full capacity, Heathrow will still have challenging peak periods either on the airfield or within terminal infrastructure.

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[7] CAP1940 para 2.22
[8] CAP1940 para 2.20
[9] CAP1940 para 2.25
[10] CAP1940 para 2.22

Developing Outcome-Based Regulation

25. BA understands the CAA's position on **Outcomes-Based Regulation** ("OBR") with regard to both updating the Q6 Service Quality Rebate & Bonus ("SQRB") scheme in the short-term and, in tandem, developing the H7 OBR scheme for introduction in the medium to long-term. BA sees value in the existing components of the SQRB scheme, which should remain a key part of the OBR measures, targets and incentives. They have played a key role in significantly improving and maintaining good levels of service from HAL in the Q6 period. The SQRB scheme has always been based on delivering high-quality, timely and efficient airport journey for consumers and this will continue to be needed in H7. The SQRB performance measures ensure that airlines have the confidence that HAL is providing service levels in a quantifiable way that in turn allows us to manage our own operations and ultimately deliver service to the consumer. **We support the CAA's aim to develop this within a wider OBR framework for H7 and beyond, to ensure the best outcomes for consumers.**

26. At the current time BA has not seen any substantive engagement from HAL on updating **the Q6 SQRB scheme in the short-term**. Our experience to date is that HAL's response is to approach the scheme from a financial perspective and attempt to de-risk themselves. This has been by proposing lowering equipment availability targets, and not re-introducing any form of passenger and staff security queue measurement in terminals or vehicle security queue measurement at control posts. We will look to engage with HAL further but at the current time we do not think that HAL's behaviour shows enough focus on the needs of consumers. An apparent reluctance to get modified forms of SQRB reporting in place would not appear to bode well for introducing new SQRB measures focused on Covid-19 response either.

27. The CAA's aspiration to developing **a "continuous improvement" approach to OBR** "that reflects consumers' evolving priorities and preferences during H7" will require HAL to engage with airlines to develop a mechanism that enables this to happen. The Q6 SQRB scheme is able to be updated through HAL and airline agreement (subject to CAA review and approval), but in practice during Q6 this has not happened. This is in part down to the incentives within the scheme itself. If airlines requested HAL to increase rebates on a measure where performance was challenging and "fund" that by reducing rebates where there is strong performance there is no incentive for HAL to do so as they would simply be increasing the risk within the scheme, i.e. they would be more liable to incur a higher rebate payment. Addressing this will form part of HAL and airline discussions in CE.

28. BA welcomes the CAA's position that HAL should "as a minimum…focus on delivering consumers' and airlines' core needs and priorities" within the RBP and that future scenarios should outline the levels of service quality that consumers and airlines could expect[11].

[11] CAP1940 para 2.36

Efficiency incentives: capital expenditure

Development of capital efficiency policy

29. BA welcomes the CAA's review of capital efficiency incentives for HAL, which are needed to ensure that the Regulated Asset Base only grows based on benefits being delivered to consumers and airlines.

30. However, we are concerned that the move towards **an ex-ante led approach** was predicated on managing HAL's multi-billion-pound expansion programme. In that context we broadly agreed with the CAA's approach as there was a clear requirement for HAL to face risk incentives to manage very large and complex capital programmes in a way that the existing ex-post capital efficiency governance would struggle to do.

31. With the certain pause of the expansion programme – for H7 at least – we now face **a more normal five-year regulatory period.** The **recovery of passenger volumes from Covid-19 lows is likely to persist** well into the H7 period and BA's view is that there should not be significant investment into terminal and airfield infrastructure. HAL and airlines should look to leverage the significant investments made to the airport over the last ten to fifteen years to deliver benefits for the consumer, and that spending should be prioritised on safety, maintenance and critical service improvement projects.

32. Our assessment of the likely composition of the capital programme therefore raises questions about **whether the ex-ante led approach developed for expansion is necessarily appropriate for H7**. Developing a more complex regime at this time raises issues around how it will be administered and policed to ensure that it improves the actual performance of HAL without raising costs to consumer and airlines in its delivery. Our final assessment of the case for ex-ante proposals must also be informed by the outcome of the Q6 capital efficiency review that is currently ongoing which should be concluded as soon as possible.

33. BA notes that the **CAA's upcoming working paper** will go into more detail on the capital efficiency proposals in CAP1940 and we will fully engage with that. The rest of this section details high-level comments regarding the CAA proposals.

Initial comments on CAA proposals

34. We support the **retention of the Development & Core approach** from Q6 and its evolution. We note the CAA recognises that "it should also preserve the vital role of airlines in helping to assess HAL's project proposals, delivery and quality standards, and costs"[12]. We are concerned that symmetrical financial incentives simply place more cost on consumers and airlines in funding additional bonuses to HAL for delivery of investment, whose risk they have already been fully remunerated for through airport charges. We will look to understand further the CAA's proposals on how such incentives will work in the upcoming working paper, to fully understand this and inform our position.

[12] CAP1940 para 3.6

35. The **balance of incentives** will change as the CAA propose to move a majority of projects from ex-post to ex-ante, with ex-post reviews by exception. We will need to assess this further in light of the CAA working paper. Ex-post reviews should be retained for both larger projects and any project that substantially over-runs beyond the point where the ex-ante incentive is seen to be effective.

36. The proposals for **treating cost categories differently and applying incentive rates** will need to strike a balance between being effective and not too complex to set and administer. BA is concerned that the CAA refer to an ex-ante incentive rate of 13% in Q6 that needs to be higher in H7. When such allowances are set against capital projects which already applied an average 15% "leadership & logistics" allowance rate, the actual cost of projects is already raised by c.28% over the baseline. Cost categories must be transparent, promote efficiency, and not be treated as a simple overlay on every project. We will address this more thoroughly in our response to CAP1951.

37. **Setting delivery obligations** should help ensure HAL face the appropriate incentive to deliver investment as needed. BA supports setting these at Gateway 3 and requiring airlines to agree subsequent changes. More detail is needed for each capital expenditure category, with detailed work required to ensure they remain effective both in terms of definition and ongoing management. We will consider this further as part of the CAA working paper.

38. BA has concerns regarding **trigger payments**. The CAA's CAP1940 webinar stated that "trigger payments penalise HAL for late delivery of projects". BA does not agree with this characterisation of triggers which return funds to airlines where a service or asset is not brought into use on time. Rather than penalising HAL, triggers simply compensate consumers and airlines with a rebate, to ensure consumers are not paying for a service or an investment that is not being provided at that point in time. BA does not support making triggers "symmetrical" as simplistically delivering an asset early but at the wrong time is unhelpful unless airlines and consumers are able to make beneficial use of that asset.

39. BA supports the CAA's comments on **setting the costs baseline**. Effectively managing the HAL capital plan and being able to track movements in projects is essential, especially if the CAA envisage a more flexible H7 capital plan. Introducing capex tramlines could reduce discipline in managing the overall capital plan. There may be other ways of introducing flexibility, whilst adding capital scope to the plan, for instance the mechanism under which the CAA allows new scope to be added to the NATS En-Route Ltd price control, which could be considered for HAL.

40. BA would support a move to **reconciling incentives during the H7 period** as opposed to waiting until the end of H7. One of the key challenges with ex-post reviews in both Q5 and Q6 is that by deferring reviews on projects until the end of the period, the actual review has been difficult due to the length of time that has passed, resulting in facts and issues not being as clear as they were at project completion. This is even more of an issue where projects run across separate price control periods further increasing the time between a project and its review.

41. BA will work with other airlines and HAL to **develop H7 governance arrangements**. We continue to see a vital role for airlines and the Independent Fund Surveyor at the Capital Portfolio Board and its stakeholder and working groups. However, we do need to ensure that the overall governance structure is manageable for airlines and that the IFS role is effective – this is a particular concern in a post Covid-19 environment where airline resource maybe less available than it has been in Q6. The governance needs to be right sized so as to allow airlines to best perform their role most effectively in the interests of consumers and to assist the CAA in monitoring HAL's performance.

42. We understand that the CAA's work in this area is ongoing and we will fully engage with the upcoming working paper and throughout the rest of the year and into 2021.

Cost of capital

43. Whilst there are areas of the Flint Global report that are uncontroversial, in comparison to the earlier PwC report to the CAA, the evidence presented – particularly in Beta and Cost of Debt does not robustly support the Weighted Average Cost of Capital ("WACC"). These require more detailed analysis and a greater evidence base to establish the cost of capital for Heathrow. The CEPA report has been jointly commissioned with the airline community and has been submitted with the LACC response to CAP 1940. The main points raised by CEPA are as follows:

- *"While we support many aspects of Flint's approach to estimating the cost of capital (prior to the covid-19 pandemic), we consider that the evidence it presents does not support a proposed increase in the WACC relative to PwC's advice to the CAA. In particular, a more comprehensive and nuanced analysis of beta and cost of debt evidence is required.*

- *International airport group relevance should not be assumed in any assessment of the beta, rather relevance should be systematically and transparently assessed based on robustness and riskiness and on group level characteristics rather than those of constituent individual airports. This assessment should take into account both operational aspects (notably capacity constraints, economic status of markets served, demand volatility and hub status) and regulatory status (including exposure to volume risk and treatment of commercial revenues). The use of evidence from three diverse airport groups without risk adjustment – and exclusion of evidence from other groups which are not demonstrated to be less relevant – has not been justified and greater transparency of Flint's analysis is required. We also conclude that the proposed cost of debt is too heavily influenced by HAL's actual debt structure and costs, particularly given that its high level of gearing reflects choices that is has made.*

- *The impact of the covid-19 pandemic is still developing. The CAA adopting a long-term perspective on the cost of capital, consistent with other UK regulators, would limit the implications of the pandemic. Equity market return estimates are based on historic data relatively unaffected by the addition of a single year of data, and market data on the risk-free rate and cost of debt will naturally incorporate* *movements driven by covid-19. Evidence on beta is varied: while some airport groups are showing elevated short-term betas, others do not appear to have been affected. There is no strong evidence that betas are unprecedented relative to previous market downturns. As part of a long-term cost of capital assessment the key issues are likely to be: (a) establishing an appropriate pre-covid reference point for beta and (b) accurately reflecting any changes in the allocation of risk. On the cost of debt, evidence of elevated spreads for HAL's actual debt is likely to reflect, at least in part, HAL's very high actual gearing, rather than the assumed gearing of the notional entity. The CAA's analysis should account for HAL's gearing, as well as recognising the fluctuation over time in HAL's debt spreads compared with market indices."*

Early Expansion Costs

44. BA does not support the CAA's proposed approach on early expansion costs, which sees consumer and airlines having to pay a minimum of £500m plus for a runway scheme which will never be built whilst HAL pay nothing and even earn a return on the costs that consumer and airlines bear. Our position is that HAL should bear the full risk for all Expansion Category B and early Category C costs to date including costs for programme wind-down and its Supreme Court appeal. If the CAA continue with their proposals despite our position, then **the following summarises our views on how this should be done.**

45. The CAA should not continue with its proposed "simplified" approach that treats Category B and early Category C costs as one and the same. Early Category C costs have not been through any form of HAL-airline governance, and airlines have clearly stated that any early **Category C expenditure undertaken by HAL was entirely at their own risk**, bearing in mind the lack of any governance and oversight that the airlines had. BA and other airlines have consistently made our position and expectation clear throughout 2019 when HAL apparently began incurring such costs. Furthermore, these costs were being incurred at a time when the runway opening date was not finalised. Airlines were ultimately proven correct in their assertion that the likely runway opening date would be 2028 or later rather than 2026, and despite HAL doubling down on 2026 (despite all evidence to the contrary), the CAA ultimately agreed with the airlines position. If HAL's rationale for incurring spend in 2019 and 2020 was based on a 2026 runway opening date, then it should not be allowed by the CAA. Even if HAL thought 2026 was achievable, the live debate during 2019 and the strong likelihood that the runway opening date was going to slip back should have led to a delay in incurring early Category C costs.

46. The CAA position is that it seeks to place £500m+ onto the RAB as efficiently incurred. The **£110m of early Category C costs should not be admitted to the RAB** as they were clearly incurred at HAL's own sole risk, and that risk has unfortunately manifested itself. HAL and its investors must carry that cost, not consumers and airlines who face not only remunerating HAL but giving them a regulatory return on top. This is not a defensible position and the CAA must not allow these costs.

47. **The £500m figure is also subject to upward pressure**. HAL is providing further information on Category B and early Category C costs incurred in 2019 and early 2020 so no doubt the £394m and £110m sums will increase. On top of that the CAA indicates that HAL will incur **expansion programme wind-down cost of circa £46 million** which it expects HAL to be able to recover. The fact that the CAA only intends to review these costs later this year once HAL has completed all of this spending is concerning as it will not allow for effective oversight on HAL.

48. The CAA also states that HAL's **costs of appealing to the Supreme Court** are an ongoing strand of HAL's expansion work and that such costs can be recovered with HAL arguing they be treated as Category B costs. BA believes this position is flawed. When HAL incurred Category B costs related to achieving approval of the Airports National Policy Statement there was clear Government policy support for expansion. That Government support is now completely lacking as evidenced by them not addressing or appealing the Court of Appeals decision.

49. Even if HAL win their appeal, there is no clear benefit to consumers of HAL doing so in the absence of that Government support. **It is HAL's right to appeal the judgement, but the CAA should not be allowing HAL to pass that cost onto consumers and airlines**.

50. BA believes that the Category B planning costs should have the 85:105 risk-sharing mechanism applied as the runway scheme has failed. This would mean that **only 85% of the proposed £394 million Category B costs should be allowed** by the CAA. The risk-sharing mechanism should also be applied to the programme wind-down costs as these are driven by the planning costs. However, in the event that the scheme programme re-starts at a later date these wind-down costs should be adjusted out of the RAB at that point as re-start costs will be being incurred from that point. BA assumes that the £500 million figure the CAA refers to includes costs already incurred and paid through airport charges and is not solely an additional amount that the CAA will propose to be allowed.

51. Finally, bearing in mind that the CAA's policy on Expansion costs did not provide for a scenario where the regulatory treatment would be determined without a DCO decision we believe that this should also form part of the CAA's decision on these costs. In addition to the application of the 85% risk share on Category B costs **the CAA should only allow the Cost of Debt/New Debt to be earnt on any additions to the RAB**. This better reflects the risks borne with consumers and airlines paying for 85% of expansion costs with Cost of Debt return only and HAL paying 15% of expansion costs and foregoing a full WACC return on 100% of the costs. In an ideal world these costs should all be borne by HAL, so this stops significantly short of that position.

52. The overall expansion costs that the CAA is minded allowing HAL to add to the RAB and earn a return on could easily exceed £600 million under these proposals. There are no tangible benefits to consumers and airlines of doing so**. Twice in the last ten years, consumers and airlines have paid for runway schemes that have never seen the light of day at a total cost exceeding £1 billion**. Meanwhile the cost to HAL of having pursued these schemes at no risk to themselves is effectively nil, and HAL will continue to earn a return on those failed schemes for years. The CAA cannot allow this situation to arise

again and it should review these proposals now to ensure a better balance of risk and cost between HAL and consumers

Heathrow West proposals

53. BA notes the **CAA's assessment of the alternative Heathrow West proposals** for expansion:

    "We consider that the progress made on the tests alongside other evidence demonstrated that Heathrow West's proposals were reasonably mature and credible, and would likely be sufficient to allow CAA to commence more detailed work on them."[13]

54. In addition, we note the CAA's decision to "not consider undertaking further work on Heathrow West's expansion proposals unless circumstances change sufficiently to justify us recommencing this work"[14].

If you have any further comments or questions on this response, please do not hesitate to contact me.

Yours sincerely,

Alexander Dawe
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[13] CAP1940 Appendix G para 8
[14] CAP1940 Appendix G para 9