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**British Airways Response to CAP2274**  
**Economic regulation of Heathrow Airport Ltd**  
**Working paper on outcome-based regulation**

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

## Executive Summary

We view service quality measures as a critical element of the price control; they ensure that Heathrow is incentivised to spend appropriate amounts to meet the service quality outcomes specified by the CAA, and that the operating expenditure allowance is not inappropriately constrained in order to drive up investor returns at the expense of consumer outcomes

Nevertheless, we are disappointed with the outcomes that have emerged from the H7 periodic review to date; the outcomes proposed by Heathrow remain vague and inappropriately focussed upon areas that are not controlled by Heathrow in its role as provider of airport operating services

As a result, measures and targets that stem from these outcomes remain too loosely connected with the consumer outcomes that are relevant to the airport operating environment; it is of critical importance for the CAA to understand how Heathrow uses its operating expenditure to deliver airport operating services, and therefore how targets can be calibrated to deliver measures that are either within Heathrow's control or influenced by decisions over its expenditure

We incorporate by reference the response of the LACC/AOC to this consultation, which summarises analysis performed by the airline community and additional evidence from ICF in order to help the CAA better calibrate the measures and targets proposed as part of this consultation and the H7 Initial Proposals; in addition, we intend to provide further information to the CAA that sets out the customer journey and the relevant interactions with Heathrow



that must be incentivised to ensure that we can deliver our services effectively to our customers

It would be an error for the CAA to calibrate targets that do not effectively incentivise Heathrow to deliver services that support airline operations across the relevant parts of the entire customer journey; we remain concerned that the CAA has not understood our requirement for certain measures to be based where relevant upon the impact on individual consumers, individual flights and specific instances of failure rather than grouping and averaging those metrics over 24 hour periods and whole months

It is particularly important the CAA consider that it is airlines who deliver customers through Heathrow and airlines who are responsible and receive complaints when Heathrow fails to deliver to the required standard; as a result, it would be irrational to ignore airlines' perspectives on measures and targets, and we encourage the CAA to engage with us to effectively understand the relevant customer journey through the airport, along with the activities that need to happen in support of its effective delivery

## 1. Outcomes based regulation

- 1.1. Service quality measures are critical to the price control; they ensure that the regulated company faces a commitment to spend money to meet the service quality outcomes specified by the regulator, and that the operating expenditure allowance is not inappropriately constrained in order to drive up investor returns at the expense of consumer outcomes
- 1.2. It is critical as a result that the OBR regime links directly to the CAA's analysis of operating expenditure and commercial revenues, ensuring that key areas of expenditure are identified, and that the level of expenditure is calibrated to the required service outcomes; this reinforces the requirement that measure focus upon services provided by Heathrow as the regulated entity
- 1.3. This requires the CAA to have a strong understanding of how the airport operates in order to avoid a situation where the regime is ineffective, drive unintended behaviour by focussing on the wrong area, or can be circumnavigated by the regulated company; Southern Water<sup>123</sup> is only the most prominent recent example of regulatory failure that the CAA must seek to avoid
- 1.4. For example, Heathrow does not have sufficient focus on the domestic arrivals transfer desk, resulting in extensive queues in a very small and constrained area; as a result, airlines have attempted to map the entire passenger journey – departing, transfer and arriving – in order to understand the various contact points with Heathrow that passengers and cargo might encounter

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<sup>1</sup> [Financial Times, "Southern Water fined record £90m for dumping raw sewage", 9<sup>th</sup> July 2021](#)

<sup>2</sup> [Financial Times, "Southern Water hit by £126m penalty for 'serious failures'", 25<sup>th</sup> June 2019](#)

<sup>3</sup> [Financial Times, "Southern Water staff convicted of obstructing sewage probe", 27<sup>th</sup> August 2019](#)



- 1.5. In addition, cleanliness measures only extend to front of house areas, resulting in extremely filthy conditions for our staff in some areas of the airport and particularly back of house corridors; this demonstrates a natural focus on the incentives that the CAA have placed upon them, and demonstrates the urgency of approaching OBR from a customer journey perspective supported by the requirement for airlines to deliver for consumers, rather than a narrow focus on delivery to targets
- 1.6. We therefore urge the CAA to consider the points raised by the airlines throughout the OBR process, and ensure that the OBR incentives are appropriate for the operating environment we require to deliver service to customers

### **Development of the incentive**

- 1.7. We agree with the CAA that the consumers' interests are furthered by ensuring that the services Heathrow provides "meet their needs in terms of their range, availability, continuity and quality"<sup>4</sup>; the current regime of service quality rebates and bonuses ("SQRB") is essential for ensuring that Heathrow's operating expenditure is not inappropriately reduced after the allowance has been set
- 1.8. We support the evolution of the SQRB scheme to one that is focussed upon outcomes received in terms of level of service, and believe this outcomes based regulation ("OBR") approach should serve to focus Heathrow's efforts more directly upon delivery of service outcomes as opposed to simply inputs
- 1.9. Nevertheless, we are extremely concerned that OBR measures proposed by Heathrow could lead to service delivery being undermined, particularly if these remove focus on key operational inputs that are required for airlines to deliver service to customers; as a result, we will engage fully with the CAA in the OBR working paper<sup>5</sup> to ensure OBR targets are appropriate and support our operation
- 1.10. We are particularly concerned that Heathrow has taken a consistent approach of attempting to undermine the effectiveness of the proposed OBR regime through its inappropriate focus on "willingness to pay" analysis to justify unnecessary investment that would inflate the RAB and make charges even more expensive
- 1.11. Fundamentally, such an analysis is flawed due to the hypothetical nature of the exercise, based upon the fact that it is not measuring actual willingness to pay in practice; this hypothetical bias undermines the efficacy of such an approach, particularly where there is neither an incentive nor test of actual willingness to pay
- 1.12. As we note above, it is particularly important that the regime calibrates the incentive to ensure the level of operating expenditure remains appropriate to service quality, driving efficiency whilst not compromising consumer outcome

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<sup>4</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.1

<sup>5</sup> [CAP2274: Working paper on outcome-based regulation](#)

- 1.13. We note that Ofwat used a methodology that dictated companies “should not propose top-down, calculated outperformance and underperformance payment rates derived from a pre-set Return on Regulated Equity (“RoRE”) range or amount of revenue”<sup>6</sup>, but “should use forecast efficient marginal cost levels in their estimates of incremental cost in the underperformance payment formula”<sup>7</sup>
- 1.14. Heathrow’s contention that generosity of the scheme is irrelevant to the analysis is fundamentally incorrect; to meet the requirements of CAA12, the scheme must be designed around the intent to assure consumer outcomes that reflect a reasonable assessment of the inputs required, plus additional stretch to drive continuous improvement to reflect required efficiency gains over time
- 1.15. It is particularly important that where capital is invested to deliver greater service quality outcomes, that the OBR measures are updated to reflect those promises that have been made through the capital investment process
- 1.16. For example, the significant investment in Regulated Security should deliver a step change in capability that allows significantly improved targets to be introduced over queuing and satisfaction measures, and there must be a mechanism so to ensure this is updated and reflected mid-period without waiting until the H8 periodic review
- 1.17. We note that the CAA is not “proposing to change HAL’s maximum potential exposure to rebates, which is currently 7% of airport charges revenues”<sup>8</sup>; we have no particular view on whether this should be higher or not, but ultimately wish to ensure that the incentive remains effective over particular measures and targets, ensuring that appropriate operating expenditure is incentivised to meet the appropriate service quality outcome required
- 1.18. It would be a mistake if this 7% figure were not allocated based upon fundamental analysis that ensures Heathrow is incentivised to deliver; it would be an error to set an incentive whereby it is more profitable to fail the incentive than deliver to the specified quality of service

### **Outcomes**

- 1.19. We note that the CAA proposes to accept Heathrow’s outcomes, with justification that these are broad enough to cover Heathrow or airline proposed outcomes, and are supported consumer research and the Consumer Challenge Board (“CCB”)
- 1.20. We continue to express concern that the outcomes are not specific enough for use in the OBR framework, and do not sufficiently appreciate the entire value chain of operations that are required to deliver airport services directly or indirectly to

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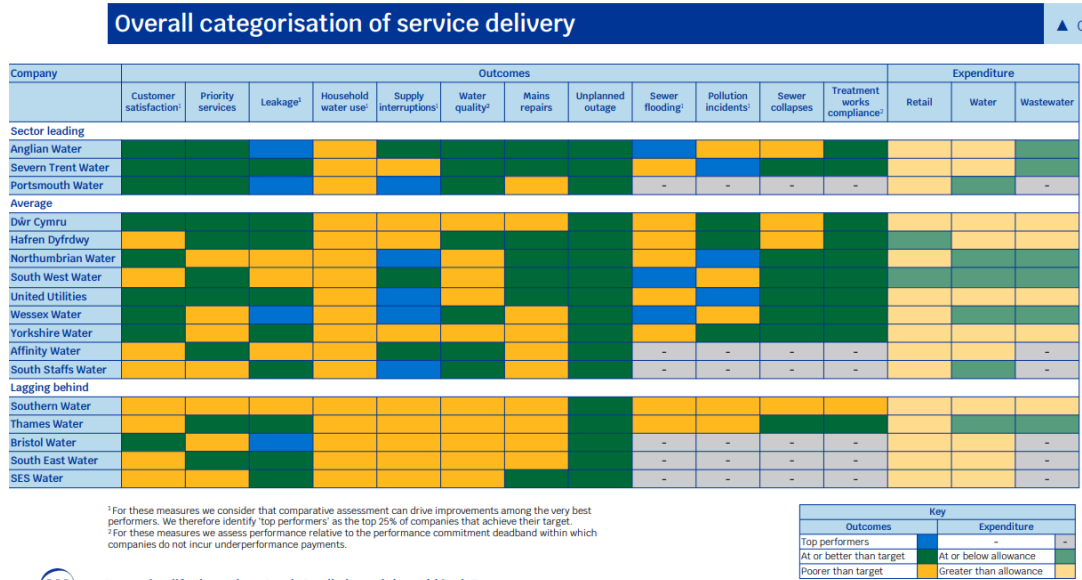
<sup>6</sup> [Ofwat, Technical appendix 1: Delivering outcomes for customers, January 2019, p10](#)

<sup>7</sup> Ibid.

<sup>8</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.47

consumers; we contrast this with the clear outcomes set as part of Ofwat's outcome delivery performance commitments<sup>9</sup>

**Figure 16.1: Ofwat overall categorisation of service delivery, 2020-2021<sup>10</sup>**



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- 1.21. We believe that these are far more robust outcomes upon which to base a regulatory framework, and continue to highlight to the CAA the risk of undermining regulation where consumer outcomes are not set on the basis of tangible and concrete outcomes that consumers value in practice
- 1.22. We are concerned that current proposed outcomes are essentially defined by the regulated company, which serve to make incentives as weak as possible and undermine the incentive for service delivery; it would be an error to rely upon Heathrow's definitions where these do allow the OBR framework to place appropriate incentives on Heathrow to deliver quality service outcomes
- 1.23. For example, the definition of Ofwat's outcomes rely far more upon detailed analysis of what is required to produce safe drinking water and process wastewater safely, resulting in specific and concrete metrics that stem from each outcome; it would be a mistake to use Heathrow's proposals, which do not achieve what Ofwat's outcomes do
- 1.24. The CAA seems to suggest that it does not really matter if the outcomes themselves are woolly, since "the role of outcomes is to help identify overarching aspects of airport operation services that are most important to consumers, which can then be reflected in a more detailed set of measures"<sup>11</sup>

<sup>9</sup> [Ofwat, Service delivery report 2020-2021](#)

<sup>10</sup> Ibid.

<sup>11</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.39

- 1.25. Whilst it is true that the measures rather than the high level outcomes are included in Heathrow's licence with associated targets and incentives, it somewhat undermines the development of the OBR framework if outcomes are deemed less relevant than the measures themselves; we note that Ofwat states "providing a truly excellent customer experience for customers is fundamental for maintaining trust and confidence"<sup>12</sup>, which demonstrates how the outcomes are defined helps to prioritise the measures that sit below them
- 1.26. We also note how in the market within which Heathrow operates, this is not dissimilar to Openreach's provision of services to other retail companies, and that "a customer's experience of these services depends on many factors including access and maintenance of Openreach's network" whilst "for the most part, however, this is invisible to customers of fixed broadband services"<sup>13</sup>, underscoring the importance that must be placed on a robust understanding of the operational environment in developing outcomes and measures
- 1.27. Outcomes are therefore critical, and it is fundamental for the OBR regime that the CAA understands the whole value chain at the airport through which airlines operate their business and whose delivery Heathrow facilitates; H7 incentives risk being misaligned if this entire value chain is not intimately understood by the CAA
- 1.28. As a result, we think it is irrational for the CAA to "consider it better to take account of particular views and evidence when deciding which measures to adopt, rather than attempting to refine HAL's broader outcomes"<sup>14</sup>; if particular outcomes only have a small number of measures associated with them, it is problematic as it suggests the wrong outcome may have been targeted for inclusion
- 1.29. Nevertheless, we agree with the CAA that there should "scope to further develop the outcomes framework over time and, if appropriate, introduce additional measures"<sup>15</sup>, though we caution against reliance upon the self-modification provisions of the licence in order to achieve this; we reiterate this point below with further reasoning as to why reliance upon this provision would be an error

### **Measures and service provision**

- 1.30. It is important that measures hold Heathrow to account for the specific services it provides to consumers and airlines, and we are not keen to see wider reputational measures undermine the regime such that the incentive is ineffective; we agree therefore with the CAA that there is an appropriate balance to be struck and issues need to be addressed on a case-by-case basis in this regard

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<sup>12</sup> [Ofwat, Delivering Water 2020: Our methodology for the 2019 price review Appendix 3: C-MeX and D-MeX, p3](#)

<sup>13</sup> [Ofcom, "Improving broadband and landline standards, a review of how Ofcom's service quality rules have affected Openreach's service level performance", 6<sup>th</sup> May 2000, para 2.5](#)

<sup>14</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.40

<sup>15</sup> Ibid.



- 1.31. In particular, we are pleased to see the CAA's recognition that services provided to airlines that ultimately support our provision of services to consumers is an important element of the framework; this role of facilitation is particularly critical in many areas of our customer-facing operation at Heathrow
- 1.32. However, the CAA must ensure it has a full understanding of where responsibilities lie in order to ensure appropriate incentives are in place; this is particularly relevant to departures and arrivals management, which the CAA describes as being difficult to identify "the boundaries of HAL's responsibility and also the fact that overall punctuality is affected by many other factors and at many different stages of consumers' journeys"<sup>16</sup>
- 1.33. This is no different than the challenge Ofcom faces in regulating Openreach, where responsibility may lie at many different points in the network<sup>17</sup>; nevertheless, Ofcom's analysis used econometric analysis to isolate the effect of its service standards on Openreach's performance, demonstrating that the CAA could perform similar analysis for Heathrow
- 1.34. Furthermore, Ofcom also noted that whilst Openreach had never breached compliance based upon annual averages for many metrics<sup>18</sup>, that actual service levels were below minimum standards within many individual months; it could however be proven that as Ofcom increased minimum service levels, performance rose due to the incentive to perform under the scrutiny offered by the regime
- 1.35. It is important to note that whilst it is difficult to isolate Heathrow's direct responsibility on – for example – overall punctuality, Heathrow is directly accountable for many contributory activities that facilitate punctuality, such as passenger and staff security, immigration, TTS, departure and transfer baggage system, escalators, gates, jetties, wayfinding, airfield management, road network and passenger information
- 1.36. It is inappropriate that Heathrow would not have measures over all contributory aspects that have been identified as being in their control, and which as a result cause punctuality challenges for airlines, impacting the customer journey
- 1.37. We will provide further, detailed feedback on each of the measures alongside additional comments on the targets proposed by the CAA in our response to the OBR working paper

### **Reputational measures**

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<sup>16</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.23

<sup>17</sup> [Ofcom, "Improving broadband and landline standards, a review of how Ofcom's service quality rules have affected Openreach's service level performance", 6<sup>th</sup> May 2000](#)

<sup>18</sup> Ibid. para 3.22

- 1.38. We are in general opposed to the use of reputational measures, particularly where these do not protect consumers from failure to meet committed service quality levels; these may in some cases serve simply to use regulatory tools inappropriately to fulfil a public relations role, and undermine scrutiny of the relevant performance for regulatory purposes that should be within Heathrow's control
- 1.39. However, where these measures offer a useful reputational incentive to improve performance in areas that are underperforming at present, there may be value in developing them in limited areas; Heathrow must have a demonstrable role in coordination of such activities to be acceptable as measures, and the CAA should have a clear target in mind for performance maintenance or improvement to avoid such proposed measures being little more than meaningless flimflam
- 1.40. The CAA should also consider reputational incentives from the converse standpoint, as Ofgem has done, that financial incentives are not appropriate to all outcome measures; in particular, that financial incentives should not be applied to outcomes outside the regulated company's control<sup>19</sup>
- 1.41. For example, in agreeing with Heathrow's measure considering "ease of access" to the airport, we ask if the CAA has considered the incentive effects of establishing the new Forecourt Access Charge ("FAC"); our passengers simply want to access the terminal on a timely basis without hassle, yet a lengthy queue reliably extends from Terminal 5 back to the M25 on Monday and Tuesday morning in normal times
- 1.42. The CAA should therefore ask how the FAC interacts with incentives across the price control, and where FAC is little more than a means of capturing a monopoly rent from a captive audience
- 1.43. Consumers would value a concrete financial incentive that encourages Heathrow to act to reduce queuing prior to the forecourt; for example this might then incentivise Heathrow to open an arrivals level lane for drop-off at peak times to alleviate the pressure on the departures forecourt
- 1.44. We therefore agree with the CAA in its rejection of measures that have no bearing on Heathrow's provision to airport operation services and exclusively cover airline activities; however, we disagree with the CAA that measures should not extend to services such as Fast Track and Other Regulated Charges ("ORCs")

### **Measures over Other Regulated Charges**

- 1.45. Heathrow is a regulated monopoly, and the provision of ORCs is of key importance to the operation of the airport; the distinguishing feature of ORCs is that they are not consumed in direct relation to passenger volumes, and Heathrow's Market Power Determination makes no distinction between these services and any others provided to ensure provision of airport operation services

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<sup>19</sup> [Ofgem, 'Consultation on Strategy for the Next Transmission and Gas Distribution Price Controls – RIIO-T1 Outputs and Incentives', supplementary annex, 17<sup>th</sup> December 2010](#)





- 1.46. The fact that some airlines may have previously had a commercial agreement for the provision of Fast Track services does not change the fact that Heathrow is the sole monopoly provider of these services; it would be an error to assume that commercial terms can therefore control the monopoly power Heathrow holds, particularly where airlines have had significant disagreements with Heathrow over restoring its provision during the pandemic recovery period
- 1.47. It is also important to note that Heathrow sells individual Fast Track access as a product directly to consumers from its website; without measures to support service standards, there is nothing to prevent Heathrow selling excessively and causing a detrimental impact on service standards as a result
- 1.48. We therefore disagree with the CAA that OBR should not be extended to cover "optional" services provided on a "commercial" basis, as Heathrow continues to hold monopoly pricing power and is able in effect to extract a rent that in aggregate is likely to exceed the maximum yield set by the CAA after the price control has been set through provision of such services separately from the airport charge
- 1.49. It would be a fundamental error to suggest that ORCs are provided on a commercial basis, particularly since these are established as cost pass-through mechanisms where airlines have little ability to control service standards; as noted above in relation to Heathrow's recent renewal of the contract for services to Passengers with Restricted Mobility ("PRM"), Heathrow shut out airlines from such negotiations and removed many critical service standards, resulting in significant degradation of performance and airlines oversight
- 1.50. As we explain in the ORC section of our response, these services are in dire need of significant efficiency and service quality incentives, with Heathrow management actions lacking transparency and opacity over how contracts are formulated with service providers

#### **Measures over key areas of expenditure**

- 1.51. We agree with the CAA that baggage performance and provision of check in facilities are key areas of focus for airlines; however, we are concerned that the CAA does not appreciate the extent of our reliance upon departure gate facilities provided by Heathrow, which are comparable to check in facilities even where self-boarding functionality is not installed (and also that has already been installed and is in service across a significant part of the airport)
- 1.52. We are also concerned that the CAA may not appreciate Heathrow's central role in determining the performance management of NATS in delivery of its services to manage aircraft on the ground; this critical incentive means that perverse outcomes may arise where – for example – aircraft may be held on stand to accommodate an air traffic control slot, delaying inbound aircraft from using that stand (which is additionally charged as parking time to the airline)

- 1.53. Given the renewal of the contract with NATS for five years in October 2021<sup>20</sup> and the management of that contract sits with Heathrow, we are concerned that the delay to the whole H7 periodic review may have resulted in a missed opportunity to ensure this particular contract renewal incorporated measures that could have improved air traffic management at Heathrow
- 1.54. At a minimum for the performance of its duties under CAA12, the CAA should acquaint itself with the particular features of this contract that may impact upon the incentives it places upon Heathrow for the H7 period; it would not be in the consumer interest that such a core part of Heathrow's service delivery avoids appropriate scrutiny, and would amount to a failure by the CAA to perform its duties under CAA12

### **Measurement frequency**

- 1.55. We reiterate the CAA's observation that moving averages mask variability in performance, and note that as a result under the current SQRB regime, on days when disruption occurs, this rarely manifests itself as a failure of existing measures; the performance of Heathrow with just £11m<sup>21</sup> of rebates paid since the inception of Q6 demonstrates the need to recalibrate what is now a weak incentive
- 1.56. Consumers are impacted by the disruption they individually experience, and it is cold comfort that Heathrow might perform on average over a smoothed period of time when that individual's outcomes have been compromised
- 1.57. To be clear, we do not believe that the H7 price control should be designed to drive an impossible level of performance that automatically results in significant rebates over the course of the price control, but a strong incentive with additional continuous improvement over time, whose calibration will be demonstrated by the existence of occasional rebates and management action to improve performance in response to learnings
- 1.58. Specifically, we refute Heathrow's suggestion that variability of monthly performance means that it is acceptable that some consumers will face worse performance during the month; service quality should be viewed as the minimum acceptable standard required to deliver the service performance that consumers fund, primarily through operating expenditure element of the price control
- 1.59. We therefore continue to advocate performance measures that reflect individual consumer outcomes where reasonable, such as daily, hourly or even more frequent measurement to the level of the individual consumer where appropriate, and welcome the CAA's acknowledgement of the need to consider these further
- 1.60. Nevertheless, we note that Heathrow propose rebates that are calculated as one twelfth of the annual maximum, and have "justified this proposed change on the

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<sup>20</sup> [NATS lands Heathrow 5-year contract extension, 18<sup>th</sup> October 2021](#)

<sup>21</sup> [Heathrow Regulatory Accounts, 2014 to 2020](#)

ground that it would the problem of weakened incentives once Heathrow has paid a particular rebate six times in a year"<sup>22</sup>

- 1.61. We agree with the CAA that Heathrow's proposal could be a mistake, and that maintaining rebates calculated as one sixth of the annual maximum (under a monthly rebate regime) would retain stronger incentives that outweigh the theoretical disadvantage of weaker incentives that result if Heathrow were to have triggered the rebate six times in one year
- 1.62. Nevertheless, any move to more frequent measurement as proposed by airlines would require this allocation of rebates to be modified to ensure that the incentive retains its effect; we would not want to inadvertently undermine the effectiveness of incentives with our proposals, and it is not our intention that should be the case

### **Development of targets**

- 1.63. We caution that reliance upon the self-modification criteria for later introduction of measures would be a mistake, since it is not in the interests of the regulated company to agree to any changes in the power of its incentives; we note that Ofcom has recommended that such changes are phased to ensure the regulated company can adjust, and become more stretching over time<sup>23</sup>
- 1.64. This has been proven by the fact that Q6 licence had a requirement to measure queue times at an individual passenger level, which has not yet been delivered as it is not in Heathrow's interests to do so; the reliance upon self-modification to manage changes to incentives would be a substantial error by the CAA
- 1.65. There is undoubtedly regulatory risk in trying to introduce too many changes at the same time, particularly where the business is in a state of significant change; nevertheless, we are concerned that the licence provisions may not allow development of targets over the course of H7, particularly given the lack of use of the self-modification provision in Q6
- 1.66. This is particularly demonstrated by the perverse outcome resulting from the lack of any SQRB measurement of some security control posts in Q6; a regulated business will never agree to increased scrutiny and incentive strength over its business, and it is unrealistic for the CAA to expect Heathrow and airlines to agree any changes to the OBR regime – the CAA is obliged to act as regulator, and must take the necessary steps to perform its duties under CAA12
- 1.67. We will engage further in our response to the CAA's working paper on proposed targets, but reiterate that the RAB adjustment and Heathrow "optimal" capital expenditure plan are completely unrelated to the key incentives that need to be established under the price control for service quality

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<sup>22</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.35

<sup>23</sup> [Ofcom, "Improving broadband and landline standards, a review of how Ofcom's service quality rules have affected Openreach's service level performance", 6<sup>th</sup> May 2000, p2](#)

- 1.68. It would be an error for the CAA to incorporate any of Heathrow's business plan based upon its alarmist analysis that suggests this is dependent upon a RAB adjustment, which itself has been categorically rejected by the CAA; we do not have any faith that the arguments stemming from the RAB adjustment represent any more than an egregious attempt to game regulation

### **Information requirements**

- 1.69. Furthermore, we challenge the CAA notion that it is Heathrow who should be recording and retaining "suitable" data "to allow for different options to be examined thoroughly"<sup>24</sup>; this is an error, as the CAA needs to stipulate what data needs to be collected in order for the options to be assessed properly and thoroughly, and ensure it has sight of this data on a monthly basis, similar to how Ofgem, Ofwat and Ofcom collect information on the businesses they regulate
- 1.70. Without a specific licence obligation to record and share specific information, this proposal would have no effect, and will continue the situation where Heathrow has an information advantage over the CAA and airlines; as a result, it would be an error not to define this more clearly in Heathrow's licence
- 1.71. Without specifying what data should be measured, how frequently and how it should be delivered to the regulator for scrutiny, there is a risk that Heathrow will obfuscate and avoid either collecting or sharing the data it has access to; it is neither realistic nor appropriate that Heathrow and airlines will be able to agree targets for the CAA to implement, and airlines are reliant upon the CAA both to understand Heathrow's business and precisely how the incentive links to operating expenditure
- 1.72. Airlines do not have access to the detail of Heathrow's operating expenditure or sight of the detailed information collected by Heathrow at present; nevertheless, we are aware of many areas where Heathrow has a large databank of information that results in a fundamental asymmetry, where Heathrow is fully aware of what lies behind its operational processes – the CAA must require that Heathrow share all existing information with airlines and the CAA in these areas in order to develop its incentives effectively and in a manner that allows airlines to be genuinely informed and engaged throughout the process
- 1.73. For example, Heathrow has highlighted its data collection activities as a result of forming its Airports Operations Centre ("APOC"), stating "in order to plan effectively for security queues APOC monitored traffic flow on the M25 and arrival times of the Heathrow Express train service"<sup>25</sup>, and "social media comments

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<sup>24</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.29

<sup>25</sup> [Competition and Markets Authority, BAA airports: Evaluation of the Competition Commission's 2009 market investigation remedies, 16<sup>th</sup> May 2016, para 5.39](#)

relating to service quality at the airport were tracked and relayed to operational staff within six minutes"<sup>26</sup>

### **Interpretation of data**

- 1.74. We agree that many targets would need to be reset and the underlying data examined to ensure that the incentive is appropriate; however the CAA should ensure it understands the reasons for any volatility of the underlying data – for example, are rostering practices for security staff based upon inappropriate and outdated agreements that need to be revised to better meet peaks and troughs of demand at security checkpoints?
- 1.75. In addition, the CAA must understand how such incentives on passenger security queue times interact with commercial revenue raising incentives, where Heathrow earns demonstrably greater value from customers in minutes immediately following security; it would be inappropriate for airlines to excessively fund an incentive that duplicates the existing incentive on Heathrow to maximise commercial revenues, and further demonstrates why OBR must be tailored to ensure consistent incentives across Heathrow's price control
- 1.76. Ultimately, queue measurement was a requirement of the Q6 licence, which Heathrow has deflected and avoided installing in order to avoid being held accountable to the incentive that was supposed to be in place in 2014; it is disappointing that Heathrow's arguments to avoid being held accountable have delayed the implementation of the incentive as envisaged at the Q6 periodic review, and we are concerned that Heathrow is attempting to further delay the implementation of the incentive at this review

### **Asymmetry and incentive strength**

- 1.77. Asymmetry of the scheme is also irrelevant, and Heathrow's views on this matter reveal its desire to use bonuses as a means of raising its revenue potential above the maximum yield set by the CAA<sup>27</sup>; this is incompatible with the purpose of the regime, and speaks to a fundamental misalignment of incentives that already exist in the Q6 price control, an issue which if continued could manifest itself in future in corporate governance issues that are incompatible with the consumer interest<sup>28</sup>
- 1.78. CEPA have noted in their advice to Ofwat for PR24 that "there is no requirement for the allocation of each individual risk to be a 'fair bet'; rather this is a constraint

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<sup>26</sup> Ibid.

<sup>27</sup> We understand that bonuses are at present incorporated into the cap, as originally intended when introduced in Q5; should this understanding be at variance with the Q6 settlement, we believe that

<sup>28</sup> [Financial Times, "Southern Water staff convicted of obstructing sewage probe", 27<sup>th</sup> August 2019](#)

on the overall package"<sup>29</sup>; furthermore, the CMA set out several potential reasons to favour asymmetric incentives<sup>30</sup>

- 1.79. Indeed, Ofwat target upper quartile service quality performance (and **not** average performance) in PR19<sup>31</sup> as an appropriate level of performance to achieve a financial performance in line with the settlement; in addition, full compliance is required in a couple of key performance commitments in order to avoid rebates and penalties
- 1.80. At heart, the regulatory regime should support the ability for Heathrow to deliver service quality in all reasonable circumstances; just as it would be unacceptable for water companies to propose that 5% of customers might receive water that fails to meet safe drinking levels, we also believe it is unacceptable and contrary to the objectives of CAA12 for the regime to be designed in a manner that would allow significant numbers of customers to experience outcomes that are incompatible with the service quality intended
- 1.81. It is particularly relevant that PR19 does not permit companies to "propose additional enhancement expenditure or submit cost adjustment claims to enable them to reach the committed performance levels"<sup>32</sup>; we do not support Heathrow's view that standards should fall under a "safety only" capital plan (which is actually focussed on asset management and maintenance of service quality), and it would be entirely inappropriate to reduce service standards as a result given the primary incentive for the regime relates to operating expenditure
- 1.82. There is no evidence to suggest that Heathrow's £2.8bn RAB adjustment is required or appropriate justification for maintenance of the existing service standards; the RAB adjustment and its "optimal" capital expenditure plan are completely unrelated to the key incentives that need to be established under the price control for service quality, and significant new capital expenditure is unlikely to be required during H7, which will be defined by recovery from the pandemic
- 1.83. We note when setting target levels that other regulators have observed that beyond a compliance level, it can be more profitable for the regulated company to pay compensation than to provide the specific level of service<sup>33</sup>, and the CAA must work to avoid this perverse economic incentive arising; this is of critical importance to ensuring that the incentive is calibrated appropriately, and demonstrates how it has to link to the operating expenditure used in its provision
- 1.84. As a result, when determining targets, the CAA would be advised to access the copious information that Heathrow has collected over the years on all the present

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<sup>29</sup> [CEPA, Allocation of Risk, prepared for Ofwat, 18<sup>th</sup> June 2021](#)

<sup>30</sup> [CMA Final report, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, para 7.128](#)

<sup>31</sup> [Ofwat, Technical appendix 1: Delivering outcomes for customers, January 2019](#)

<sup>32</sup> [Ofwat, Technical appendix 1: Delivering outcomes for customers, January 2019, p8](#)

<sup>33</sup> [Ofcom, Fixed Access Market Review 2014, volume 1](#)

measures and many other aspects of its operation; other regulators collect this information to be able to perform detailed econometric analysis that allow incentives to be effectively calibrated, without which OBR will be a missed opportunity to ensure incentives are effective and appropriate for H7

### **Knife edge rebates**

- 1.85. We continue to reject Heathrow's assertions that sliding scale targets should be introduced, and refer to our previous comments on this in past consultation responses; suffice to say that as proposed by Heathrow, sliding scale targets represent a significant reduction in incentive strength where the top end of the sliding scale is set at the same point as the current knife edge target
- 1.86. As a result, we agree with the CAA that knife edge targets are simpler and more transparent, rebates are clearer and less complex, and the pass or fail threshold "supports the reputational element of the OBR framework, and avoid the notion of acceptable failure"<sup>34</sup>
- 1.87. Heathrow's contention that it will no longer have the incentive to deliver service quality once it has missed a target is not credible, since failure would not materialise as a result of the knife-edge nature of the incentives, but as a result of averaging over the course of a number of days, weeks or months; Heathrow's position is not credible as it is incompatible with its continued desire to average targets over as long a period as possible to avoid rebate payments where possible
- 1.88. Furthermore, we agree with the CAA that Heathrow's position is supported by weak evidence that does not justify either sliding scale or the payment of bonuses above the relevant target; notwithstanding our issues with stated preferences in WTP analysis as set out above, we agree that Heathrow has not set out any specific levels of performance that are particularly important in support of its proposals

### **Allocation of rebates**

- 1.89. We agree with the CAA that allocating rebates and bonuses based upon a mapping against ranked consumer research findings is inappropriate; we reiterate our view that incentives need to be tailored to the operating expenditure requirements, and should further be scaled to ensure compliance and avoid a situation where it could be more profitable for Heathrow to breach such service quality targets
- 1.90. We oppose Heathrow's proposed incentives, since these are based upon consumer research findings that we strongly disagree with; Heathrow's study is neither robust nor statistically sound due to its reliance upon the specific questions that were asked, and we agree with the CAA that these would have likely influenced the outcomes that have been stated, and that this is particularly the case given queuing is one thing that typically most irritates consumers

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<sup>34</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.32

- 1.91. The CAA should evaluate the allocation of value towards certain rebates and bonuses based upon its analysis of operating expenditure requirements and a detailed understanding of where performance improvement needs to be driven; we draw attention to the way in which Ofwat designed its PR19 service quality measures<sup>35</sup> and focussed them upon areas that are either critical or require focussed improvement over the course of the price control
- 1.92. Nevertheless, it does not appear unreasonable to take a prudent approach to allocation of rebates at the start of H7, particularly to avoid undermining incentives that work at present during the Q6 period; we therefore welcome the CAA's approach to "take a high-level overview of the pattern of rebates, including what should change compared with the current allocation of rebates"<sup>36</sup>, though caution that the CAA cannot rely upon self-modification provisions to update the incentive as new evidence comes to light during H7

### **Continuous improvement**

- 1.93. We support the CAA's desire to introduce further measures over the course of H7 as part of a continuous improvement programmes, and note the failure to include certain control posts<sup>37</sup> in the Q6 measures has resulted in the under-utilisation of assets that have been funded through capital expenditure
- 1.94. However, this should additionally result in the target for certain measures becoming more demanding over the course of the price control; this would truly mimic the effect of competition on measures, which is the most fundamental intent of economic regulation as enacted through CAA12
- 1.95. We will engage with the subsequent working paper on OBR, but we note the CAA comment in relation to the self-modification provision whilst "we may propose a minor change to the scope of this provision, we do not intend to specify particular timescales for reviews or decisions, or to specify a particular process that must be followed for changes that are agreed between HAL and airlines"<sup>38</sup>
- 1.96. We believe this would be a mistake, since the incentive on the regulated company will be not to agree to any changes should the incentive be weak, and to seek all and every means to remove an incentive that is challenging; this asymmetry is natural, but as we have noted repeatedly, the CAA cannot rely upon self-modification to change the licence in H7
- 1.97. We also note the CAA comment that "it is for the parties themselves to decide if a particular process (such as an annual review) should be adopted, and the nature and scope of any discussions"<sup>39</sup>; we also believe this would be an error, since the

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<sup>35</sup> [Ofwat, Technical appendix 1: Delivering outcomes for customers, January 2019](#)

<sup>36</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.47

<sup>37</sup> See airline community control post analysis, 2021

<sup>38</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.51

<sup>39</sup> Ibid.



role of CAA as regulator and arbiter is essential to ensuring that the OBR is appropriately tailored to drive the objectives of the CAA

- 1.98. Whilst we note the CAA's desire to ensure that such continuous improvement "does not undermine the current structure of five-yearly price control reviews and should not expose stakeholders to additional risk"<sup>40</sup>, we believe this is a mistaken view of how risk materialises; it is particularly important that incentives have sufficient strength particularly where information is largely collected by the regulated company
- 1.99. As the price control progresses, and it becomes apparent that certain measures lack the appropriate strength that was intended, it does not increase risk on the company to reset the target over that incentive; on the contrary, it restores risk to where it was originally intended to have been set
- 1.100. We favour an annual review process that ensures Heathrow, airlines and the CAA have full visibility over the evolution of OBR in its infancy, ensuring all parties are fully informed when the H8 periodic review arises; a single mid-period review of OBR would be insufficient to ensure timely implementation of key H7 measures for which data is still being gathered, and risks undermining OBR effectiveness
- 1.101. Were the CAA to commit to annual reviews of OBR in a similar manner to Ofwat's annual review of outcomes service and delivery<sup>41</sup>, this would ensure the CAA is better equipped with information to effectively regulate Heathrow, and be able to use appropriate powers to intervene where Heathrow is not acting in the best interests of consumers
- 1.102. As noted by Ofwat<sup>42</sup>, transparency and provision of information ensures they and other stakeholders can hold companies to account; in the absence of more frequent reviews, the CAA risk leaving Heathrow to its own devices, which would be a mistake when there is the combination of "a number of significant changes to the SQRB framework and also the uncertainty created by the impact of the covid-19 pandemic"<sup>43</sup>
- 1.103. In addition, if investments were made that resulted in new measures being required, it would be a mistake to wait until a mid-period review to ensure the asset was under effective monitoring from its date of delivery; we refer again to the peculiar case of the control post completed in early Q6 that has no measures attached to it despite having been completed early in Q6, which is a waste of money as a result
- 1.104. We believe reviews should be annual as a minimum, since otherwise, the ability of the CAA to update the OBR regime for certain information that may not be

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<sup>40</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.52

<sup>41</sup> [Ofwat, Service and delivery 2020-2021](#)

<sup>42</sup> [Ofwat, Monitoring and assuring delivery](#)

<sup>43</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.53

apparent at present may be constrained; the CAA's examples<sup>44</sup> of areas to which such a review may be limited to appear extensive but may not cover the heart of an issue that develops in future

- 1.105. In addition, it may also be appropriate to revisit the overall level of rebates and bonuses, particular if significant new information came to light that suggested underlying operating expenditure had not been assessed correctly, and therefore that the incentive had be set too low

### **Bonuses**

- 1.106. We remain opposed to the use of bonuses in general, particularly where these result in outperformance payments that are not linked to Heathrow's obligations as licence holder; in particular we do not believe bonuses as currently proposed are appropriate given they are neither calibrated to any particular improved consumer or environmental outcome, nor is there appropriately evidenced consumer support for such payments
- 1.107. We view the Ofwat guidelines for bonuses to be a more appropriate means of judging when such payments are appropriate; these are described as where "outperformance payments are for strong outperformance and not for carrying out the "day job", demonstrate there are benefits from improved performance, and provide evidence of customer support for its proposed outperformance payment"<sup>45</sup>
- 1.108. As a result, we cannot yet support the CAA's allocation of 1.44% towards bonuses, particularly given two of the Q6 measures are no longer proposed for H7, leaving just cleanliness and wayfinding measures in place; the CAA should not be seeking to fill the bonus pot with inappropriate measures if there is not a demonstrable consumer benefit that can tangibly be incentivised through the application of a bonus
- 1.109. It would be an error to simply maintain a bonus allocation of 1.44% without having identified a specific consumer need to service quality improvement, and irrational to allocate it in a way that is not compensation for strong outperformance

### **Conclusion**

- 1.110. We will comment further on OBR in the coming weeks and months; our comments in this section should therefore be viewed as preliminary until we have further considered the interaction of measures and targets under the CAA's Initial Proposals
- 1.111. We support the CAA's introduction of OBR to ensure consumers' interests are furthered through the regulatory regime; we remain concerned that Heathrow's

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<sup>44</sup> CAP2265D: Chapter 14, Outcome based regulation, para 14.54

<sup>45</sup> [Ofwat, Technical appendix 1: Delivering outcomes for customers, January 2010, p9](#)



proposals for OBR will undermine service delivery, and it is critical that OBR continues to support airlines' operational delivery of services for consumers through understanding marginal cost of critical services, delivers continuous improvement, and is consistent with the capital programme and analysis of operating expenditure and commercial revenues within the price control

- 1.112. We believe outcomes should be more specific, as are those specified by Ofwat in PR19, and whilst the OBR will be subject to evolution in H7 cannot rely upon self-modification provisions in the licence for such an important incentive; whilst it may be difficult to distinguish where responsibility lies in some cases, this difficult task must be undertaken to ensure measures exist over all critical areas of Heathrow's operation, similar to how such analysis is performed by Ofcom and Ofgem
- 1.113. Financial incentives are what makes Heathrow responsive, and we do not believe reputational measures have the same effect on Heathrow's incentives, and therefore support the CAA's rejection of some of Heathrow's measures where they have no bearing on delivery of its licence obligations; nevertheless we believe it is critical for ORCs and other key areas of expenditure to be covered by OBR measures in full, particularly where there is a clear and longstanding problem in service delivery, such as in PRM service
- 1.114. We believe measurement should be at as granular level as possible to recognise the effect upon individual passenger outcomes, and avoid averaging effects that introduce a concept of acceptable failure or grouping in the case of vehicle control posts; in addition, we believe that measurement should be based upon the time that assets are required rather than a whole 24hr period, which at present undermines the delivery of outcomes when they are required e.g. the availability of a serviceable jetty for a particular arrival or departure
- 1.115. We believe that the information requirements for OBR should be supported by an appropriate licence obligation, and that it is appropriate for certain asymmetry in the OBR where certain outcomes are more desirable, or it is not appropriate to incentivise an increase in performance above the baseline level; we agree that knife edge rebates therefore remain appropriate

Yours sincerely,

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