

Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control

CAP 1540



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About this document

This document sets out guidance to Heathrow Airport Limited (HAL) on its business plans for the period after the current arrangements are due to expire at the end of 2019. These plans will need to encompass both its existing business activities and the new runway capacity expansion. The CAA may update or revise this guidance from time to time.

This document also consults stakeholders on two specific issues: whether we should provide a financial incentive on HAL to develop a high quality business plan; and how best to align the regulatory and business planning timetables in light of developments with the wider process for runway capacity expansion.

We will publish a further consultation at the end of June 2017 on the regulatory framework for the price control review.

Views invited

Please email your response to economicregulation@caa.co.uk by no later than 5pm on 2 June 2017. We cannot commit to take into account any representations received after this date.

If you would like to discuss the issues raised in this document please contact Beth Corbould on beth.corbould@caa.co.uk or on 020 7453 6191.

Representations will be made available on our website. Any material considered confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to disclosure of information under Section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000 and it may be necessary to disclose information consistent with these requirements.

Associated documents

March 2016	Strategic themes for the review of Heathrow Airport Limited's charges: A discussion document Strategic themes for the review of Heathrow Airport's charges: Technical appendices
May 2016	Incentivising the right consumer outcomes - discussion paper
June 2016	Increasing airport resilience - discussion paper
September 2016	Decision on the Terms of Reference for the H7 Consumer Challenge Board (CCB)
October 2016	Notice of proposed modification to Heathrow Airport Limited's economic licence to extend the current price control by one year
November 2016	Terms of Reference: Assessment of airport-airline engagement on the appropriate scope, design and cost of new runway capacity
December 2016	Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime
January 2017	Economic regulation of the new runway at Heathrow Airport: consultation on CAA priorities and timetable
February 2017	Airport capacity expansion: Update to DfT

Summary

1. The current regulatory arrangements that apply to HAL (known as Q6), including a price control and standards for service quality, are due to expire on 31 December 2019. HAL is currently at an early stage in formulating its development of business plans for the period beyond 2020. This document provides high-level guidance to HAL on its business plans (which will need to cover both its existing operations and capacity expansion). This guidance includes our expectations on outcome-based regulation (OBR) and consumer engagement following our earlier consultations on these subjects. The CAA may update or revise this business planning guidance from time to time.
2. As well as providing guidance this document takes the opportunity to consult stakeholders on two specific issues. First, whether we should provide a financial incentive on HAL to develop a high quality business plan. Second, how we can best align the regulatory and business planning timetables in light of developments in the wider process for new runway capacity. We will discuss both these issues with HAL and the airline community (and any other interested stakeholders) over the coming weeks.

Background to the H7 review

3. Early in 2016 we initiated our review of the regulatory arrangements that should apply after 2020 (known as H7) by consulting on four strategic themes¹:
 - empowering consumers and furthering their interests;
 - incentivising the right consumer outcomes;

¹ In March 2016, we launched a review (the H7 review) of the issues that should shape the framework for the next control period CAA (2016) 'Strategic themes for the review of Heathrow Airport Limited's charges: A discussion document', <http://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=7243>

- increasing airport resilience; and
 - promoting cost efficiency and financeability.
4. Based on feedback from stakeholders on the uncertainties associated with possible capacity expansion, we decided in summer 2016 that it would be appropriate to extend the current regulatory arrangements by one year so that they expire at the end of 2019 rather than 2018.
 5. We noted that an extension to Q6 would also allow more time for our consumer focused work, including developing our approach to quality of service regulation and establishing (in partnership with HAL and airlines) the Consumer Challenge Board (CCB).
 6. In October 2016 the Government announced that its preferred option for the expansion of airport capacity in the South-East of England was the Heathrow north-west runway. Soon after this we issued guidance about our expectations of HAL in its engagement with airlines on the design of new runway capacity². We were also asked by the Secretary of State to advise him about the effectiveness of HAL's engagement process³.
 7. In January 2017 we issued our consultation on the priorities and timetable for developing the regulatory framework, such that the regulatory arrangements for HAL would properly take account of capacity expansion, continue to protect consumers, and incentivise HAL to finance and develop new capacity in an efficient way. The four key priorities we identified were that HAL should develop:
 - a scheme design to further the interests of consumers by engaging in a transparent and effective way;

² Letter from Andrew Haines to John Holland Kaye regarding CAA's expectations on the appropriate scope, design and cost of the new runway capacity

<http://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294981598>

³ Terms of Reference: Assessment of airport-airline engagement on the appropriate scope, design and cost of new runway capacity

http://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airports/Economic_regulation/Price_control_files/Section%2016%20ToR%20on%20HAL%20engagement%20with%20airline%20community.pdf

- robust cost estimates and we would need to develop regulatory arrangements to incentivise HAL to deliver the project in a timely and efficient way;
 - proposals for efficient financing and we would need to develop the regulatory framework consistent with this, affordability and financeability; and
 - coordinated proposals for existing operations (i.e. for the H7 price control) alongside its proposals for the new runway and capacity expansion, so that its overall business plan is affordable and financeable.
8. These are consistent with the strategic themes for the H7 review identified above. Priority 1 (a scheme design to further the interests of consumers) will lead to more resilience in the provision of services to consumers. Priorities 2 and 3 are consistent with efficient costs and financing. Priority 4 (that HAL should produce an integrated business plan for its existing activities and capacity expansion) underlines the importance of the H7 review encompassing all of HAL's activities.
9. While capacity expansion is of vital importance to consumers, HAL should also be incentivised not to lose focus on its existing business activities especially in the period between 2020 and the opening of the new runway capacity (assuming that HAL receives planning permission to proceed).

Guidance and incentives for a high quality business plan

10. HAL's business plans should be high-quality, clear, robust, and well-justified by supporting evidence. We expect HAL's initial business plan (IBP) to build on its engagement with airlines this year and provide robust information to facilitate constructive engagement (CE) with airlines on the main options for its final business plan (FBP).
11. HAL's Board should certify that the FBP reflects efficient costs and financing, is affordable, deliverable (including in respect of financeability),

and reflects consumer views and preferences to the fullest extent practicable.

12. As well as the reputational incentives associated with Board certification and public scrutiny we would welcome views on whether we should introduce a financial incentive on HAL to produce a high quality business plan.

OBR and resilience

13. In our December 2016 consultation, we said that we would like the regulatory regime to be responsive to the outcomes that consumers' value and include an outcome-based approach to service quality regulation for H7. Those airlines that responded to our consultation on these matters have argued vigorously that the existing quality of service regime has worked well, and that any changes need to take proper account of the circumstances at Heathrow and the role of airlines in protecting the interests of passengers.
14. We recognise that at Heathrow the airlines have a vital role to play in helping deliver an appropriate quality of service for passengers and in working with HAL to develop a coordinated approach to service provision. For the successful implementation of OBR it will be appropriate for HAL to recognise the role held by the airline community at Heathrow and work with the airlines to develop OBR. This will involve building on the success of the existing Service Quality Rebate and Bonus (SQRB) scheme.
15. This guidance confirms the principles that we think should underpin the outcome-based framework that we will expect HAL to develop as part of its business plan. As part of this, HAL should explore areas where resilience could be more closely aligned to an outcome-based approach to regulation.

Consumer engagement

16. It is important that HAL (which will be responsible for designing and delivering the overall consumer engagement programme), the airline community (who have important insights from their internal customer research to share), and the CCB (who will be scrutinising and challenging HAL on its consumer engagement programme) are clear on our expectations for high quality consumer engagement. In summary HAL should:
- use an appropriate range of data and techniques;
 - understand the needs and requirements of different consumers;
 - engage consumers on complex issues by informing and educating them;
 - carefully design willingness-to-pay studies to increase robustness; and
 - engage with consumers on an ongoing basis.
17. We are also providing guidance to the CCB on how it can best frame its advice to the CAA and the areas where it should focus its attention as it begins to engage with HAL and the airlines.

Aligning the regulatory and business planning timetables

18. In extending the existing price control by a year in 2016 we said we would consider whether there was a case for a further extension to the Q6 price control during 2017. It is now important to review the regulatory timetable again in the light of developments in the wider timetable and process for capacity expansion.

What happens next?

19. We will publish a further consultation at the end of June 2017 on the regulatory framework for the price control review – including our developing

thinking on key aspects of the incentive arrangements for HAL. The June document will also provide the opportunity to update our thinking (in the light of the responses to this consultation) on the regulatory timetable.

Our duties

20. In developing the policy in this document we have had full regard to our statutory duties under the Civil Aviation Act 2012 (the Act), which are summarised in Appendix A.

Structure of this document

21. The structure of this document is:
- Chapter 1 sets out our views on criteria for a high quality business plan and sets out for consultation a possible approach to providing financial incentives on HAL to develop a high quality plan;
 - Chapter 2 provides guidance to HAL on outcome-based approach to service quality regulation and resilience;
 - Chapter 3 provides guidance to HAL on consumer engagement and more detail on the role of the CCB; and
 - Chapter 4 discusses and sets out for consultation the timetable for the H7 price control review.

Chapter 1

Guidance and incentives for high-quality business plans

Background

- 1.1 In previous regulatory reviews, we have taken a light touch approach to setting guidance or requirements for HAL's business plans and business planning processes. In our March 2016 consultation, we said that our approach should evolve and we would provide more high level guidance at an early stage. The intention is to increase transparency with respect to our expectations of HAL and help it to produce more useful business planning information and a higher quality initial business plan (IBP) and final business plan (FBP). This should help to improve the scope and depth of the discussions which take place in constructive engagement (CE) between HAL and the airlines, and thus further improve the FBP which should form a key input to the final H7 price control settlement.
- 1.2 This Chapter sets out:
- guidance to HAL on what we mean by a high quality business plan;
 - how we expect the business plan to facilitate CE;
 - the regulatory and other incentives on HAL to produce a high quality plan; and
 - a brief description of the initial efficiency studies carried out by the CAA as background to HAL's IBP, and to promote early stakeholder engagement.

High-quality business plan criteria

- 1.3 HAL's business plan should be high-quality, clear, robust, and well-justified by supporting evidence. More detailed criteria are set out in Table 1 below.

Table 1: business plan criteria

<p>Outcomes and consumer engagement</p>	<ul style="list-style-type: none"> • HAL’s plans should take account of and demonstrate a deep understanding of consumer preferences based on a wide range of engagement and research. Its approach should be reviewed and tested by the CCB. • There should be strong evidence that consumers have been fully engaged in developing the outcomes that HAL proposes to deliver. The plan should be clear about how engagement has shaped and influenced the proposed outcomes. We expect a clear and transparent process to be used to convert consumer research into business plan outcomes. • Throughout its plans we expect HAL to demonstrate that it has made robust assumptions, that possible options have been carefully considered (including the trade-off between affordability and service) and how in the FBP strategic choices have been made, and that the options proposed are best placed to achieve maximum value for consumers. • In addition to robust engagement with consumers, HAL should engage extensively with airlines throughout the process – including in the development of the IBP (and so ahead of CE).
<p>Resilience</p>	<ul style="list-style-type: none"> • HAL’s plans should include a clear focus on the resilience of the airport. The plans need to provide evidence not only on how the airport will remain operationally resilient over the H7 period, but also how sufficient resilience is being built into the design of new infrastructure. • HAL must provide evidence it has robust resilience contingency arrangements to mitigate operational impacts resulting from construction and any increase in capacity which is likely to occur during H7 period. • HAL’s approach to resilience needs to be joined up across the business, and thus reflected not only in the business plan, but also in the operational resilience plan (consistent with its licence obligations).
<p>Costs</p>	<ul style="list-style-type: none"> • HAL should provide evidence showing a wide range of possible cost options, including both operating and capital solutions and the links with outcomes. The FBP should clearly illustrate how the best options have been selected and how maximum value for money will be achieved. • Forecast costs should combine the evaluation of past performance with realistic assumptions about the scope for increased efficiency in the future. Where practicable costs should be market-tested or benchmarked, and baseline assumptions clearly explained.
<p>Incentives and risks</p>	<ul style="list-style-type: none"> • HAL should identify key risks associated with delivering its plans. Risk management and mitigation strategies should be clear and proportionate. • The FBP should set out the regulatory incentives (including outcome delivery incentives) that it considers will best support efficient delivery for consumers, including evidence that supports its proposals and the calibration of the incentives. • It should be clear on the relationship between risks and incentives and where risks remain how these have been allocated and how the proposed allocation is consistent with protecting the interests of consumers.
<p>Financeability / affordability</p>	<ul style="list-style-type: none"> • HAL should provide robust evidence that its FBP is financeable and affordable, and that the financing costs are efficient – including under a reasonable range of downside scenarios. • Its proposal on the WACC should be consistent with efficient financing and its assumptions on risks and incentives.
<p>Scope</p>	<ul style="list-style-type: none"> • HAL’s business plans must be integrated and fully encompass proposals for both existing operations and the new runway capacity expansion. • The focus should be on the period from the end of the existing price control arrangements (end 2019) to the expected opening of the new runway (currently 2025) with higher level projections to demonstrate longer-term financeability and affordability beyond 2025. • HAL should provide a level of detail on projects which reflects the time periods for their

	delivery– projects that are further in the future will typically have less detail.
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Quality of business plan incentives

- 1.4 In previous consultations on this issue we raised the possibility of a range of incentives to encourage HAL to produce a high quality business plan:
- reputational – for example by the CAA making a public statement about the quality of the business plan HAL has submitted;
 - financial – for example other regulators have rewarded companies for high quality plan with a higher allowed return;
 - administrative – for example, a high quality plan may require less scrutiny and thus the airport could receive its price control determination earlier than it otherwise might have; and
 - procedural – similar to administrative, a high quality plan could be subject to a lighter-touch, more risk-based assessment by the regulator.
- 1.5 In the light of further consideration (including the responses to our consultations) we have now ruled out administrative or procedural incentives. Given the complexities created by capacity expansion, these types of incentives do not appear practicable.
- 1.6 Reputational incentives remain appropriate and we intend to pursue this approach through requiring HAL’s Board to certify that its plans meet our aspirations for a high quality plan and through an open and transparent assessment of the plan’s quality by the CAA and other stakeholders.
- 1.7 We also want to explore further the options for a financial incentive for a high quality business plan. Other regulators have started to develop such incentives and we invite views on whether such an approach might be appropriate for HAL.

Board certification and plan assessment

- 1.8 As part of the process for HAL submitting its FBP, we expect HAL's Board to certify that the business plan is:
- based on efficient costs and financing;
 - affordable;
 - deliverable (including in respect of financeability); and
 - reflects consumer views and preferences to the fullest extent practicable.
- 1.9 The Board should submit a statement alongside the FBP that explains its views of the plan, and how its members have assured themselves of its quality.
- 1.10 The CAA will assess the FBP as a key part of setting the H7 price control. This will involve consideration of both how well HAL has met the criteria summarised in Table 1 and feedback from the airline community, the CCB, and other interested stakeholders. It is important to underline that we would be unlikely to consider a plan high quality if the airlines, CCB and other stakeholders do not broadly support the plan. We will set out our assessment of HAL's plan as part of our initial proposals for the price control determination.

Financial incentives

- 1.11 Some of the financial incentives used by other regulators for business plans (for instance where the regulator benefits from being able to make comparisons across the business plans of a number of different regulated companies) are not available in the circumstances of HAL, where regulation focuses on a single airport. Nonetheless, we would like to consider whether there are effective and proportionate ways to incentivise HAL to develop an ambitious business plan that has the support of key stakeholders such as the airlines and the CCB. A business plan with such broad support could have significant benefits for consumers and HAL in terms of the efficiency of the regulatory process.

- 1.12 One approach is to consider whether we make a fixed financial sum available for a business plan that in our view is of high quality. Another approach might be to take into account the quality of the business plan as a relevant factor in exercising our judgement about the appropriate cost of equity for HAL, specifically as one of the factors we take into account in reaching a judgement on the final point estimate within our determined plausible range consistent with all other aspects of the regulatory framework and the risk environment⁴.
- 1.13 We would welcome views on whether we should financially incentivise HAL to develop a high quality business plan with widespread stakeholder support and how this could best be achieved.

Constructive engagement (CE)

- 1.14 CE between HAL and the airlines is a critical part of the development of the regulatory settlement for HAL. We expect the formal CE process to take place between HAL's submission to the CAA of the initial and final business plans.
- 1.15 CE is designed to bring the operational knowledge and experience of the airline community to bear on the IBP and help the parties identify the best FBP for consumers and airlines. Even if final agreement cannot be reached between HAL and the airlines, CE can provide very valuable information to the CAA's subsequent final price control setting process.
- 1.16 As in previous years, the scope of CE should be focussed on HAL's business plan, and the investment and services to be delivered by HAL in the next regulatory period. We would expect to issue a specific CE mandate nearer the time to set out detailed expectations as was the case with the previous price control review.

⁴ A more explicit approach based on linking the quality of business plans to the regulatory cost of equity is adopted by the Essential Services Commission in Victoria, Australia, for example see - <http://www.esc.vic.gov.au/wp-content/uploads/2014/12/A-new-approach-to-regulatory-pricing-for-Network-September-2016.pdf>

- 1.17 We expect CE to build on the airport/airline engagement taking place this year on overall scheme design for capacity expansion. This process should lead to the selection of a preferred option for capacity expansion and this should inform the development of HAL's IBP. Nonetheless, the detail of the plans for capacity expansion will also need to evolve and be refined further. Therefore, CE should encompass both HAL's existing activities and capacity expansion. To the extent practicable, CE should follow on seamlessly from the current engagement process on capacity expansion with airlines.

Consultancy studies

- 1.18 HAL and airlines have been keen for the CAA to bring forward some of our technical consultancy studies in order that they can be used to help facilitate their engagement around HAL's business plan. To help provide background for HAL's IBP and facilitate early dialogue with airlines and other stakeholders we commissioned a series of studies examining key elements of HAL's costs and revenues. These were designed to provide some independent, high level evidence against which HAL's current performance can be assessed and which we expect HAL to take into account in formulating its IBP.
- 1.19 There are currently five studies that we intend to publish over the coming months. These are:
- capital expenditure governance arrangements – this report examines the effectiveness of the Q6 arrangements for airport/airline governance and the regulatory incentives for capital projects;
 - top down benchmarking – this study focuses on high-level economic and financial metrics and compares Heathrow to other large airports. These metrics include airport charges per passenger, total revenue per passenger, profit per passenger, operating expenditure per passenger and commercial revenue per passenger;

- commercial revenues – this report compares HAL’s performance in terms of optimising commercial revenue with the assumptions made in setting the Q6 price control, and includes an assessment of the reasons for variances and the scope for future increases in commercial revenues;
- operating expenditure efficiency – this study makes a range of benchmark comparisons of operating costs and provides an initial assessment of the scope for further efficiency improvements; and
- cost and revenue allocations – this report focuses on how HAL allocates expenditure between operating and capital costs and how it allocates and treats different streams of revenue.

Chapter 2

Outcome-based regulation (OBR)

Background

- 2.1 In our December 2016 consultation, we said that the regulatory regime should be responsive to the outcomes that consumers' value and include an outcome-based approach to service quality regulation for H7. We said that we considered the regulation of the quality of airport services provided by HAL could be improved by strengthening the link with consumer preferences and priorities. This would reflect best practice in regulation and be fully consistent with our primary duty under the Civil Aviation Act 2012 to protect the interests of consumers.
- 2.2 We had six responses (which are available on our website⁵) to our consultation, from HAL, the Airline Operators Committee (AOC) and London Airline Consultative Committee (LACC), Heathrow Airport Consultative Committee (HACC) Passenger Services Sub-Committee (PSSC), Virgin Airlines, British Airways, and Gatwick Airport Limited (GAL).
- 2.3 We have carefully considered these responses in developing our final policy on OBR, and we have refined our views since our earlier consultations.

Final policy decision for outcome-based regulation

- 2.4 In their responses to our consultations on these matters airlines have argued vigorously that the existing quality of service regime has worked well, that any changes need to take proper account of the circumstances at Heathrow and the role of airlines in protecting the interests of passengers. They have also said that there would be a danger that a broader approach using passenger outcomes as the basis for incentives could effectively expand regulation to activities best left to competitive forces and commercial negotiations.

⁵ <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Heathrow-price-control-review-H7/>

- 2.5 We recognise that at Heathrow the airlines have a vital role to play in helping deliver an appropriate quality of service for passengers and in working with HAL to develop a coordinated approach to service provision. For the successful implementation of OBR it will be appropriate for HAL to recognise the role held by the airline community at Heathrow and work with the airlines to develop OBR.
- 2.6 The current approach to service quality (output-based regulation through the SQRB) at HAL incentivises many of the key services HAL provides to airlines. We therefore consider that OBR should be an evolution of the SQRB, with service provided to airlines remaining a key part of the incentive regime. We expect to see a balance between the service quality elements that are provided directly to passengers (such as cleanliness and way-finding) and the services that are focussed at enabling airline to provide services to passengers (such as stand and pier asset availability, pre-conditioned air and fixed ground power). In this context HAL should develop suitable outcomes, measures, targets and incentives for adoption as part of OBR.
- 2.7 In addition to this careful and explicit recognition of the role of the airlines in terms of service quality, it is also important to recognise the important role of HAL in coordinating operation across the whole airport. For instance, the resilience of the airport's services is one of the important areas that HAL has a role in coordinating. This wider coordinating role shows the importance of expanding on the SQRB so that outcomes capture the wider passenger experience at HAL. Nonetheless, in developing wider measures, HAL will need to consult carefully with airlines and the CCB, and have regard for their ideas and concerns.
- 2.8 To implement OBR, we consider the following five principles for the design of an OBR framework remain appropriate. Principle 3 emphasizes the importance of airline and CCB involvement and principle 4 stresses that HAL should build on the success of the SQRB in developing outcomes;
- Principle 1: OBR should be informed by robust consumer research;

Principle 2: the structure of OBR should include outcomes, measures, targets and incentives;

Principle 3: CCB and airlines play a key role in the development of OBR;

Principle 4: OBR should build upon the SQRB; and

Principle 5: performance reporting should be comprehensive and targeted at consumers.

- 2.9 Further guidance on the structure of OBR (i.e. Principle 2 above) is set out below.

Outcomes

- 2.10 Outcomes are the over-arching objectives that identify the most important aspects of the airports services that consumers' value. They should be simple and easy for consumers to understand. They can encompass those aspects for airport performance that impact on other stakeholders, such as the provision of services to airlines and environmental performance - but are nonetheless important to consumers.

Measures

- 2.11 Each outcome should have one or more associated performance measures that indicate progress towards the outcome. The overall package of measures should cover all aspects of airport operations that are either directly or indirectly important to consumers. For the avoidance of doubt, this should include aspects of service which may not be immediately visible or obvious to consumers, such as the availability of ground power or pre-conditioned air, but have a significant impact on consumer experience.
- 2.12 Measures can comprise a mixture of traditional outputs (e.g. security queue time) and metrics based on the stated or revealed preferences of consumers (e.g. passenger survey results). We consider an appropriate OBR framework would continue to measure the key outputs contained in the SQRB, where these align with airline and consumer priorities.

Targets

- 2.13 Targets should be based on evidence and take account of the following factors:
- customer preferences and satisfaction with respect to historical and current performance levels;
 - the scope for improving performance (including consideration of innovative ways of working) without incurring significant extra costs on the basis of setting demonstrably challenging targets for management; and
 - the willingness of consumers and airlines to pay for investment to further improve performance beyond that possible using existing facilities. This willingness to pay information should also be used as part of process of robust investment appraisal to identify the most cost beneficial option to deliver service improvement.

Incentives

- 2.14 We expect the majority of targets to have financial incentives although reputational incentives could also be considered where appropriate. Where practicable incentives should be both positive (reward) and negative (penalty).
- 2.15 Incentives must be justified and calibrated with respect to consumer priorities and willingness to pay. They must also be integrated with the business plan and HAL's proposals for efficiency incentives. Consumers should not be expected to pay twice for the same investment – so if HAL's proposals for a cost baseline include the funding of service improvement, this should be taken into account in the calibration of incentives relating to service improvement.
- 2.16 The incentives should also be clear and reasonably easy to understand. We expect HAL, in discussion with the CCB and airlines, to develop a credible and balanced set of incentives. HAL will also need to consider the

likely impact of these incentive arrangements on creating a balanced risk and reward package for its FBP.

Further development of the OBR framework

- 2.17 HAL will be responsible for the initial development of OBR, in discussion with airlines and the CCB. HAL and the airline community, with scrutiny by the CCB, are best placed to understand passenger preferences and to work together to take this framework forward. HAL must prepare a business plan reflecting airline community views and which fully integrates an OBR framework into its IBP and FBP.
- 2.18 There is a risk that HAL and the airline community cannot agree on an OBR framework that protects consumers. The CAA retains the power to step in and impose solutions to ensure that consumers' interests are properly protected.

Resilience

- 2.19 Ensuring and incentivising resilience at Heathrow is a strategic theme for the H7 price control review. The existing resilience condition in HAL's licence also requires it to secure the availability and continuity of airport operation services, particularly during disruption, to mitigate the likelihood and impact of disruption (regardless of the cause) for the benefit of consumers⁶.
- 2.20 In June 2016, we held a seminar exploring stakeholders' appetite to build on the good progress made in Q6 by considering further improvements to the regulatory incentives for resilience. Key stakeholder feedback from the seminar⁷ included that:

⁶ HAL is also required to comply with other obligations under the resilience condition. See condition D2 <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Economic-licensing-of-Heathrow-Airport/>

⁷ The discussion paper and seminar note are on our website. See: <http://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Heathrow-price-control-review-H7/>

- there is already good operational resilience planning and collaboration between stakeholders and investment in facilities, procedures and systems;
- there is no appetite for more intervention through the regulatory regime; and
- airspace management and change are key factors in improving resilience at the airport in the future.

2.21 We also commissioned qualitative consumer research focussing on consumers' views on day-to-day disruption at the London airports and the trade-offs between resilience, cost, and service level⁸. This research indicated that existing levels of disruption were not generally seen by consumers as such a major problem that might warrant either reduced choice or increased prices in return for more resilience. Nonetheless, consumers were concerned that, as airports and airspace get busier in the future, delays and disruption may get worse. HAL should consider these findings as background to its approach to consumer engagement.

2.22 There are also particular issues at Heathrow during the next price control period – as capacity expansion could distract HAL from its focus on resilience and the construction of new infrastructure could interfere with the day-to-day operation of the airport. Therefore, it is important that the regulatory framework continues to provide appropriate incentives for resilience.

A consumer focused, outcome-based approach to resilience

2.23 When developing our approach to resilience in the Q6 initial proposals, we made it clear that the licence obligation had an overarching focus on consumer outcomes⁹. Responsibility and accountability for resilience rests with HAL as the operator of airport facilities. HAL is best placed to deliver a coordinated response to disruption, and to do so through good

⁸ Consumer attitudes to journey disruption - A qualitative research report. In particular see chapters 5-8 <http://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=7617>

⁹ Economic Regulation at Heathrow from April 2014: Initial Proposals - see page 203 <http://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=5521>

collaboration with airlines and other stakeholders. We expect HAL to build on the progress it has already made and take account of the following factors in embedding resilience into its business plans.

Proactive leadership and accountability for resilience outcomes

- 2.24 HAL should continue to take ownership of resilience in collaboration with stakeholders to deliver good resilience outcomes for consumers in line with its licence obligations and CAA guidance on resilience. For example, HAL already plays a role in requiring, monitoring and encouraging good performance across the whole airport under the Ground Operations licences, monthly performance reports and via scorecards. This is complementary to the commercial arrangements between airlines and ground handlers that provide for contracted service levels and performance standards. This shows HAL can help coordinate service providers to deliver good consumer outcomes, without unduly cutting across existing voluntary or commercial arrangements. We expect HAL to consider how this approach could be applied to deliver resilience in other areas of the airport.

To develop resilience outcomes as part of OBR framework

- 2.25 HAL should explore areas where resilience could be more closely aligned to an outcome-based approach to regulation where consumer research confirms this is something consumers' value. We consider HAL and airlines (with scrutiny and assistance from the CCB) are best placed to consider areas where resilience could be further incentivised by OBR but we reserve the right to mandate measures, targets and incentives if this collaborative approach were to fail and it were to be in the interests of consumers to do so.

Robust resilience planning should be reflected in the operational resilience plan required under the licence

- 2.26 HAL should develop its existing operational resilience plan, in consultation with stakeholders, by including robust plans and contingency measures to avoid and reduce the impact of disruption from construction and any

increase in capacity occurring during the H7 period as part of capacity expansion. For example, HAL's plan should identify and clearly set out particular pinch points that are most likely to impact resilience and develop corresponding measures to mitigate them. HAL's approach to resilience should be joined up across the business, and its operational resilience plan should be aligned with the resilience measures in its business plan. We expect HAL to consult on and update its operational resilience plan when needed as the capacity expansion programme progresses.

Chapter 3

Consumer engagement

- 3.1 HAL's business plans must explain how it is going to deliver the right set of outcomes for consumers. To inform its plans and the day-to-day operation of its business HAL should effectively and meaningfully engage with consumers to understand the outcomes they want from their airport experience.
- 3.2 To provide advice on how well HAL has reflected consumer engagement in its business plans we will seek the views of the CCB. We published the Terms of Reference (ToR) for the CCB in September 2016 and since then we have worked with HAL and the airlines to appoint the Chair and the CCB members.
- 3.3 This Chapter:
- includes guidance for HAL designed to reinforce the importance of high quality consumer engagement; and
 - sets out high level guidance for the CCB to help it achieve the objectives set out in the ToR.

High quality consumer engagement

- 3.4 It is important that HAL (which will be responsible for designing and delivering the overall consumer engagement programme), the airline community (who have important insights from their internal customer research to share), and the CCB (who will be scrutinising and challenging HAL on its consumer engagement programme) are clear on our high-level expectations for consumer engagement. In particular HAL should:
- use an appropriate range of data and techniques;
 - understand the needs and requirements of different consumers;

- engage consumers on complex issues by informing and educating;
- carefully design its willingness-to-pay studies to increase their robustness; and
- engage with consumers on an ongoing basis.

3.5 These high level expectations are discussed further below.

Use an appropriate range of data and techniques

3.6 HAL should make sure it properly engages with airlines and understands their views and research about consumers' interests and what consumers value.

3.7 In conducting its own research HAL should adopt a range of different techniques to build up a robust and comprehensive picture of consumer views and opinions. For example, before carrying out large scale, representative quantitative research, such as willingness-to-pay (WTP) studies, it may be necessary to carry out qualitative research to test the proposed approach. This could include a qualitative phase of research to ensure that surveys use language that is meaningful to respondents and are structured in ways that minimise bias. Qualitative research can also play a role in understanding and validating the findings of quantitative research.

Understand the needs and requirements of different consumers

3.8 It is important for HAL to understand (and respond in its business planning and service delivery) the different needs and requirements of different consumers, particularly those with characteristics that may mean they experience air travel very differently to the majority of consumers. One way to help ensure that all relevant consumers are represented in the consumer engagement process could be to carry out a consumer segmentation exercise as part of the research. HAL must also ensure that it appropriately takes into account consumers' interests in the short term and over the longer-term.

Engage consumers on complex issues by informing and educating

- 3.9 Consumers may need to be engaged on multifaceted issues that involve complex trade-offs. In these circumstances, consumers must be sufficiently informed and educated about the key issues, particularly costs and impacts on price, before they can meaningfully express their preferences. For example, engagement on resilience may require educating consumers on the risk of disruption in order to meaningfully test the trade-off between higher costs and less disruption.

Carefully design willingness-to-pay studies to increase robustness

- 3.10 Stated Preference or Conjoint research are part of the more general class of WTP research techniques which measure respondents' willingness to pay for product or service improvements. Respondents are required to trade-off between competing service levels and prices and so 'reveal' their willingness to pay for improvements. These techniques are widely used across all sectors and markets, including in contexts where the service in question is not subject to full competition. HAL's prices and service levels are regulated and only subject to limited competitive pressure.
- 3.11 A key benefit of WTP research is that it provides a monetised estimate of consumers' preferences, making those preferences directly comparable with each other. This allows the testing of service improvement scenarios across a range of service attributes, with the aim of specifying the optimum service definition (maximizing consumer utility/satisfaction) within the operational and budgetary constraints.
- 3.12 WTP research often requires the use of a sophisticated statistical design and the application of advanced modelling techniques, and so we would expect to see strong assurance that the work has been conducted to a high quality, and with the use of best practice design and analysis.

Engage with consumers on an ongoing basis

- 3.13 Consumer engagement should be thought of as a continuous process of learning and responding, and not as a one-off exercise that takes place before a regulatory review. HAL should demonstrate that it has embedded

its approach to consumer engagement beyond just the business plan, and made it part of its business as usual.

Guidance for the CCB

- 3.14 We expect the reports from the CCB to significantly enhance our assessment of the quality of HAL's H7 business plan. The CCB's role is to challenge HAL on how it has carried out engagement with consumers, interpreted and applied the results and reflected these matters in its business plan. As set out in our decision document on the CCB's ToR engagement with the CCB is not a substitute for consumer engagement.
- 3.15 While the CCB ToR provides broad direction we are taking this opportunity to provide guidance to the CCB on our expectations for the H7 price control review. The CCB will be focussed on ensuring the research that HAL is conducting is robust, and that the process HAL and airlines use to define outcomes from consumer research is appropriate and transparent.
- 3.16 As an independent body the CCB will be left to determine for itself how it scrutinises and challenges HAL. However, we have clear expectations on how CCB reports to the CAA and have developed a set of questions for the CCB to consider. These may be updated or revised by the CAA from time to time.

Table 2: key questions for the CCB to consider in reporting to the CAA

Effectiveness of relationships	Has the CCB been able to fulfil its role objectively and independently, including having access to the information, resources and senior staff from HAL it needs in order to fully scrutinise the company's engagement and business plan proposals?
Consumer engagement	Has HAL developed a genuine understanding of consumers' priorities, needs and requirements, drawing on a robust, balanced and proportionate evidence base, including information from airlines? Has HAL effectively engaged with and informed consumers on its current levels of performance and how this compares to other relevant businesses in a way consumers could be expected to understand?
	Has the evidence and information obtained from consumers (including from airlines and through HAL's day-to-day contacts with consumers) genuinely driven and informed the development of its business plans?
	Has HAL effectively engaged with and understood the needs and requirements of different consumers, including those in circumstances that make them vulnerable? Has HAL considered the most effective methods for engaging different consumers, including those that are hard to reach? What trade-offs between the needs of different consumers have been identified and how has HAL proposed to deal with these?
Development of outcomes	How well evidenced is HAL's assessment of consumers' expectations and the outcomes it has developed in response? Is there a clear line of sight between consumer priorities and the final agreed set of outcomes?
	Are the measures of success and outcome delivery incentives appropriate and are the targets sufficiently challenging? Are incentives aligned with the interests of consumers, and do they reflect an appropriate degree of simplicity, clarity and transparency?
Overall assessment	Overall, has HAL's plan responded to customers' expectations and priorities? Are there areas for further scrutiny?

3.17 With regard to the new runway and capacity expansion, the CCB's role is to try and ensure that HAL's plans are consumer focussed – although there will clearly be less focus on short term measures of performance and

more emphasis on considering the evidence put forward by HAL that the overall design is fit for purpose.

3.18 There are also issues we consider are outside of CCB's remit – including detailed scrutiny of HAL's efficiency, financeability and factors such as traffic and commercial revenue forecasts.

3.19 In terms of the reports from the CCB to the CAA we expect:

- a formal, written report on both HAL's IBP and FBP;
- the report on the IBP should be available at same time as the IBP in order that the time for HAL and the airline community to respond to any potential issues raised is maximised. HAL must therefore work closely with the CCB in finalising its IBP;
- we expect the report on the FBP to be available within two weeks of the FBP;
- we will also engage with the CCB in other ways, as well as through these formal reports. This means the CCB will keep us briefed on its work and the issues that it is encountering, and we will respond to any requests from the CCB for guidance on specific issues; and
- the CCB needs to fully explain how it has influenced and validated HAL's business plan, so that stakeholders are able to understand how the CCB arrived at its positions on each issue and the CCB is able to demonstrate its independence from HAL.

Chapter 4

Aligning regulatory and business planning timetables

Impact of the new runway and capacity expansion

- 4.1 The development of new capacity at Heathrow has created significant issues for the timetable of the H7 review. In July 2016 we started to respond to these pressures by consulting on a one year extension to the Q6 price control. We confirmed this one year extension later in 2016 and said that we would decide by summer 2017 if a further extension to the Q6 price control would be warranted. The original Q6 price control ran until the end of 2018 and the extended control (Q6+1) runs until the end of 2019.
- 4.2 The current timetable for H7 would require HAL to produce its IBP at the end of 2017, to allow for CE during 2018. We would then issue initial proposals at the end of 2018, with updated/final proposals in June 2019. This timetable allowed for a final decision on the price control and licence modifications to be made by October 2019, following a statutory consultation period in September 2019. The new price control would take effect from the start of 2020. This is summarised in Table 3 below.

Table 3: the current timetable for the H7 price control review

Dec 2017	HAL provides IBP
Until end Jun 2018	Constructive engagement
Sep 2018	HAL provides FBP
Dec 2018	CAA's initial proposals
Jun 2019	CAA's updated/final proposals
Sep 2019	CAA's statutory notice proposing licence modifications
Oct 2019	CAA's decision modifying licence

Jan 2020

New control commences

- 4.3 It is important to note that any CMA determination (that would occur in the circumstances where the licence modification was rejected by HAL and/or those airlines with right of appeal) would take place in 2020 – after the start of the new price control period. This is consistent with precedent in other regulated sectors – for instance in the water sector the regulator made price proposals in December 2014 and there was an appeal by Bristol Water with a CMA determination made in October 2015, seven months into the new price control period.
- 4.4 HAL has raised questions about the timetable in its response to our January 2017 consultation on the priorities and timetable for capacity expansion. Given its views on the likely timetable for developing its DCO application for capacity expansion, it is concerned that it would not be able to develop a high quality IBP by December 2017 which properly reflected its choice of final scheme. Further, it has suggested that the indicative timing of some of the milestones in 2018 for developing the regulatory framework may not be consistent with it developing its FBP in an orderly way and consistently with the DCO process.
- 4.5 There appear to be two fundamental difficulties with the existing regulatory timetable in light of the latest understanding of HAL’s timetable to prepare its DCO application:
- HAL is working with airlines on developing a preferred option for capacity expansion during 2017 and it is not expected that this work will have identified a final preferred scheme before a consultation by HAL on the options for expansion which may run until towards the end of 2017 or into 2018. If HAL’s IBP is to focus on the preferred scheme and is to further explore the detail of the preferred scheme and the implications for investment in the existing infrastructure, HAL will need time to carry out this further work and the end of 2017 is not a credible timetable for the production of its IBP; and

- the wider timetable for capacity expansion involves HAL working towards getting approval for its DCO application at the end of 2020 and full scale construction beginning very soon after this approval. In contrast the price control timetable envisages final proposals in the middle of 2019. Estimates of capital and financing costs may evolve significantly between 2018 (when HAL's final business plan is due) and the start of construction in 2021.

4.6 These challenges suggest that the timetable for the price control review may need to be better aligned with that for overall capacity expansion.

Options for aligning timetables

4.7 We consider there are at least two broad options for dealing with the above challenges, which we will discuss with HAL, airlines and other interested stakeholders before reaching a decision on these matters.

4.8 First, we could move back the date that HAL needs to provide its IBP, but retain 2020 as the start date for a new price control period. This would mean either condensing or combining deliverables and stretching the timetable for the price control review. Two possible scenarios are set out in tables 4A and 4B below.

Table 4A: condense the existing timetable and retain a 2020 start date

Mar 2018	HAL provides IBP
Until end Aug 2018	Constructive engagement
Sep 2018	HAL provides FBP
Jan 2019	CAA's initial proposals
Jun 2019	CAA's updated proposals
Sep 2019	CAA's statutory notice proposing licence modifications
Nov 2019	CAA's decision modifying licence
Jan 2020	New control commences

Table 4B: combine and stretch and retain a 2020 start date

Mar 2018	HAL provides IBP
Until end Sep 2018	Constructive engagement
Nov 2019	HAL provides FBP
Apr 2019	CAA's initial proposals
Sept 2019	CAA's updated proposals and statutory notice proposing licence modifications
Nov 2019	CAA's decision modifying licence
Jan 2020	New control commences

- 4.9 The scenario set in Table 4A would give HAL more time to produce the IBP, but would run the risk of squeezing the time available to the CAA to develop the regulatory framework. It also does not avoid the problem of there being a sizeable gap between the time when costs need to be finalised for the price control, and the time when the DCO application is approved and construction commences.
- 4.10 The scenario set in table 4B would also give HAL more time to produce the IBP, but would mean that the CAA issued its final proposals and statutory consultation on the licence modification together. This should not cause insurmountable difficulty if the process were made clear at a reasonably early stage and respondents were given time to comment on key issues in the consultation on the initial proposals. The statutory consultation on the licence modifications would still occur, but its focus would be on the technical issues associated with translating the final proposals into legal drafting. This is a common approach in other sectors subject to economic regulation. Nonetheless, we will need to consider further whether this would be appropriate in the circumstances of airport regulation and welcome the views of respondents on these matters.

- 4.11 While the scenarios above would give HAL more time to produce its initial business plan, neither scenario realigns the price control timetable with that of the overall timetable for capacity expansion including the timetable for seeking and receiving development consent.
- 4.12 The second broad option involves extending the existing price control by a further year so that the new control would start in 2021. In addition to allowing more time for the IBP, this would better align the overall price control review timetable with the current timetable HAL is working to in respect of its DCO application in 2020. This could involve realigning the timetable as Table 5 below.

Table 5: realign by 12 months

Dec 2018	HAL provides IBP
Until end Jun 2019	Constructive engagement
Aug 2019	HAL provides FBP
Dec 2019	CAA's initial proposals
May 2020	CAA's updated proposals
Sept 2020	CAA's statutory notice proposing licence modifications
Nov 2020	CAA's decision modifying licence
Jan 2021	New control commences

- 4.13 An important issue in these scenarios would be how to reset the existing price control for a further year. In consulting on and making the initial extension to the Q6 price control (i.e. the Q6+1 control) we adopted a simple rollover of the existing price control. This was based on the precedent established in extending the Q5 price control and that a more detailed approach would risk distracting stakeholders from any necessary work on capacity expansion (and so would cut across the main purpose of extending the price control).

- 4.14 We also highlighted the downsides from a simple extension of the price control by two years or more – the likelihood that variances from the original price control assumptions would be significantly greater than with a one year extension, and there would be no precedent for a simple extension by two years or more. Bearing these factors in mind there may be more of a case to look at underlying costs and revenues in any further extension of the price control to make sure that the price control protects the interests of consumers and allows HAL to finance efficiently incurred costs.
- 4.15 Nonetheless, a full price control process is an onerous undertaking involving a significant commitment in terms of time and resources from the CAA, HAL and airlines. Therefore, it would be important to find a proportionate and reasonable way of resetting the price control for the additional period. For instance, in the timetable set out in Table 5 above it would be possible to use the information emerging from CE to calibrate a price control towards the end of 2019 for 2020.
- 4.16 We welcome the views of respondents on all the options discussed above and any other proposals for the price review timetable that respondents consider appropriate. We intend to publish a revised timetable at the end of June 2017.
- 4.17 Given the inherent uncertainties associated with an infrastructure development of this size then it may be necessary to flex the price control timetable again in the future in response to any significant changes in the overall capacity expansion process. We would expect to consult on any further changes to the timetable.
- 4.18 Whatever option is adopted by the CAA it is important to note that we intend to continue with the same momentum of engagement with HAL and the airlines about how the regulatory framework can best facilitate the timely and efficient delivery of new runway capacity. While some of the detailed numbers and CAA proposal documents would be produced slightly later in the process under the options above, we consider it remains important to work with stakeholders on the regulatory design with

the same current intensity in order to narrow down options and manage expectations.

Appendix A

Our duties under CAA12

- A.1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (AOS), including capacity expansion, are set out in the Civil Aviation Act 2012 (CAA12).
- A.2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
- A.3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of ‘consumers’.
- A.4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- A.5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These secondary duties include:
- the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and

- the Better Regulation principles.
- A.6 In relation to Heathrow airport, these duties relate to the CAA's functions concerning the activities of HAL as the licence holder at Heathrow.
- A.7 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and Gatwick Airport Limited are subject to economic regulation.
- A.8 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.