Economic regulation of Heathrow Airport Limited: H7 Initial Proposals

Appendices

CAP2265E

Published by the Civil Aviation Authority, 2021

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

First published October 2021

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

The latest version of this document is available in electronic format at: www.caa.co.uk/CAP2265E

Contents

Appendix A

Our duties

A1 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 CAA12.

A2 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.

A3 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".

A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.

A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These 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.

A6 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 GAL are subject to economic regulation.

A7 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.

Appendix B

Glossary

B1 The terms used in this document are arranged in the following groups:

- Legislation and regulatory processes
- Price controls
- Stakeholders
- CAA documents
- Stakeholder documents
- Financial
- Capex-related
- Recurring terms

Legislation and regulatory processes

Acronym / term	Description
ACR2011	Airport Charges Regulations 2011
AOS	Airport Operation Services
CAA12	Civil Aviation Act 2012
CE	Constructive Engagement – a CAA-mandated process that requires the airport operator to discuss its business plan with the airlines before we need to reach a decision on the appropriate price control. For H7, CE took place between August 2020 and October 2020
CMA	The Competition and Markets Authority
CMA Provisional Findings	CMA provisional findings report in relation to the NERL RP3 regulatory appeal
Companies Act 2006	Companies Act 2006
Consumers	As defined in CAA12, consumers are passengers and cargo owners, both now and in the future
DCO	Development Consent Order
NPS	The Airports National Policy Statement published on 5 June 2018 produced by the Government under the Planning Act 2008

S factor	The security factor in the price control formula that allows a partial pass-through of costs resulting from changes to security standards

Price controls

Acronym / term	Description
Q5	Q5 is the price control for the period from 2008 to 2013, the approach to which was subsequently extended to cover January to March 2014.
Q6 / Q6 price control	Q6 is the price control for the period from 2014 to 2018, the approach to which has subsequently been successively extended to cover 2019-2021
H7	The next price control for Heathrow, assumed to be in place from 1 January 2022 untile 31 December 2026
iH7	Heathrow Interim H7 price control, running from 1 January 2020 until 31 December 2021
H8	The price control for Heathrow following H7
PR19	The five-year price control settlement for water companies in England and Wales for 2020-2024. Ofwat's decision published in December 2019 can be found here: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Overview-of-final-determinations.pdf
RP3	The NATS En Route plc (NERL) Reference Period 3 price control that was originally expected to run from 1 January 2020 to 31 December 2024
RIIO2	Ofgem RIIO2 price control, for details please see Network price controls 2021-2028 (RIIO-2) | Ofgem

Stakeholders

Acronym / term	Description
AOC	Airline Operators' Committee (for Heathrow)
BA/IAG	British Airways plc/International Airlines Group (owner of British Airways)
CAA ("us"/"we")	The Civil Aviation Authority

CAA Consumer Panel	A non-statutory body established to act as a "critical friend" to the CAA. It provides expert advice to make sure that the consumer interest remains central to CAA policy development
CCB	Consumer Challenge Board. The H7 Consumer Challenge Board (CCB) was established by the CAA in partnership with HAL and the airlines that currently use Heathrow to strengthen the link between consumer outcomes and priorities and the regulation of Heathrow
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport
IATA	International Air Transport Association, a global trade association representing airlines
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport
NERL	NATS En Route plc
VAA	Virgin Atlantic Airways

CAA documents

Acronym / term	Description
FPs / Final Proposals	The CAA's final proposals for H7, due to be published in 2022
Initial Proposals	The CAA's initial proposals for H7 published in October 2021
The December 2016 Consultation	CAP1486 "Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime", www.caa.co.uk/cap1476
The April 2017 Guidance	CAP1549 "Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control", www.caa.co.uk/CAP1540
The April 2018 Consultation	CAP1658 "Economic regulation of capacity expansion at Heathrow: policy update and consultation", http://www.caa.co.uk/CAP1658
The July 2019 Consultation	CAP1819 "Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable", www.caa.co.uk/CAP1819
The Updated Business Plan Guidance	Guidance included as an Appendix in CAA publication CAP1819 "Economic regulation of capacity expansion at

	Heathrow: consultation on early costs and regulatory timetable", www.caa.co.uk/CAP1819
The August 2019 Working Paper	CAP1832 "Economic regulation of Heathrow Airport Limited: working paper on financial resilience and ring fencing", www.caa.co.uk/CAP1832
The December 2019 Consultation	CAP1871 "Economic regulation of Heathrow Airport Limited: policy update and consultation on early costs of capacity expansion", www.caa.co.uk/CAP1871
The January 2020 Consultation	CAP1876 "Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues", www.caa.co.uk/CAP1876
The April 2020 Update	CAP1914 "Economic regulation of Heathrow: programme update", www.caa.co.uk/CAP1914
The June 2020 Consultation	CAP1940 "Economic regulation of Heathrow: policy update and consultation", www.caa.co.uk/CAP1940
The June 2020 Business Plan Guidance	Guidance included as an Appendix in CAA publication CAP1940 "Economic regulation of Heathrow: policy update and consultation", www.caa.co.uk/CAP1940
The August 2020 Working Paper	CAP1951 "Economic regulation of Heathrow Airport Limited: working paper on capital expenditure efficiency incentives", http://www.caa.co.uk/CAP1951
The September 2020 Working Paper	CAP1964 "Economic regulation of Heathrow: working paper on the efficiency of HAL's capital expenditure during Q6, September 2020", http://www.caa.co.uk/CAP1964
The October 2020 Consultation	CAP1966 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", http://www.caa.co.uk/CAP1966
The February 2021 Consultation	CAP2098 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", http://www.caa.co.uk/CAP2098
The April 2021 Way Forward Document	CAP2139 "Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward", http://www.caa.co.uk/CAP2139
The April 2021 RAB Adjustment Decision	CAP2140 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", http://www.caa.co.uk/CAP2140
The April 2021 Working Paper	CAP1996 "Economic regulation of Heathrow Airport Limited: working paper on Q6 capital expenditure and early expansion costs", http://www.caa.co.uk/CAP1996

Stakeholder documents

Acronym / term	Description
ABP	Airlines' publication, Alternative Business Plan submitted in February 2021
BBU	HAL's publication, Building blocks update with a revised financial forecast submitted in July 2020
IBP	HAL's publication, Initial Business Plan submitted in December 2019 in response to the Updated Business Plan Guidance, https://www.heathrow.com/company/about-heathrow/economic-regulation/h7-update
RBP	HAL's publication, Revised Business Plan submitted in December 2020
RBP update / Updated RBP	HAL's publication, Revised Business Plan updated to take the 2021 situation into account submitted in July 2021

Financial

Acronym / term	Description
CAPM	Capital Asset Pricing Model
CPI	Consumer price index
EBITDA	Earnings before interest, taxes, depreciation and amortisation
Equity beta	Company specific estimate of risk relative to the whole market
FFO	Funds From Operations
iBoxx indices	The Markit iBoxx Corporates Indices represent investment grade fixed-income bonds issued by public or private corporations and are produced by IHS Markit. For the purpose of calculating HAL's cost of debt, we have used two of these indices corresponding to A-rated and BBB-rated bonds respectively. Both of these comprise sterling-denominated bonds of 10-year or greater maturity
IRR	Internal Rate of Return
Notional financial structure	Financial structure of the regulated company that reflects our views on the efficient balance between debt and equity finance

NPV	Net Present Value
P0	The price per passenger at the beginning of a price control
PMICR	Post Maintenance Interest Cover Ratio
RORE	Return On Regulatory Equity
RPI	Retail Price Index
TMR	Total Market Return
WACC	Weighted Average Cost of Capital

Capex-related

Acronym / term	Description
AM	Asset Management
Capex	Capital Expenditure
Category A costs	Costs which are incurred by HAL during the Airports Commission process, or before Heathrow was named as the preferred location for new runway capacity on 25 October 2016. For more information please see Appendix C to the July 2019 Consultation
Category B costs	Costs associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow. For more information please see Appendix C to the July 2019 Consultation
Category C costs	Costs incurred by HAL in connection with implementation and construction of new capacity, up to entry-into operation. For more information please see Appendix C to the July 2019 Consultation
Core and development framework	The core and development framework describes the transition of capex from development capex to core capex. Core capex is capex that has been through Gateway 3 (investment decision stage) of capex governance, in line with the approach for the Q6 price control. Development capex is capex at an earlier stage of development
DIWE	Demonstrably inefficient and wasteful expenditure
Early costs	Expansion-related costs that are incurred by HAL prior to obtaining planning consent
Gateway 3 (G3)	Capex projects follow an eight phase “Gateway” process which aligns with each project’s level of maturity. Project business

	cases are reviewed at key points (Gateways) throughout their life. Gateway 3 is an investment decision stage of capex governance arrangements, in line with the approach for the Q6 price control.
IFS	The Independent Fund Surveyor for Heathrow, which is jointly appointed by HAL and the airlines, with a duty of care to the CAA. The scope of the IFS role is broadly to assure that capital funds are invested efficiently to meet agreed project objectives
IPCR	Independent Planning Costs Reviewer appointed by the CAA under the Planning Costs Recovery Policy Statement
Wind-down costs	Expansion-related costs that HAL has incurred since the Court of Appeal's judgement in February 2020

Recurring terms

Acronym / term	**Description**
Building blocks	Price control building blocks, including passenger numbers, operating costs, capital costs and commercial revenues
CdG	Charles de Gaulle Airport
Commercial revenues	Revenues HAL derives from services to passengers, such as retail, food and beverage, *bureaux de change*, advertising, car parking and car rental, or from services to airlines, check-in desks, office rental, airline lounges and warehousing
Expansion	HAL's programme to expand Heathrow airport by the construction of a new northwest runway and associated infrastructure in accordance with the Airports National Policy Statement NPS
HBS	Hold Baggage Screening
Lower Quartile scenario	This scenario uses the lower quartile of the input range used in financial modelling. One end of the input range is HAL's updated RBP projections scaled to CAA passenger forecasts. The other end of the input range is CEPA/Taylor Airey's mid case.
OBR	Outcomes Based Regulation, the proposed service quality regulation regime for H7
Opex	Operational Expenditure

ORCs	Other Regulated Charges, which are for specified services and facilities that are collected separately from the general regulated airport charges and are, in general, levied on a “user-pays” basis.
Price Control Model	The financial model developed by the CAA to compute the revenue requirements for H7
RAB	Regulatory Asset Base
Revenue risk sharing	A mechanism that allows Heathrow to share the impact to aeronautical and non-aeronautical revenues due to the difference between outturn and forecast passenger traffic
RNS	The London Stock Exchange Regulatory News Service
Shock factor	A downward adjustment to volume forecasts to address the asymmetry of risks
SQRB	Service Quality Rebates and Bonuses, the service quality regulation regime for Q6
TRS	Traffic Risk Sharing
TTS	Track Transit System
Upper Quartile scenario	This scenario uses the upper quartile of the input range used in financial modelling. One end of the input range is HAL’s updated RBP projections scaled to CAA passenger forecasts. The other end of the input range is CEPA/Taylor Airey’s mid case.

Appendix C

Notice of Proposed Licence modification to insert a new price cap from 1 January 2022 to 31 December 2022

Introduction

C1 This Appendix gives notice under section 22(2) of the Civil Aviation Act 2012 ("CAA12") that the CAA proposes to modify HAL's licence[1] ("the licence") to:

- remove the definition of "Regulatory Period" in Condition A3 (Definitions) at Condition A3.1(f) and all subsequent references to that term throughout the licence;
- amend the definition of "Regulatory Year" in Condition A3 (Definitions) at Condition A3.1(g) to remove references to specific years so that it refers only to the twelve-month period from 1 January to 31 December in any year;
- replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes a price cap for the Regulatory Year 2022;
- include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6; and
- modify paragraph 4 in Schedule 1 to the licence (Statement of Standards, Rebates and Bonuses) to ensure that rebates and bonuses can continue to be accrued in relation to performance against the targets set in Tables 1a to 10 in that Schedule.

C2 A draft of the proposed modifications is set out in Table C1 below.

Representations invited

C3 We welcome representations on any of the modifications proposed in this notice. Please e-mail responses to economicregulation@caa.co.uk by no later than 17 November 2021. We cannot commit to take into account representations received after this date.

C4 We expect to publish the responses we receive on our website as soon as practicable after the period for representations expire. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 CAA12 and the Freedom of Information Act 2000.

1 The licence granted to Heathrow Airport Limited by the CAA under section 15 of the CAA12 on 13 February 2014.

C5 If you would like to discuss any aspect of this document, please contact Rob Toal (robert.toal@caa.co.uk).

Reasons for the proposed modifications to the price control condition

Background

C6 HAL's current price control ends on 31 December 2021. For the reasons set out in Chapter 15 of this Initial Proposals consultation, the final decision on licence modifications for a new five year control period for H7 will not be made until early in 2022. As a result, without further action by the CAA, no price control will apply to the airport charges levied by HAL from 1 January 2022 until the licence modifications to implement the H7 price control have effect. We currently expect that those modifications will not have effect until the summer of 2022.

C7 The absence of a price cap in the intervening period would create very significant risks of consumers being exposed to charges that would be unduly high in 2022 and could also create or exacerbate a conflict between the interests of "present consumers" travelling during the first part of 2022 and "future consumers" travelling later in the H7 period. Present consumers could experience materially higher charges while future consumers somewhat lower charges because of the impact of any "truing up" arrangements.

C8 Chapter 15 of this Initial Proposals consultation sets out the details of our engagement with HAL and the airlines on this issue since our April 2021 Way Forward Document and their views on it. We have been encouraging HAL and the airlines to see if they could agree the level of a "holding cap" which would be trued up with the CAA's final decision. HAL and airlines have said that they support the approach of introducing a holding cap, but they have not been able to reach agreement on the level at which such a cap should be set and how it should be implemented.

C9 At the end of August 2021, HAL issued its consultation on airport charges for 2022, which it considered was in accordance with the requirements of the ACR2011. HAL's consultation assumes a yield of £37.60 per passenger (nominal prices) which it derived from the assumptions included in its updated RBP.

C10 The ACR2011 provides limited, largely procedural, protection to consumers. It does so indirectly through the requirements on airports to consult on the level of charges they intend to set in advance. In normal circumstances, the ACR2011 requires HAL to consult airlines at least four months before changing charge levels and to notify airlines of its decision on charges at least two months before the change takes effect. Nonetheless, there is some flexibility within the ACR2011 that allows for shorter periods of consultation and notice in exceptional circumstances.

Setting an interim price control

C11 The reasons why action by the CAA is needed to set an interim price control are set out in detail in Chapter 15 of the Initial Proposals. Those reasons apply to, and form part of this notice. In summary, we:

- consider that the absence of a holding cap exposes consumers to the risks identified in paragraph C.7 above;
- do not consider that the provisions in the ACR2011 provide an adequate level of protection for consumers because the focus of the ACR2011 is on transparency and consultation processes rather than the level of airport charges;
- take the view that the competitive dynamics of the airline market suggest airlines will seek to pass increases in airport charges directly to consumers in the form of higher airfares;
- are concerned that higher airport charges in 2022 could artificially restrict airlines' ability to support the recovery in services, which would also disadvantage consumers and limit the demand for AOS; and
- consider that the interests of consumers will be served by having clarity on the level of airport charges at Heathrow in 2022 as soon as possible.

C12 Therefore, we consider that action by the CAA may be needed to put in place a licence condition to prevent HAL unduly increasing prices for 2022 to the detriment of consumers overall and to manage the conflict between the interests of present and future users of Heathrow airport. Given the importance of charges in 2022 to consumers discussed in Chapter 15, any such licence modification would need to

- set the holding cap; and
- be accompanied by a provision that compelled HAL to price to the level of the holding cap in 2022 and consult under the ACR2011 to that effect.

C13 If the modifications were not to do this, HAL might seek to leave in effect any charging arrangements it had put in place following its consultation on its charging proposals in August 2021 and rely on the operation of the truing up of charges and/or the correction factor mechanism with the price control licence condition to address the difference. If HAL took this approach, the benefits to consumers of addressing the issues set out in paragraph C7 and C11 above would not be realised.

The structure of the price control condition

C14 The licence modification proposed by this notice would remove the current price control condition in its entirety (save for relevant definitions in Condition C1.16, which shall be restated as Condition C1.4) and replace it with the new condition setting a single price cap.

C15 The proposed condition does not include any adjustment arrangements for corrections for any over recovery against the maximum yield in 2020, or bonuses under the SQRB scheme in Schedule 1 of the Licence. We will replace these adjustment factors into Condition C1 (Price Control) and will take these factors into account in the truing up of the holding cap against the price control we put in place following our Final Decision for H7.

C16 The proposed condition also does not include the adjustment factors for additional security measures, the transition of capital projects from "development" to "core" status, capital project tiggers, business rate revaluations or expansion. These are generally adjustments to the price control in the year after the expenditure is incurred and, as we are intending to reinstate most of them in the H7 settlement,[2] it is not necessary to include them here.

C17 Given our preference and that of stakeholders for a five year price control period for H7, the holding cap will be trued up against the price control we put in place following our Final Decision for H7, as discussed in Chapter 15. Our current view is that the Final Decision would simply remove the holding cap from HAL's licence and the correction factor in the price control would automatically adjust revenue in the later years of the price control for any under or over recovery of revenue against the level specified for 2022 in our Final Decision.

C18 We are proposing this approach to provide a simple price control for a short period until the modifications to implement the H7 price control come into effect. We consider that this approach will provide clarity for HAL and the airlines on airport charges in 2022 but, through the truing up of the holding cap against the price control we put in place following our Final Decision for H7, will allow for the current uncertainty over the level of the cap to be corrected through the H7 settlement. This will ensure that present consumers are protected in 2022 and future consumers through the operation of the H7 price control. As such, this approach will manage the conflict between the interests of present and future consumers in the manner we think furthers the interests of each of them best.

The level of the maximum allowable yield

C19 As discussed in Chapter 15, there is a significant difference between HAL and airlines on what they consider the appropriate level of the cap in 2022 should be. HAL's analysis, driven by its financeability concerns, implies a price of £37.6 (nominal prices). Airlines have said they want "flat or falling" charges and have suggested no increase in real terms from 2021 levels.

C20 Our detailed analysis of the appropriate range for HAL's H7 price control for the notional company, which should further the interests of consumers and has been developed having regard to our duties under CAA12 as a whole, is set out in Chapter 11. Chapter 15 discusses the uncertainty that remains about the appropriate level of charges for the H7 period and the overall range for charges set out in our Initial Proposals. On balance, for the reasons set out in Chapter 15, we consider that the middle of the range for the cap on airport charges of £24.50 - £34.40 per passenger would both further the interests of consumers and have appropriate regard to supporting the financeability of the notional company in 2022. On this basis, the holding price cap proposed by this notice is based on the mid-point of this range which we have rounded to £29.50 per passenger.

C21 As Chapter 15 makes clear, this figure is based on analysis for our Initial Proposals, our calculation of the building blocks and the precise estimates that we select within them are all subject to further comments from stakeholders and analysis by us as we prepare our Final Proposals. Other variables and assumptions might also change. As a result, the proposal for the level of the

---

2 As discussed in relevant Chapters in this Initial Proposals consultation.

holding cap cannot, and should not, be interpreted as indicating that the CAA would necessarily take the view that the mid-point of the range is the appropriate price cap for the full H7 period when we come to make the Final Decision on the H7 price control.

Requiring a new consultation on the airport charges.

C22 Our expectation is that HAL's decision on its current ACR2011 consultation should account fully for the CAA's proposals for a price cap for 2022.

C23 Nonetheless, we are also proposing to include an obligation on HAL to carry out a new consultation on its airport charges under the ACR2011 within one month of the modifications set out in this notice taking effect, if it has already made a decision under the ACR2011 based on a higher maximum yield per passenger. We consider that this condition is necessary to protect consumers from higher prices in 2022 as otherwise HAL may decide to continue with its original decision and rely on the correction factor, once it has been re-inserted into the price control in the H7 settlement, to repay any 2022 over recovery in later years. As discussed in paragraph C13 above, unless addressed, this could negate the effect of the modifications set out in this notice to manage the conflict between the interests of present and future consumers in the manner we think furthers the interests of each of them best. Furthermore, including this additional condition in the licence should provide airlines with greater clarity on the level of charges in the first part of 2022, which should allow them to plan how this is passed through ticket prices more consistently across the year.

Arrangements for capital investment

C24 Although we are not proposing to include the adjustment factors for capital investment, we are proposing to retain the existing capital governance arrangements and triggers, so that discussions on these important elements can continue as normal. As compliance with these arrangements will not be an element of the formulae for the price control, to effect this, we are proposing to include a requirement on HAL to maintain the existing capital governance arrangements and capital investment triggers handbook. The proposed simple licence condition will achieve this.

Summary

C25 For the reasons set out above and in Chapter 15, we consider that:

- action is needed in relation to the charges that HAL sets for 2022;
- the proposals set out in this notice will further the interests of present and future consumers regarding the cost of AOS provided at Heathrow airport during 2022 by preventing HAL from unduly increasing prices for 2022;
- these proposals will not make it unduly difficult for the notional company to finance its activities at Heathrow airport and will support it in meeting the demands of consumers at Heathrow in 2022; and
- putting in place the modifications to HAL's licence set out in this notice is appropriate in the context of the principles set out in section 1(4) CAA12 because

(i) it is more transparent than relying on commitments by HAL in relation to its charges;

(ii) it is consistent with both the CAA's ongoing approach to the economic regulation of HAL and the Initial Proposals;

(iii) setting prices at the mid-point of the range calculated for Initial Proposals, but with HAL's revenues to be trued up after the final H7 price control is set, represents a proportionate means of addressing these issues while still furthering the interests of consumers in the manner discussed above; and

(iv) the use of a licence modification ensures that any decision we make to implement these modifications will be accountable through the appeal processes stipulated in CAA12.

Reasons for, and effect of, other modifications

Condition A3 (Definitions): changing the definition of "Regulatory Year" and removing the definition of "Regulatory Period"

C26 We are proposing to change the definition of Regulatory Year in Condition A3 (Definitions) to remove the references to specific years, so the definition will simply specify the start and end dates of a Regulatory Year. This is because some of the licence conditions which use the term should not be time limited but should continue to have effect from one control period to the next, unless modified either under section 22 CAA12 or under provisions of the licence. Making this change will achieve this.[3] Where a specific licence condition needs to be time limited, this will be made clear in the condition itself.

C27 In addition to this change, we propose making some consequential changes throughout the licence to change references to "each" and/or "subsequent [number]" Regulatory Years to "any" Regulatory Year. In Condition C2 (Charges for other services) we are also proposing to change references to a "year" to refer to a "Regulatory Year". These changes will provide clarity to the licence but will have no effect on the obligations themselves.

C28 We are also proposing to remove the definition of "Regulatory Period" from Condition A3 (Definitions) and delete all uses of the term throughout the licence. This term was required for the unique period from 1 April 2014 to 31 December 2014 when HAL changed its financial and reporting year to mirror the calendar year. As this term is now redundant, it is good practice to remove it from the licence. This change will remove redundant terms from the Licence and have no effect on HAL's ongoing obligations in the licence.

[3] Relevant conditions are (C2 Charges for other services, C4 Cargo, E1 Regulatory accounting requirements, E2 Financial Resilience and Schedule 1, Statement of Standards, Rebates and Bonuses)

Condition C2 (Charges for other services) – inclusion of 2022 within the reporting requirements

C29 We are proposing to include the year 2022 with the reporting requirements for these "Other Regulated Charges" or ("ORCs"). In the Q6 settlement, we included a forecast for ORCs and required HAL to report on the reasons for any differences between actual revenues and those included in the forecast. We did not include forecasts for the extended years of the price control period (2019 to 2021), but instead required HAL to report on differences between actual revenues in each year with actual revenues in the previous year. HAL has committed to continue with this practice in 2022 but we propose to make this change for clarity and completeness. This effect of this modification will, therefore, be to ensure the current arrangements continue uninterrupted within the licence framework.

Schedule 1 (Statement of Standards, Rebates and Bonuses) – consequential changes

C30 We are proposing to make some consequential changes to the Bonus term in paragraph 4 of the Schedule 1 to the licence (Statement of Standards, Rebates and Bonuses) to remove cross references to Condition C1 (Price Control) and to modify Table 9 to remove information relating to past years and insert information relating to 2022. This is because the new Condition C1 (Price Control) does not use the bonus factor. We intend to replace the relevant terms and tables in the H7 licence modifications later in 2022 so that the bonus arrangements will remain in place for the whole of H7.

C31 We also propose to ensure that bonuses can be earned in 2022 under Schedule 1 for recovery in 2024, in line with the current arrangements. Bonuses accrued in years up to and including 2021 shall be dealt with in truing up the price control for 2022 in line with our Final Decision for H7.

C32 Redundant terms relating to the early years of Q6 will also be deleted to avoid confusion.

Next Steps

C33 Following the end of this consultation, we aim to make our final decision in late November or early December. Subject to any appeals and associated decision by the CMA to suspend the modification, the licence modification would take effect in the middle of January 2022 but be applicable to charges levied by HAL from 1 January 2022.

Table C.1 –The proposed modifications, with a summary of the reasons and effects

Relevant Condition	Summary of the Modification	Details of changes to the condition	Summary of the reasons and effects
A3.1(f) and C2.5, C4.1, E1.3, E1.5(a)&(b), E2.2, E3.5, Schedule 1: 2.1(e),(f) &(j), 2.28(a)&(b), 3.2, 3.4, 3.4(a)&(b), 3.5, 3.7, 3.11, 3.13, 3.15, 4.2, 4.4, 4.5, 5.2(b) 6.2, 6.3(c).	Delete the definition of Regulatory Period and replace with “NOT USED” and all delete all references to the term throughout the licence in text and formulae.	~~(the Regulatory Period means the period of nine months between 1 April 2014 and 31 December 2014 and this period shall also be considered to be the Licensee’s financial year for the purposes of this Licence~~ (f) **NOT USED**	This term was used for 2014 only, when HAL changed its reporting year from 1 April to 31 March to be from 1 January to 31 December and the term is now redundant. This modification has no effect other than removing a redundant term from the licence.
A3.1(g) and C2.1, C2.2, C2.3, C3.7, C4.1, E1.3, E3.1, Schedule 1: 2.4, 3.4(a), 3.5, 3.11, 6.6.	Modify the definition of Regulatory Year, Change references to “each” and/or “subsequent [number]” Regulatory Years to “any” Regulatory Year.	(g) the Regulatory Year means ~~for each of the seven years from 2015 to 2021,~~ the twelve month period beginning on 1 January and ending on 31 December. ~~These years shall also be considered to be the Licensee’s financial year for the purposes of this Licence.~~	The current definition means that all conditions using this term only have effect during the calendar years specified. However, only the Condition C1 (Price Control) should be time limited, while other conditions should continue to have effect unless changed under

			the modification process set out in section 22 CAA12. Where references to specific calendar years are needed, these should be included in the relevant condition. The reference to HAL's financial year is unnecessary as the Financial conditions (Part E) all refer to the Regulatory Years. Effect – Conditions that use the term "Regulatory Year" will no longer be time-limited, unless references to calendar years are specified within that condition.

C1	Delete the whole of the current Condition C1 Price Control and replace with new Conditions C1.1 and C1.2.	New condition - C1 Price Control C1.1 When the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022, it shall fix those charges at the levels best calculated to secure that, in that Regulatory Year, the total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the maximum revenue yield per passenger, which shall be £29.50 (2020 prices, CPI-real).	This condition is needed to implement a "holding" price control for 2022 and is being implemented for the reasons set out in the Notice above and in Chapter 15. Its effect will be to set the maximum yield per passenger that HAL can recover for 2022 at £29.50.
		C1.2 If the Licensee has fixed the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022 at levels that exceed the maximum yield per passenger set out in Condition C1.1, the Licensee shall, within 1 month of Condition C1 Price Control coming into effect in relation to the Regulatory Year 2022, consult airlines under the Airport Charges Regulations 2011 (2011 No. 2491) to reset its prices to a level calculated to secure compliance with Condition C1.1.	Given that, by the time this condition would be implemented, HAL has already undertaken a consultation on the level of its charges in 2022, this condition is being proposed in order to ensure that the charges that HAL applies in the year 2022 are designed to meet the maximum yield per passenger set out in the proposed modified Condition C1.1 so that consumers throughout 2022 can benefit from the price control set in that condition and to

			support the furthering of the interests of consumers in the manner described in Chapter 15 and in this notice above. Its effect will be to require HAL to undertake a fresh consultation on charges for 2022 to achieve this.
C1	Insert a new Condition C1.3 to require HAL to maintain the existing capex governance arrangements.	C1.3 The Licensee shall maintain the governance arrangements and the Q6 Capital Investments Triggers Handbook in relation it is core capex projects and development capex projects.	We propose to retain the existing capital governance arrangements and triggers for the early months of 2022, so that discussions on these important elements can continue as normal. We are, therefore, proposing to include a requirement on HAL to maintain the existing capital governance arrangements and capital investment triggers handbook. The proposed simple licence condition will achieve this.

C1	Retain relevant existing definitions from Condition C1.16 and restate them as Condition C1.4.	***Definitions*** C.1.4 In this Condition C.1: (a) **core capex project** is any project that has passed Gateway 3, being taken forward for implementation in accordance with the governance arrangements; (b) **development capex project** is any project under development that has not passed Gateway 3 in accordance with the governance arrangements, but for which an allowance has been included in the development capex allowance; (c) **Gateway 3** has the meaning set out in the governance arrangements; (d) **the governance arrangements** means the arrangements set out in the Q6 Capital Efficiency Handbook published by the Licensee by 1 October 2014 as agreed by the CAA, and updated in April 2015; (e) **passenger using the Airport** means a terminal passenger joining or leaving an aircraft at the Airport. A passenger who changes from one aircraft to another, carrying the same flight number is treated as a terminal passenger, as is an interlining passenger; (f) **the Q6 Capital Investment Triggers Handbook** means the handbook in existence when this Licence comes into force, having been agreed by the Licensee and the airlines. This handbook contains details of the triggers, milestone months and monthly trigger payments for core capex projects and details of how future changes to those elements can be made with the agreement of the Licensee and the airlines; and (g) **relevant air transport services** means air transport services carrying passengers that join or leave an aircraft at the Airport,	These definitions are required to support the operation of Conditions C1.1 to C1.3 above and are restated from condition C1.16 in the licence in the form it is in as at 1 October 2021. Insertion of this condition therefore supports the effective operation of those conditions.

		including air transport services operated for the purpose of business or general aviation.	
C2	In Condition C2.5 and C2.6, remove references to “2019, 2020 and 2021” and replace with “2022”	C2.5 Where in respect of any relevant ~~Regulatory Period or~~ Regulatory Year (apart from the ~~2019, 2020 and 2021~~ Regulatory Year~~s~~ 2022) actual revenue for any of the Specified Facilities differs from that forecast for the purposes of the price control review for the period 1 April 2014 to 31 December 2018 (as specified by the CAA), the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences. C2.6 Where in respect of the ~~2019, 2020 and 2021~~ Regulatory Year 2022~~s~~ actual revenue from any of the Specified Facilities differs from actual revenue in the preceding Regulatory Year, the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences.	This change is needed so that these provisions can apply to 2022: the proposed changes will have this effect.
Schedule 1 Statement of Standards, Rebates and Bonuses.	modify paras 4.1, 4.2,4.3,4.4,4.5 and 4.6. (Bonuses)	**(a) Payment** 4.1 The Licensee may recover bonuses from Relevant Parties. Bonus payments shall be included in the calculation of the ~~Airport Charges~~ maximum revenue yield per passenger in respect of relevant air transport services in ~~Condition C1~~Relevant Year 2024. **4(b) Calculation** 4.2 $B_{\cancel{t}2022}$, the bonus factor ~~as specified in Condition C1~~, is based on performance achieved in respect of specified elements k in the relevant ~~Regulatory Period or~~ Regulatory Year $\cancel{t}2022$ as set out in Table 8 of this Schedule.	Schedule 1 paragraph 4 has terms and formulae which link to the formulae in the deleted C1 price control and which are not relevant to the new C1 price control. These modifications remove the link to formulae in Condition C1 but retains ability for HAL to accrue bonuses in 2022

		4.3 ~~For the purposes of calculating M_t as specified in Condition C1, t~~The corresponding periods for which bonuses are recoverable by the Licensee ~~to be included in the calculation of M_t~~ are set out in Table 9 of this Schedule. 4.4 Not used. ~~For the purposes of calculating M_t for the Regulatory Period, $B_{t-2} = B_{2012/13}$ is set to zero; for the purposes of calculating M_t for the Regulatory Year t starting on 1 January 2015, $B_{t-2} = B_{2013/14}$ is set to zero. This is because bonuses earned in 2012/13 and 2013/14 should have been recovered through the K factor as specified in Condition C1.~~ 4.5 Not used. ~~B_t for the Regulatory Period, i.e. B_{2014}, shall be calculated as follows:~~ $\cancel{B_t = \sum_{j=April}^{j=December} \sum_{k} Max\left[0, Min\left[BNS(T2)_{kj}, BNS(T3)_{kj}, BNS(T4)_{kj}, BNS(T5)_{kj}\right]\right]}$ ~~For each month j and specified element k;~~ $\cancel{BNS(T2)_{kj} = \frac{1}{9} \times MB_k \frac{Min\left[UPL_k, MP(T2)_{kj}\right] - LPL_k}{UPL_k - LPL_k}}$ $\cancel{BNS(T3)_{kj} = \frac{1}{9} \times MB_k \frac{Min\left[UPL_k, MP(T3)_{kj}\right] - LPL_k}{UPL_k - LPL_k}}$ $\cancel{BNS(T4)_{kj} = \frac{1}{9} \times MB_k \frac{Min\left[UPL_k, MP(T4)_{kj}\right] - LPL_k}{UPL_k - LPL_k}}$	to be recovered later in the H7 price control. Redundant terms relating to the early years of Q6 are also deleted to avoid confusion.

$$\cancel{\mathrm{BNS(T5)_{kj}} = \frac{1}{9} \times \mathrm{MB_k} \frac{\mathrm{Min}\left[\mathrm{UPL_k}, \mathrm{MP(T5)_{kj}}\right] - \mathrm{LPL_k}}{\mathrm{UPL_k} - \mathrm{LPL_k}}}$$

~~where:~~

~~MB_k, LPL_k and UPL_k are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and~~

~~$MP(T2)_{kj}$, $MP(T3)_{kj}$, $MP(T4)_{kj}$ and $MP(T5)_{kj}$ are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.~~

4.6 $B_{\cancel{t}2022}$ for ~~any subsequent relevant~~ the Regulatory Year2022 ~~t~~ shall be calculated as follows:

$$B_{\cancel{t}2022} = \sum_{j=\mathrm{January}}^{j=\mathrm{December}} \sum_{k} \mathrm{Max}\left[0, \mathrm{Min}\left[\mathrm{BNS(T2)_{kj}}, \mathrm{BNS(T3)_{kj}}, \mathrm{BNS(T4)_{kj}}, \mathrm{BNS(T5)_{kj}}\right]\right]$$

For each month j and specified element k;

$$\mathrm{BNS(T2)_{kj}} = \frac{1}{12} \times \mathrm{MB_k} \frac{\mathrm{Min}\left[\mathrm{UPL_k}, \mathrm{MP(T1)_{kj}}\right] - \mathrm{LPL_k}}{\mathrm{UPL_k} - \mathrm{LPL_k}}$$

$$\mathrm{BNS(T2)_{kj}} = \frac{1}{12} \times \mathrm{MB_k} \frac{\mathrm{Min}\left[\mathrm{UPL_k}, \mathrm{MP(T1)_{kj}}\right] - \mathrm{LPL_k}}{\mathrm{UPL_k} - \mathrm{LPL_k}}$$

$$\mathrm{BNS(T4)_{kj}} = \frac{1}{12} \times \mathrm{MB_k} \frac{\mathrm{Min}\left[\mathrm{UPL_k}, \mathrm{MP(T4)_{kj}}\right] - \mathrm{LPL_k}}{\mathrm{UPL_k} - \mathrm{LPL_k}}$$

$$\mathrm{BNS(T4)_{kj}} = \frac{1}{12} \times \mathrm{MB_k} \frac{\mathrm{Min}\left[\mathrm{UPL_k}, \mathrm{MP(T4)_{kj}}\right] - \mathrm{LPL_k}}{\mathrm{UPL_k} - \mathrm{LPL_k}}$$

where:

		$\mathrm{MB_k}$, $\mathrm{LPL_k}$ and $\mathrm{UPL_k}$ are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and $\mathrm{MP(T2)_{kj}}$, $\mathrm{MP(T3)_{kj}}$, $\mathrm{MP(T4)_{kj}}$ and $\mathrm{MP(T5)_{kj}}$ are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.	

	Modify Table 9 to remove redundant information relating to the Regulatory Period 2014 and Regulatory Years 2015 -2021 and insert relevant information for 2022.	**Table 9: Periods of bonuses earned to be taken into account ~~when setting~~ ~~M_{t2022}~~ ~~as specified in Condition C1~~[11]**	

To set the maximum revenue yield per passenger $M_{\cancel{t}2024}$	$M_{\cancel{t}2024}$ representing the period	Take account bonuses earned in $B_{\cancel{t-2}2022}$	$B_{\cancel{t-2}2022}$ representing the period
~~M_{2014}~~	~~April 2014 – December 2014~~	~~$B_{2012/13}$~~	~~April 2012 – March 2013~~
~~M_{2015}~~	~~January 2015 – December 2015~~	~~$B_{2013/14}$~~	~~April 2013 – March 2014~~
~~M_{2016}~~	~~January 2016 – December 2016~~	~~B_{2014}~~	~~April 2014 – December 2014~~
~~M_{2017}~~	~~January 2017 – December 2017~~	~~B_{2015}~~	~~January 2015 – December 2015~~
~~M_{2018}~~	~~January 2018 – December 2018~~	~~B_{2016}~~	~~January 2016 – December 2016~~
~~M_{2019}~~	~~January 2019 – December 2019~~	~~B_{2017}~~	~~January 2017 – December 2017~~
~~M_{2020}~~	~~January 2020 – December 2020~~	~~B_{2018}~~	~~January 2018 – December 2018~~
~~M_{2021}~~	~~January 2021 – December 2021~~	~~B_{2019}~~	~~January 2019 – December 2019~~
M_{2024}	Regulatory Year 2024	B_{2022}	Regulatory Year 2022

[11] ~~In Table 9, for the purposes of calculating~~ ~~M_{2014}, $B_{2012/13}$~~ ~~is set to zero; for the purposes of calculating~~ ~~M_{2015}, $B_{2013/14}$~~ ~~is set to zero.~~

Appendix D

Capex efficiency incentives

Introduction

D1 Chapter 12 sets out our broad approach to forward looking (ex-ante) capex efficiency incentives. This appendix provides further details on some aspects of our policy for capex efficiency incentives. It covers:

- a summary of our overall approach for capex incentives;
- how we intend to set capex categories, delivery objectives and obligations;
- further discussion of our proposed incentive range for consultation; and
- our proposal for timing incentives.

D2 We intend to continue to work closely with HAL and airlines to develop these incentive arrangements for H7. Further collaborative working towards our Final Proposals should allow us to:

- finalise capex categories based on clearly defined delivery objectives;
- develop enhanced governance arrangements for H7; and
- work though implementation issues, for example to develop a process for incentive reconciliation.

Our overall approach

D3 We have summarised our Initial Proposal for capex incentives in Table D.1 below. This is an updated version of the summary table included in the April 2021 Way Forward Document.

Table D.1 Updated summary of our overall approach for H7 capital efficiency incentives

High-level proposal	Move from the Q6 framework where CAA assesses the efficiency of HAL's capex through *ex post* reviews, to an *ex ante* framework where HAL's performance is measured against cost baselines agreed in advance of delivery. The baselines for individual capex categories would be set based on G3 values.	
	Capex categories and baselines	**Delivery objectives / obligations**
Start of H7 **The price setting process**	The overall H7 capital envelope is set by the CAA, based on the level of capex HAL has demonstrated is needed through its H7 capex plan. The envelope is split into capex categories, based on HAL's proposed programmes and our own analysis.[4] Capex categories should include projects that have common outputs / objectives and similar levels of risk and controllability. Each capex category will have an indicative baseline. This would be the sum of forecast development and core expenditure. The purpose of the indicative baseline is to have (i) a clear initial forecast associated with a high-level objective for each capex category, (ii) track changes within period, and (iii) a clear line of sight from these to the final baseline (see below). This would enable airlines and CAA to have a good oversight of any changes that occur compared to the initial plan.	Each capex category should have a SMART[5] high-level statement of what HAL is seeking to deliver, and the reasons it has prioritised this spending. This would be the delivery objective, defined at the capex category level. **Timing incentives** Triggers would only apply to exceptional capex projects as the new framework would incentivise timely delivery (through cost incentives, delivery objectives / obligations and penalties for significant delays to capex categories). Criteria for triggers and design of the trigger mechanism will be set as part of H7 capex framework but triggered projects would be agreed by HAL and airlines during the H7 period.

[4] This can include analysis by our consultants, such as the work undertaken by Arcadis which is further detailed in this appendix.

[5] Specific, measurable, achievable, realistic, and timely.

During H7 **Enhanced governance arrangements**	As projects in HAL's portfolio move through the governance process, the indicative baselines would be updated to reflect G3 values for individual projects (when agreed). When all projects within a capex category have reached G3, the baseline becomes the G3 baseline: one baseline for each capex category which is the sum of G3 values for individual projects within that category. This G3 baseline could change subsequently to reflect a limited set of circumstances, for example, if the scope of projects changes or projects are dropped post-G3. Adjustments to the G3 baselines would only happen where changes are agreed with airlines through a change control process as part of the enhanced governance process. The CAA would also have a role as part of the change control process: as a minimum this would be an "arbiter" role as in Q6, but we will consider as part of the implementation of our policy whether this should be an explicit approval role for changes to baselines.	As projects reach G3, the high-level delivery objective would be updated to reflect more specific metrics / requirements, at the capex category level. It would become a delivery obligation, which should reflect: • outputs; • quality requirements; and • timing requirements. When any post-G3 adjustments to baselines take place during the period, the delivery obligation may also need to be updated to reflect changes in project scope. The CAA would have a role as arbiter in circumstances where HAL and airlines do not agree on either new delivery obligations (where projects pass G3) or changes to existing delivery obligations. We will also consider during the implementation stage of our policy whether we need to have a role in approving delivery obligations to ensure that outcomes are in consumers' interests.
At the end of H7 **Review of deliverables and reconciliation**	Reconciliation will be at the capex category level. The CAA will assess (and consult on) whether the delivery obligation has been met in relation to each capex category. If yes, the G3 baseline becomes the final baseline. If the delivery obligation has not been met, an adjustment for under-delivery would be applied to the baseline, and this becomes the final baseline. Reconciliation would involve comparing HAL's actual spending for each capex category to the final baseline. HAL would bear a proportion of any overspending compared with the final baseline or would get to keep a proportion of any underspending (these adjustments would be applied to the RAB). Our proposal is for a symmetrical sharing rate on over- and underspending. We are considering the detailed approach to reconciliation and will continue to work with HAL and airlines to agree a framework for how adjustments to baselines would be made as a consequence of under delivery.	

Setting capex categories

D4 Based on our assessment of HAL's capex plan, in Chapter 3 we have proposed an overall capex envelope of £2,401m for H7 (2020 prices). As part of the process for developing the *ex ante* incentives we have split the capex plan into a manageable number of capex categories to monitor capex delivery and to help set delivery objectives, cost baselines and incentive rates.

D5 We have set out our Initial Proposals for nine capex categories in Chapter 12. Our proposed capex categories start from the programmes in HAL's capital plan which we propose to include in the H7 capex envelope. We propose to split the Asset Management programme further into a number of capex categories, for the purpose of capex incentives.

D6 We commissioned our technical consultants, Arcadis, to review HAL's proposed capex categories and assess whether they meet our requirements for the purposes of setting *ex ante* incentives. Their main observations were that:

- most of HAL's proposed capex programmes are suitable for *ex ante* capex incentives, having similar levels of risk and controllability; and
- the Asset Management programme can be split into separate categories so that delivery objectives can be set.

D7 Arcadis undertook a detailed review of the programmes included in HAL's RBP update[6] and reviewed them against the capex category definition that we set out in the April 2021 Way Forward Document.[7] Arcadis also considered four additional criteria based on work by HAL's consultants Jacobs, which Jacobs identified as detailed elements of controllability.

D8 Arcadis concluded that five of the seven programmes met the CAA definition, and that two programmes (Asset Replacement and Future Ready Airport) partially met the definition. Figure D.1 summarises this assessment.

[6] This covered the three proposed envelopes: Protect the Business, Win the Recovery and Build Back Better.

[7] See para 21 of the Appendix M, April 2021 Way Forward Document. Capex categories are defined based on clearly defined outputs being delivered, and similar levels of risk and controllability.

Figure D.1: Arcadis assessment of HAL programmes as capex categories

Programme	HAL level of Controllability	Risk Profile in Programme	Regular & Repeated Activity	Efficient Contracting	Planned & Sequenced	Programme Complexity	Clearly Defined Output	CAA definition compliant
Asset Replacement	HIGH	MAJORITY SIMILAR	YES	YES	YES	LOW	YES*	**YES***
Regulated Security	MEDIUM	SIMILAR	YES	YES	YES	LOW	YES	**YES**
T2 Baggage	HIGH	SIMILAR	YES	YES	YES	MEDIUM	YES	**YES**
Commercial Revenue	HIGH	SIMILAR	YES	YES	YES	LOW	YES	**YES**
Efficient Airport	HIGH	SIMILAR	YES	YES	YES	MEDIUM	YES	**YES**
Carbon and Sustainability	MEDIUM	SIMILAR	NO	YES	YES	LOW	YES	**YES**
Future Ready Airport	MEDIUM	DIFFERING	NO	YES	YES	LOW	YES	**YES***

Additional Criteria from Updated RBP 6.1 Table 2

Source: Arcadis capex incentives report

D9 For the elements in the table above where an (*) is included, Arcadis recommended that:

- the Asset Management Programme is significant in size and includes projects that have a degree of variability in terms of risk and controllability, making it difficult to define a single delivery objective for this programme. Dividing it into sub-categories would be more aligned with the CAA's definition and allow SMART delivery objectives to be defined; and
- the Future Ready Airport category is broad in its scope and, like the Asset Management programme, presents variability in the levels of risk and controllability. Splitting this programme into sub-categories with similar risk and controllability profiles would better meet the CAA's definition.

D10 Arcadis identified three ways to define capex categories with similar levels of risk and controllability within the Asset Management programme. These were based on the location of the works, the type of works or the type of asset.

D11 Two of the approaches (type of work or type of asset) generated many capex categories, without necessarily improving on the controllability and risk criteria.

D12 Arcadis recommended that location should be used to sub-divide the projects in the Asset Management programme into six capex categories. This is because works taking place in one location have similar levels of controllability and risk and this approach provided a manageable number of capex categories.

D13 Arcadis also proposed to split the Future Ready Airport programme into two further categories, however as we have not proposed to include this programme in the H7 baseline, we do not discuss this further in this appendix.

D14 Based on the analysis by Arcadis, and our assessment of the capex envelope, we have proposed the nine capex categories as set out in Table 12.1 of Chapter 12. We have set out draft indicative baselines for three of the programmes, based on HAL's RBP update. We expect HAL to provide indicative forecasts for the new asset management categories as part of its next RBP update.

Setting delivery objectives

D15 We also asked Arcadis to review the delivery objectives that HAL proposed in the RBP update to assess whether they met our criteria. Arcadis concluded that HAL's programme objectives, as set out in the RBP update Capital Programme Mandate one-pagers, are not SMART and cannot be used as delivery objectives for the purposed of the capex incentive framework.

D16 As progress on developing appropriate delivery objective has been slow, we also asked Arcadis to develop several illustrative examples to demonstrate how SMART delivery objectives could be developed for our proposed capex categories.

D17 We asked Arcadis to consider what the structure of a delivery objective could look like for the Security Programme, and two of our proposed Asset Management capex categories: terminals and airfield. Arcadis reviewed the programme objectives that HAL had proposed and identified changes that are necessary to meet our criteria.

D18 Figure D.2 shows one of the illustrative examples from the Arcadis report. Further detail of this work is included in the Arcadis report which we have published alongside this document.

Figure D.2: Illustrative example of a delivery objective for the Asset Management – Airfield capex category

Programme	HAL Objective	S	M	A	R	T
Asset Management – Existing HAL 'Objective'	Maintain physical and technological assets to keep colleagues & consumers safe and secure, critical functions operational and ensure compliance to regulatory standards.	Y	N	Y	N	N
Specific	Maintaining airfield assets, compliance, safety critical, life expired asset replacement, maintain Declared Capacity (DC)	Y				
Measurable	Availability of airfield assets (Runways, Taxiways, Aprons, Stands) from XX to YY, No or reduction in any compliance events, replace life expired assets Declared Capacity of XX movements per hour		Y			
Achievable	Meets customer needs (Airline / regulator)			Y		
Realistic	Quantum of work suggested is deliverable within the time and HAL can programme in delivery in the time period				Y	
Time bound	Fixed time or annual (DC)					Y
New Delivery Objective*	To keep colleagues and consumers safe and secure HAL will utilise Capex to maintain HAL airfield assets to maintain the airfield Declared Capacity at XX movements per hour by reducing life expired assets from XXXX number of assets in 2019 to XXX number of assets and the average asset down time from XX mins/asset to YY mins/asset by the end of H7. The programme will deliver no incidents of non-compliance of regulatory standards on an annual basis and to the end of H7.	Y	Y	Y	Y	Y

*The New Delivery Objective can incorporate more detail to be more specific or measurable so that HAL, airlines and the CAA can achieve a level of granularity that is proportionate to the requirement for Capex Incentive assessment

Source: Arcadis capex incentives report

D19 The illustrative examples developed by Arcadis are a useful starting point for further conversations with HAL and airlines on defining delivery objectives for H7.

D20 We have set out our requirements for delivery objectives and delivery obligations for HAL's next RBP update in Chapter 12.

Incentive rate

D21 As explained in Chapter 12 we are consulting on a moderate *ex ante* incentive in the range of 20% to 30% to all of HAL's capex.

D22 Our preliminary analysis to inform the April 2018 Consultation suggested that applying a 25% incentive rate to all of HAL's capex would not make HAL an outlier compared to cost efficiency incentives placed on other energy and water network companies that are subject to economic regulation.

D23 We have updated this analysis, re-evaluating some of the key assumptions so that our assessment is based on our latest thinking and information available. For example, we have:

- assessed HAL's historical capex performance to establish a range of under and overspend scenarios; and
- used these scenarios to test an appropriate incentive rate range, in particular whether the upper end of our proposed range (30%) is appropriate.

D24 Based on HAL's historical capex performance (Q4, Q5 and Q6), HAL has, on average, generally either underspent or overspent against the relevant baseline by up to 20%. On that basis, we have adopted "low" and "high" capex scenarios of -20% and +20%. The highest over- or underspending in any given year has typically been around 30%. We have used this to inform our "very low" and "very high" capex scenarios -30% and +30%.

D25 Given these updated scenarios, exposing HAL to an incentive rate in our proposed range of 20 to 30% of any capex over- / underspending would lead to a comparable RORE assessment to the one set out in our April 2018 Consultation. Therefore, we are consulting on an incentive rate within this range.

D26 There are several reasons why we consider that a range of 20% to 30% is moderate:

- the flexibility offered by the core and development framework means that the baseline against which we assess HAL's performance can be updated during the period as new information becomes available which provides a level of forecasting risk protection for HAL;
- HAL's H7 capex portfolio consists of less risky and more controllable capex programmes (see chapter 12) compared to the expected capex at the time of our previous assessment of incentive rates which included the expansion programme;

- as explained in chapter 12, an element of our proposed H7 capex baseline (around 18%[8]) will not be subject to *ex ante* capex incentives; and
- we are assessing HAL's cost performance against the G3 capex baselines which means that the incentive rate would not apply to pre-G3 development capex that HAL incurs.[9]

D27 For our capex scenarios of under or overspending, we estimated the impact on HAL's RORE of it incurring a penalty of 30% of any overspending (or allowing HAL to retain 30% of any underspending). Our updated analysis, including our proposal for HAL's H7 capex plan, suggests that a rate of 30% (the top of the range we are proposing) would lead to a comparable RORE assessment to the one set out in our April 2018 Consultation.

D28 We will assess stakeholder feedback on our proposed range and carry out further analysis based on our final proposal for HAL's capex baseline to ensure that the incentive rate is appropriate.

Timing incentives

D29 In the April 2021 Way Forward Document, we set out a detailed proposal for a targeted set of timing incentives. We remain of the view that timing incentives are an important element of our overall capex efficiency incentive package. They strengthen the incentives for HAL to operate efficiently and avoid cost overruns.

D30 As set out in Chapter 12 we are proposing:

- to update the trigger mechanism in H7; and
- apply penalties for failing to deliver a capex category beyond a delay of 12 months from the agreed date of delivery so that HAL is incentivised to avoid lengthy delays in delivery.

D31 This section sets out more detail on our proposals for these incentive mechanisms.

An updated trigger mechanism for H7

D32 In previous regulatory settlements, we included a trigger mechanism in the price cap formula so that HAL's charges are reduced if specified project milestones are not achieved by the project trigger date that has been agreed with airlines. The mechanism reduced charges by the cost of capital that HAL would ordinarily earn on the capex for the relevant project from the agreed date of delivery until the date of full delivery of the project.

D33 In the April 2021 Way Forward Document, we set out our proposal for updates to the trigger mechanism which included:

[8] Cross rail and transitional capex projects that are already significantly underway before the start of H7.

[9] Based on discussions during capex efficiency engagement with HAL, our understanding is that the average ratio of pre-G3 capex to total capex is usually around 10% for typical projects.

- updated criteria for when projects can be triggered[10] and we explained that for H7, because we are introducing delivery obligations which will include a timing requirement, we expect that triggers would only be applied to exceptional, material and complex projects where timing is important for consumers;
- where a project is subject to a trigger, HAL would face:
  - a penalty for late delivery that will be based on the existing Q6 calculation; or
  - a modest reward (10% of the penalty payment) if it both delivers the project ahead of the agreed trigger date and where early delivery before the trigger date would result in clear benefits to consumers.

Stakeholder views

D34 BA agreed with our proposal that triggers could be more targeted in H7, but only if the timing requirement of the new delivery obligations are clearly set out. However BA did not agree with our proposal of introducing an additional reward for early delivery of triggered projects because early delivery is unlikely to result in any tangible consumer benefit, whereas late delivery would have a direct impact on the ability to start work on follow-up projects for example.

D35 The AOC/LACC did not agree with our proposal to reduce the use of triggers during H7. It also suggested further engagement is necessary on how triggers are treated on projects that cross multiple settlement periods.

Our initial proposals

D36 We maintain the view that triggers should only be applied to exceptional key projects during H7 because we will be introducing other mechanisms to incentivise delivery, including the cost incentive mechanism. We are also considering whether it is proportionate to apply penalties for significant delays to delivering capex categories.

D37 We note airlines' views on our proposal to include a modest reward for early delivery. However, we consider that, where triggers are applied to exceptional H7 capex projects, this reward will provide a stronger incentive on HAL to deliver on time. All triggered projects should be reviewed by the IFS in advance to provide a view on whether the trigger date agreed between HAL and airlines is realistic.

D38 Our proposed policy defines the trigger design and sets the appropriate criteria for applying triggers in H7. The actual decision of whether any project put forward in H7 satisfies these criteria and if so, should be triggered will remain a matter for HAL and airlines to agree on. Where HAL and airlines cannot agree, we will decide whether it is appropriate to apply a trigger. This is consistent with the existing arrangements and we will consider the criteria for applying triggers in making our decision.[11]

---

[10] See paras 53-54, Appendix M, April 2021 Way Forward Document.

[11] See paras 53-54, Appendix M, April 2021 Way Forward Document.

D39 In terms of transitional arrangements for Q6 or iH7 capex, triggered projects that have still not been delivered by 31 December 2021 should be rolled over into H7. That is, HAL should continue to be incentivised to deliver those projects in a timely manner into H7 as well. Our understanding is that only the Main Tunnel project, which should be delivered in 2023 according to HAL's updated RBP capex plan projections, falls in this category. We expect HAL and airlines to arrange for an update to this trigger to ensure it does not automatically expire at the end of this year.

Penalty for delayed delivery of capex categories

D40 In the April 2021 Way Forward Document we said that the *ex ante* incentive arrangements, including the timing requirements set out in the delivery obligations, will incentivise HAL to deliver programmes on time. We said that:

- as part of the reconciliation process, we will consider whether the delivery obligations have been met, and that this will include an assessment of whether HAL has met the timing requirements; and
- we could consider setting a penalty for delivering capex categories with significant delays compared to the agreed date of delivery.

D41 We received limited views on this aspect of our proposal, so we are still considering whether it is proportionate to apply penalties for late delivery of capex categories. If we do decide to apply this approach, the mechanism could be implemented so that, for example:

- 12 months after the agreed date of delivery, a penalty of 50% of the trigger penalty calculation (that is, half of the return on those undelivered capex categories) will continue to be deducted until the final delivery of the capex programme; and
- if there is a longer delay of more than 24 months, we will continue to apply an increased penalty equivalent to 80% of the trigger calculation until final delivery of the capex programme.

D42 We consider that this will provide HAL with a strong incentive not to delay difficult, but important, capex categories.

D43 Our proposal of a penalty for significant delays in the delivery of capex categories has several differences from the trigger mechanism:

- it will be set at a capex category level rather than project level;
- penalties will only apply beyond a significant delay in delivery of 12 months;
- the proposed level of the penalty is lower to recognise the wider capex incentive package HAL will face in H7;
- the application of the penalty is automatic for each capex category and we will be involved in calculating the penalty as part of the incentive reconciliation process; and

- we propose to apply the penalty as a RAB adjustment, rather than an annual adjustment to HAL's charges.

D44 We consider that the introduction of a penalty for significant delays to capex categories means that the trigger mechanism would only apply to projects in exceptional circumstances.

D45 Finally, we have also considered the option of a more streamlined approach to setting the penalties for significant delays to capex categories. Under this approach, penalties will start accruing at the end of 2028, 12 months after the reconciliation backstop date set at the end of 2027. We welcome stakeholder views whether that is a more proportionate and appropriate approach than the example we set out above where we base the penalties on the dates of delivery agreed between HAL and airlines.

D46 We welcome further engagement on our proposed approach for timing incentives.

Enhanced governance arrangements

D47 In the April 2021 Way Forward Document, we explained our approach of building on existing capex governance arrangements where possible (for example by retaining the core and development framework) and enhancing these arrangements in areas where we consider it is necessary to do so.

D48 We also set out our initial thinking around the possible role for the CAA, airlines and independent advisors as part of the H7 enhanced governance arrangements, and we plan to continue discussing these issues with HAL and airlines over the following months (ahead of the publication of the Final Proposals), as well as after we have issued our Final Proposals, as part of the implementation of our policy.

D49 One issue that airlines have raised is around the treatment of risk allowances and capital overheads as part of the updated capex incentives framework. As explained in Chapter 3, HAL's updated RBP capex plan was high-level, and did not deal with risk allowances and capital overheads explicitly. For that reason, we have not been able to consider in detail how these two elements of the capex plan should be treated as part of the capex incentives framework.

D50 We note that some of the airline suggestions (for example, AOC/LACC provided a list of detailed suggestions, including having a central allocation for risk, and changes to the treatment of capital overheads), could be either updated within the existing Capital Efficiency Handbook or included within appropriate guidance documents relating to the CAA's updated capex incentives framework.

D51 We will continue to work with HAL and airlines, including once we receive an updated version of the capex plan, to develop an approach for the Final Proposals for the treatment of risk allowances and capital overheads.

Appendix E

Q6 Capex Review

Introduction

E1 An important element of the CAA's regulation of HAL is ensuring that the price control includes an appropriate framework for capex incentives to encourage HAL to develop and maintain its assets in a way that is efficient and provides value for money for consumers.

E2 A central part of our approach in the Q6 price control to furthering the interests of consumers in relation to capex was the backward looking (*ex post*) assessment of capex incurred by HAL during the Q6 period to determine whether it has been efficiently incurred. This Appendix sets out our initial proposals in relation to our assessment of Q6 capital efficiency, including:

- a summary of the work we have completed so far on the Q6 efficiency review;
- an update on the efficiency assessment of key projects and related issues;
- a summary of our initial proposals with respect to these matters; and
- next steps and implementation.

E3 Based in part on the challenges that we have encountered in this *ex post* review, we are placing greater emphasis on new forward-looking (*ex ante*) incentives for capital efficiency during the new H7 period. Our initial proposals in respect of these matters are summarised in Chapter 12 of this document.

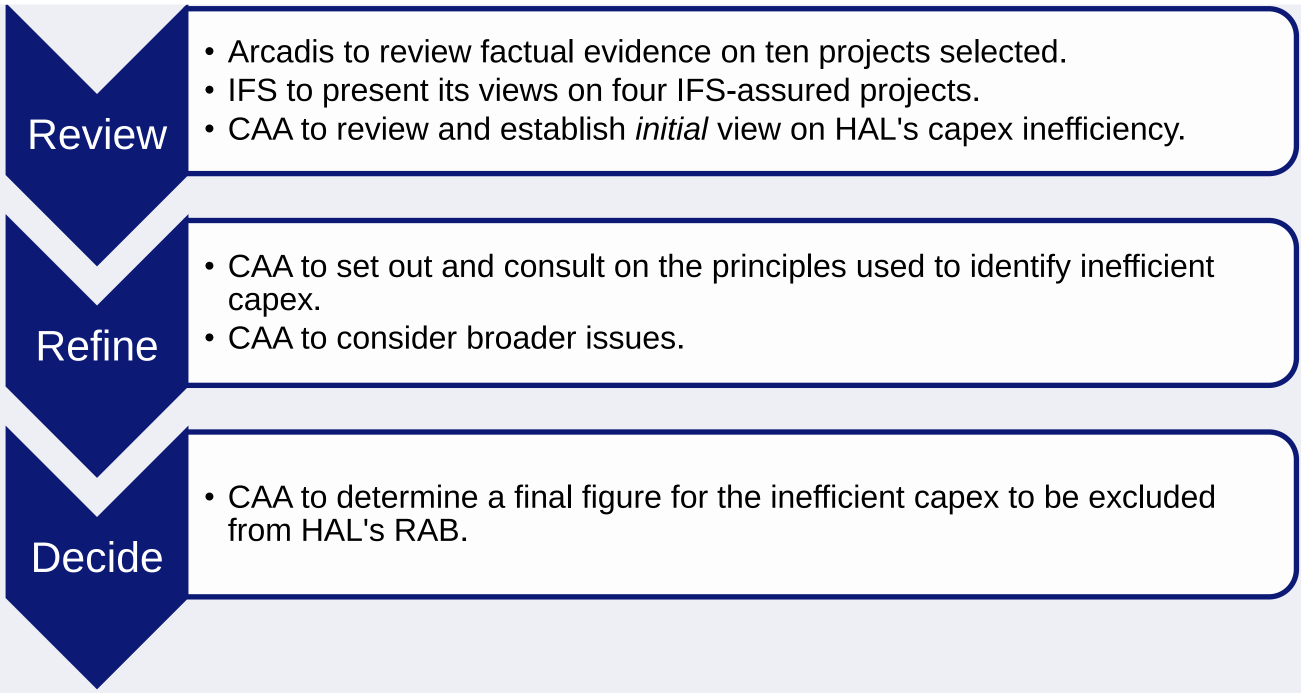
Summary of earlier consultations

E4 In 2018, we started reviewing HAL's overall capex during Q6. Our review followed a number of steps from 2018 to 2020, including: reviewing existing evidence, developing project selection and assessment criteria, and engaging with stakeholders.

E5 In the September 2020 Working Paper, we outlined initial conclusions from our review of ten capital projects that HAL had completed or were still in progress during the Q6 price control (as extended). We also described a number of broader issues around the delivery of HAL's wider capex programme. In the April 2021 Working Paper, we provided an update on the key policy areas and our emerging conclusions. Each of the September 2020 Working Paper and the April 2021 Working Paper set out our emerging views on capex efficiency during the Q6 period.

E6 Our broad approach is summarised in Figure E.1 below. This appendix focuses on the "Decide" stage of the project.

Figure E.1: Proposed Q6 capex adjustment framework



Source: CAA

E7 The April 2021 Working Paper set out the following issues for stakeholder comment:

- our intention to retain a framework in which out-turn expenditure may only be disallowed from the RAB at the end of the price control period where it is "demonstrably inefficient and wasteful expenditure" ("DIWE");
- our interim conclusions on the Cargo and Main Tunnel projects, proposing that, once these projects are complete (or at the end of the H7 price control period if this is earlier), if there appears to be new evidence that suggests a greater level of efficiency or inefficiency, we will review these matters further;
- our view that a downward adjustment to HAL's RAB in the range between £12.3 million and £12.7 million would be appropriate for the inefficiency in relation to the Cargo Tunnel project. This adjustment would be made at the start of the H7 price control period;
- we did not propose any adjustment for the Main Tunnel at this stage or any adjustment in relation to the other eight capital projects that we reviewed;
- the need for HAL to adhere to the existing capex governance arrangements;
- our intention not to make any adjustments for exceptional performance in relation to the Transport Study framework; and
- our view that capital overheads are an important area and that further work will be carried out on these costs as part of our H7 price control review.

Update on the main projects and other related issues

Cargo Tunnel

E8 In the April 2021 Working Paper, we explained that our conclusions on the Cargo Tunnel project should be regarded as interim in nature. That is, once the project is complete (or not later than the end of H7, to provide a backstop date in the case of further delays) HAL should have an opportunity to make the case that the expenditure is efficient, and we will consider whether there is further information at that stage on over-runs or inefficiency. In addition, we also said that, on the basis of the evidence and our analysis, we expected to make an adjustment to HAL's RAB in the range of £12.3 million to £12.7 million. This range of potential RAB adjustments was derived directly from the analysis of project costs we commissioned from Arcadis.[12]

Stakeholder views

E9 Both BA and AOC/LACC supported our proposals to treat any adjustment to the RAB in respect of the Cargo Tunnel project as an interim arrangement. However, AOC/LACC noted that the review of capex on the Cargo Tunnel should not be conditional on new evidence being put forward. BA welcomed our proposed inefficiency adjustment for the Cargo Tunnel. However, each of these respondents expressed disappointment with the size of the proposed range for the adjustment and considered that it should be higher.

E10 HAL welcomed the proposal to continue monitoring and reviewing progress on the Cargo Tunnel. However, it also noted that it would not expect a substantial re-examination of Q6 costs at the end of H7. It considered that any review should focus only on new investment. In addition, HAL was disappointed by the proposed deduction from the RAB and did not consider that any RAB adjustment should be made. HAL also noted that the range set out in the analysis performed by Arcadis included £0.75 million of asbestos-related removal and assurance costs that it said should be considered separately.

Our views

E11 Based on these stakeholder views and our further consideration of these matters, we confirm that we will be treating the RAB adjustment that we make in respect of the Cargo Tunnel project as an interim arrangement. However, we do not agree with the view that AOC/LACC put forward that the future review should not be dependent on new evidence being put forward. We consider that *ex post* reviews are likely to continue to be a resource intensive exercise and, therefore, should be proportionate and conducted only where there is evidence of potential consumer detriment.

Initial Proposal on the costs of the Cargo Tunnel

E12 The range for the RAB adjustment in the April 2021 Working Paper was £12.3 million to £12.7 million. We have now given further consideration to this range:

[12] More details of this analysis are set out in their September 2020 Report available on the CAA website.

- we developed and quantified a proposed range for the RAB adjustment of £12.3 million to £12.7 million based on the analysis undertaken by Arcadis, which we explained in our April 2021 Working Paper. The evidence base at that time provided strong support for an adjustment of £12.7 million;
- we received no additional factual evidence in response to the April 2021 Working Paper that persuaded us that £12.7 million was not an appropriate adjustment.

E13 As further context for our considerations, we also note that:

- we have ongoing concerns around cost overruns and other issues in delivering this project, which is currently paused and scheduled to restart during the H7 period; and
- HAL's own update in the January 2021 airport-airline governance forum (Capital Portfolio Board) identified that some of the historically incurred costs of the project related to design packages, materials and other costs are due to be written off (or impaired) by HAL in the future.

E14 Given all of the above, we are of the view that an adjustment at the top of the range of £12.7 million is appropriate.

E15 We also note HAL's argument that the range includes £0.75 million of asbestos-related removal and assurance costs, which HAL says should be treated separately. This argument appears to have been raised late in the process and we have not received additional factual evidence from HAL to support its argument. Accordingly, we have not been persuaded by HAL's argument but remain open to considering this further as part of any future review.

Main Tunnel

E16 In the April 2021 Working Paper we said that that we did not consider that there is sufficient evidence at present of inefficiency to disallow any of the capex incurred on this project. In addition, as with the Cargo Tunnel project, we said that our assessment of this project should be treated as an interim position. That is, once the project is complete (or not later than the end of H7, to provide a backstop date in the case of further delays), if there appears to be new evidence of inefficiency, we would review this project further, noting that stakeholders have identified ongoing concerns on the efficiency of the project as it progresses.

Stakeholder views

E17 BA and AOC/LACC supported the proposed interim arrangements for the Main Tunnel. However, BA was disappointed with our conclusion that there is not currently sufficient evidence of inefficiency on this project.

E18 On the other hand, HAL welcomed and supported our view that there is not sufficient evidence of inefficiency.

Our views

E19 As with Cargo Tunnel project, we confirm that we will be treating our findings on the Main Tunnel project as an interim position.

Initial Proposals

E20 Consistent with the assessment summarised above, we do not consider that, at present, an inefficiency adjustment should be made to the H7 RAB in relation to the Main Tunnel project under the DIWE criteria.

Remaining capital projects

E21 In the April 2021 Working Paper we said that the issues (if any) with the remaining eight projects reviewed by Arcadis are not sufficient to justify a RAB adjustment under the DIWE criteria. However, we also considered that compliance with the relevant governance arrangements was, at times, problematic during Q6 and noted that we may use any relevant evidence of non-compliance in future reviews in forming our views on capital efficiency.

Stakeholder views

E22 BA was disappointed that we did not identify any quantified evidence of inefficiency on the T3 Integrated Baggage (T3IB) and T5 Western Baggage Upgrade (T5WBU) projects. The AOC/ LAC response reiterated that our proposed adjustment for inefficiency falls “over £200m short” of their view, with reference back to their previous submission, which provided their views on relevant projects in more detail. Each stakeholder, however, welcomed our recognition of governance failures at times on complex/larger projects and our proposal that HAL’s compliance with relevant governance arrangements could inform our views on capital efficiency in the future.

E23 HAL welcomed our finding that the T3IB and T5WBU projects do not require an adjustment for inefficiency. Similarly, for the remaining six projects, it welcomed Arcadis’ view that these have been delivered efficiently.

Our views and Initial Proposals

E24 Given the absence of new evidence, we remain of the view that the issues, if any, with these projects are not sufficient to justify an adjustment for inefficiency under the DIWE criteria.

E25 We also confirm that we will be monitoring HAL’s ongoing compliance with the relevant capex governance regime closely, and that we may use such evidence in future reviews, where this is an appropriate and proportionate approach.

Other capex-related issues

Capital overheads and risk allowances

E26 In the April 2021 Working Paper, we confirmed that we would be considering capital overheads and risk allowances as part of our work on the H7 price control. We also said that the Capital Efficiency Handbook (and other relevant governance documents) should be updated to reflect our analysis of Q6 projects and our updated capex incentives policy.

E27 All three respondents broadly agreed that HAL’s capital overheads and risk allowances should be considered as part of the work on the H7 price control. In addition, AOC/LACC made a list of detailed suggestions, including: having a central allocation for risk; updating triggers; having an annual reconciliation of capital included within the RAB; and changes to treatment of overheads within business cases; among others.[13] These, according to AOC/LACC, could be either updated within the existing Capital Efficiency Handbook or newly included within appropriate guidance documents.

Our views

E28 Given that stakeholders broadly agreed with our proposals for taking forward policy in these areas, we confirm our previous view that we will consider these matters as part of our work on the H7 price control review. We explain in Appendix D how these issues will be taken forward.

iH7 capital projects

E29 In the April 2021 Working Paper, we noted that there are a number of projects that were ongoing during the iH7 period and have finished, or are about to finish. There are also other projects that started during the iH7 period and will continue into H7. We said that we would consider reviewing these projects in the future if the IFS (or other stakeholders) identified potential inefficiencies with the spending.

Stakeholder views

E30 AOC/LACC proposed that we consider reviewing certain capital projects and related areas at the end of iH7, including projects that HAL stopped due to the impact of the covid-19 pandemic, as well as other potentially problematic projects such as Project Magenta[14] and the T4 Hold Baggage System (T4HBS).

E31 HAL took the view that if any further reviews were to be required, these should be done in a timely manner so not to put pressure on resources. It also asked us to confirm the scope and timing of any further reviews as well as encouraging us to plan on the basis of not reopening the initial H7 RAB at the end of H7 as this could lead to significant uncertainty and increased risk.

Our views

E32 We agree with HAL that any review of iH7 projects, if required, needs to be done in a timely manner, but given that we are currently in the process of setting the H7 price control, conducting any review now would likely put significant pressure on both our, and stakeholders', resources.

E33 Furthermore, our understanding is that, at present, the situation with the iH7 related projects is dynamic as some of the projects that have been paused are yet to restart. We expect that restarting these projects is likely to depend primarily on traffic recovering and we will monitor this situation as it develops.

E34 In line with the April 2021 Working Paper, we would expect that any further *ex post* reviews would take place towards the end of the H7 price control period. We would consider a further review if the IFS (or other stakeholders) identify

[13] In particular, they also proposed a review of HAL's property strategy and an audit of the "Cost of change" programme

[14] An IT project proposed by HAL

potential inefficiencies with projects delivered during the period, and present evidence of these potential issues and difficulties.

Summary of Initial proposals

E35 Our Initial Proposals are summarised below:

- we will be reducing HAL's opening RAB by £12.7 million to reflect the inefficiencies we have identified in relation to the Cargo Tunnel project;
- we will reserve the option of conducting a further review of efficiency of the Main and Cargo Tunnel projects once those projects are complete (or at the end of the H7 price control period if this is earlier);
- we will not make any further adjustments in relation to the remaining eight capital projects we have reviewed;
- we will be requiring HAL to update its Capital Efficiency Handbook (and other related governance documents) as discussed in Chapter 12, as well as reviewing the treatment of capital overheads and risk allowances as part of our further work on capital expenditure; and
- we may review capital projects that were ongoing during iH7 at the end of H7 if there is evidence that these may have been delivered inefficiently.

E36 We consider that these proposals represent a proportionate response to the evidence of inefficiency that we have been presented with and, as such, the adjustment set out will further the interests of consumers by protecting them from being exposed to inefficient costs. Given the scale of the adjustment, we do not consider that it will have any material effect on HAL's financeability.

Next steps and implementation

E37 We welcome the views of stakeholders on any of the issues raised in this appendix and will consider these carefully as part of our work to develop final proposals.

E38 Chapter 6 describes our broader policy on the RAB, and the RAB adjustment of £12.7 million is put into effect in Chapter 11 on calculating the price control.

Appendix F

Early expansion costs

Introduction

F1 Early expansion costs relate to expenditure incurred by HAL on developing its plans for the "expansion" of Heathrow airport by the construction of a third runway and associated terminal and other buildings. These costs were incurred mainly between 2017 and early 2020, prior to HAL's decision to pause its plans for expansion in light of the Court of Appeal's decision to set aside the Airports National Policy Statement ("NPS"). While the Court of Appeal's decision was subsequently overturned by the Supreme Court, expansion was quickly overtaken by the onset of the covid-19 pandemic and remains paused.

F2 We have previously said that HAL's efficiently incurred early expansion costs should be added to its RAB and recovered during the H7 price control period and beyond. In making these commitments, we took the view that developing expansion was in the interest of consumers at the time the expenditure was incurred.

F3 It would not be consistent with this approach, or good regulatory practice for the CAA to revisit this broad approach with the benefit of hindsight in the context of the impact of the covid-19 pandemic or other events outside of HAL's control. To do so would create very significant regulatory uncertainty and this would inevitably have an adverse impact on HAL's ability to fund its activities, which would not be in the interests of consumers.

F4 This appendix covers:

- the background to HAL's expansion plans, including the events leading up to the pause of expansion in early 2020, and our subsequent policy proposals for the assessment and recovery of efficient costs;
- stakeholders' views on the April 2021 Working Paper on these issues (which was published alongside the April 2021 Way Forward document);
- our views on stakeholder feedback; and
- our Initial Proposals on the assessment of efficient costs.

Background

F5 On 27 February 2020, the Court of Appeal delivered its judgment that the NPS had not been lawfully produced.[15] This led HAL to pause its expansion programme. This judgment was appealed by HAL to the Supreme Court, which

[15] See: R (Friends of the Earth) v Secretary of State for Transport and Others [2020] EWCA Civ 214.

ruled in December 2020 that the Government's decision to designate the NPS had been lawful, reversing the decision of the Court of Appeal.[16] Nonetheless, expansion has remained paused given the very significant impact of covid-19 on the aviation sector and Heathrow airport.

F6 In the light of HAL pausing the expansion programme in early 2020, we set out a refocused policy in the June 2020 Consultation for the recovery of both Category B and Category C costs[17] incurred before March 2020. We proposed to treat all expansion costs incurred by HAL before March 2020 in the same way, rather than having separate policies for Category B and Category C costs. These costs would be added to HAL's RAB at the beginning of H7, subject to an efficiency assessment.

F7 The April 2021 Working Paper provided a further update on our policy in relation to early expansion costs, and set out the initial findings from our assessment of the efficiency of costs incurred by HAL before the end of February 2020.

F8 Table F.1 below provides an overview of Category B and Category C costs incurred from 2017 to the end of the period covered by our assessment. We note, however, that Category B costs for 2017 and 2018 were not in scope of the present assessment, as they had already been reviewed by the IPCR and dealt with by our earlier consultations.[18]

Table F.1: Summary of early costs incurred by HAL between 2017 and February 2020

£million Nominal prices	2017	2018	2019	Jan-Feb 2020 [2]	Total
Category B	78	118	167	21	384
Category C	6	11	71	21	109
Total	84	129	238	42	493

Source: HAL data.

[1] Jan-Feb 2020 data is based on HAL's internal accounting information.

F9 HAL has continued to incur some expansion costs since March 2020. These costs relate to winding down the expansion programme (around £30 million between March and December 2020 and under £10 million forecast for 2021), appeal related costs (around £1.1 million in 2020) and costs associated with the Interim Property Hardship Scheme (forecast to be under £5 million in 2021).

[16] See R (on the application of Friends of the Earth Ltd and others) (Respondents) v Heathrow Airport Ltd (Appellant). https://www.supremecourt.uk/cases/uksc-2020-0042.html

[17] Broadly, Category B costs are broadly those related to seeking planning consent for expansion, while Category C costs are early construction costs.

[18] There was also a small amount of Category B expenditure incurred at the end of 2016 (post-October 2016) which we allowed (with an efficiency challenge). See Appendix B of the July 2019 Consultation and Appendix D of the June 2020 Consultation.

F10 In parallel to our review of these early expansion costs, we have also been carrying out an *ex post* review of Q6 capex, the findings of which we also consulted on in the April 2021 Working Paper. We provide an update on the Q6 capex review in Appendix E.

F11 Our assessment of Q6 capex has been undertaken subject to the "demonstrably inefficient and wasteful expenditure" ("DIWE") framework developed by the CMA. For early expansion costs we had set out our high level approach to assessing the efficiency of early expansion costs before the CMA set out its use of the DIWE framework in the context of aviation and air traffic control in 2020. Bearing in mind the advantages of regulatory consistency noted in the introduction we have decided it would not be in the interests of consumers to revisit our approach to these matters and so we have not formally adopted the DIWE framework for the assessment of early costs.

F12 We also note that the DIWE framework was designed primarily for capex projects where the construction phase was substantially complete, rather than for project planning and development costs such as early expansion costs. Nonetheless, a significant component of our approach to early costs involves assessing whether there is evidence of inefficiency and so there is a degree of consistency across these approaches.

Stakeholders' views

F13 We received three responses to the April 2021 Working Paper: from HAL, AOC/LACC and BA. The responses are available on our website.[19]

F14 HAL and airlines said that, should expansion restart in the future, the CAA should put in place a clear policy for the recovery of any further expansion costs, from the outset. AOC/LACC specifically said that this future policy should cover governance arrangements in relation to costs, including any costs incurred without airline approval, and that, if expansion re-starts, consumers should not pay twice for activities that HAL has already been remunerated for under the present policy.

F15 BA said that, because the NPS has now been reinstated (following the Supreme Court's December 2020 decision), but HAL has not progressed expansion, this amounts to "unilateral withdrawal" by HAL for the purposes of its policy on the recovery of Category B expansion costs set out in February 2017, and the CAA should consider the impact of this on its policy for expansion costs.[20]

F16 HAL said that the CAA had not carried out a full consultation or set out a policy decision on the use of 4.83% as the cost of capital for the iH7 period. It said that

---

[19] Consultations and policy documents | UK Civil Aviation Authority (caa.co.uk)

[20] The application of the policy that BA argued for would see us deciding that HAL could recover less than the 85% recovery threshold set out in the risk sharing arrangement in our Category B planning costs policy. However, we do not consider that there is the compelling evidence required that HAL has unilaterally withdrawn from the planning process for that element of the policy to apply. See The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: Policy Statement (CAP1513): www.caa.co.uk/CAP1513.

the decision to apply the rate to 2020 and 2021 costs is not consistent with previous CAA policy in setting the iH7 price control. HAL said the Q6 cost of capital should apply to early costs incurred in 2020 and 2021.

F17 HAL also argued that the CAA imposed reporting requirements in relation to expansion went beyond normal requirements and drove higher costs.

Our views

F18 We agree that, should expansion re-start in the future, we should put in place a clear policy for how any expansion costs can be recovered by HAL, including a requirement that HAL should demonstrate that any work carried out previously which can be used again (such as design work) is not duplicated. We would consult further on these matters if it appears to be in the interests of consumers for capacity expansion to restart and HAL brings such proposals forward.

F19 In response to the points raised by BA in relation to “unilateral withdrawal”, we note that HAL has currently paused expansion, rather than stopped the programme entirely. We consider that it would not be sensible or efficient, or in the interests of consumers, for HAL to be actively pursuing expansion at this time, given the ongoing impact of the covid-19 pandemic.

F20 Bearing the above in mind we remain firmly of the view that HAL has not “unilaterally withdrawn” from the expansion process and, therefore, we do not consider there is a case for changing our overall policy for the recovery of expansion costs already incurred.

F21 In relation to HAL’s point on the level of the WACC for the iH7 period, we note that the CAA consulted on options for determining the cost of capital that should apply to Category B costs in the July 2019 Consultation (CAP1819). We set out the decision to use the 4.83% rate in the December 2019 Consultation (CAP1871). No new evidence has been presented that would cause us to alter our view on this issue.

F22 In relation to the reporting requirements on HAL, given the scale and importance of the expansion programme, we do not consider these were excessive or disproportionate.

Policy on early costs and the efficiency assessment for 2018

F23 For our assessment of expansion costs incurred before March 2020, we set out our initial findings in the April 2021 Working Paper. In this document, we are building on that assessment and setting out Initial Proposals in respect of the efficiency of costs.

F24 Specifically, we cover:

- the assessment of expansion costs incurred in 2018 and reviewed by the IPCR;
- our policy for the recovery of early expansion costs, covering costs incurred both before and since HAL paused expansion; and

- findings from our efficiency assessment of expansion costs incurred before March 2020.

Expansion costs incurred in 2018

F25 In the June 2020 Consultation, we set out key findings from the IPCR's review of Category B costs incurred by HAL in 2018, as well as our view in relation to that evidence. In the light of the IPCR's review, we proposed not to make any adjustments for inefficiency in relation to 2018 Category B expenditure but said we would consider representations from stakeholders before making final decisions on these matters.

F26 Responses to the June 2020 Consultation were either supportive of our proposals (for example HAL and the HCEB) or did not raise specific issues with the IPCR's assessment or our proposal. We therefore confirm the proposal from the June 2020 Consultation that all Category B costs incurred in 2018 will be added to the RAB at the start of H7. This amounts to £118 million.

Policy in relation to the recovery of early expansion costs

Costs incurred before March 2020

F27 As set out in the April 2021 Working Paper, we have a finalised policy for recovery of early expansion costs incurred by HAL before March 2020. This policy covers all Category C costs incurred since 2017, and any Category B costs not previously reviewed by the IPCR.

F28 Our final policy in relation to the recovery of expansion costs incurred before March 2020 is as follows:

- Category B and Category C costs incurred by HAL before March 2020 can be added to the RAB at the beginning of 2022, subject to our efficiency review;
- risk sharing arrangements, recovery caps for costs incurred in 2020 and 2021, enhanced reporting requirements and a new licence condition on governance arrangements are no longer necessary or appropriate and will, therefore, not apply to these costs; and
- we will make an allowance for financing costs for costs incurred before March 2020 as follows:

  i. the Q6 cost of capital of 5.35% for the period up to the end of 2019; and

  ii. the iH7 cost of capital of 4.83% for the period after January 2020.

Wind down costs

F29 HAL continued to incur costs associated with the expansion programme after pausing the programme in March 2020. We refer to these costs, which consist of the costs of pausing and demobilising the programme, as "wind down" costs.

F30 We understand from HAL that the costs of pausing expansion are likely to continue until late 2021, although most of the expenditure was incurred in 2020. Based on HAL's submissions to date, wind down costs from 1 March 2020 until the end of 2020 total £30 million. This spending includes costs such as residual staff costs, costs associated with fulfilling supplier contractual commitments, and HAL's pre-existing agreements relating to property acquisitions. Preliminary figures from HAL suggest wind down costs for 2021 of under £10 million.

F31 In response to the April 2021 Working Paper, AOC/LACC said that they support a full review of wind down costs incurred by HAL. BA said that it had not had visibility of wind down costs incurred since the programme was paused.

F32 We are now confirming that HAL will be allowed to add wind down costs to the RAB, subject to an efficiency assessment.

F33 We will review the full amount of wind down costs incurred by HAL when HAL is no longer incurring costs or incurring very little further cost. To facilitate this HAL should make a formal submission in relation to wind down costs incurred over 2020 and 2021 as soon as practicable following the end of 2021. This submission should exclude or separately identify the cost categories discussed below, namely appeal costs and costs associated with the IPHS.

Appeal costs

F34 We have said previously that we consider the cost of HAL appealing to the Supreme Court was an ongoing strand of the expansion work as it related to HAL obtaining planning consent for expansion. As a result, we consider that appeal costs incurred by HAL from March 2020 should, as far as practicable, be treated in the same way as costs incurred before that date.

F35 The CAA will undertake a proportionate review of HAL's appeal costs (around £1 million) before these costs can be added to the RAB.

Interim Property Hardship Scheme ("IPHS")

F36 The IPHS is a discretionary HAL policy that aims to assist eligible property owners who:

- have a compelling need to sell their property;
- but have been unable to do so, except at a substantially reduced price; and
- as a consequence, are facing significant hardship

as a direct result of expansion proposals. Under the IPHS, property owners who can demonstrate that they meet certain eligibility criteria are able to have their property purchased by HAL.

F37 We explained in the April 2021 Working Paper that, following the reinstatement of the NPS (following the Supreme Court decision), HAL and airlines jointly wrote to CAA on 30 March 2021 to ask for confirmation that future expenditure efficiently incurred in connection with the IPHS would be added to HAL's RAB.

F38 We wrote to HAL and set out in the April 2021 Working Paper that we are minded to approve the addition of such expenditure to HAL's RAB, subject to a set of criteria that:

- HAL complies with appropriate governance arrangements for the Hardship Panel[21] and manages its costs within the budgets set out in the further costing information it provided to us on 1 April 2021;
- HAL takes reasonable steps to maximise the rental revenues from these properties (the amounts of which will be taken into account at the H7 price control review, most likely as part of the single till calculations); and
- any future sale proceeds from these properties will be deducted from HAL's RAB.

F39 In response to the April 2021 Working Paper, HAL welcomed the CAA's minded to position and confirmed it was in the process of reinstating the Hardship Panel that assesses IPHS applications. HAL has since confirmed that the panel has been reinstated and has already started reviewing applications.

F40 AOC/LACC and BA also supported the CAA's minded to position, subject to HAL fulfilling the criteria set out by the CAA. Both respondents asked the CAA how the fact that HAL has not re-started work on expansion following the reinstatement of the NPS affects the proposed position in relation to the IPHS.

F41 The reinstatement of the IPHS was triggered by the Supreme Court's decision (which led to the reinstatement of the NPS). In addition, the statutory "blight" regime, which means that eligible property owners can serve "blight notices" on the Secretary of State, was also triggered following the reinstatement of the NPS. While expansion remains paused, we consider that our approach to blight and IPHS costs remains valid.

F42 We confirm our minded to position from the April 2021 Working Paper, and propose that expenditure in relation to the IPHS should be added to the RAB provided that HAL is able to meet the criteria set out above.

Efficiency assessment of costs incurred from 2019 to February 2020

Background

F43 The April 2021 Working Paper set out our approach for reviewing early expansion costs not previously reviewed by the IPCR, and the initial findings from our review.

F44 The costs in scope of our assessment are set out in Table F.2 below.

[21] The independent panel that assesses applications for the IPHS.

Table F.2: Early costs in scope of our assessment

£ million Nominal prices	2017	2018	2019	Jan-Feb 2020[22]	Total
Category B	Reviewed by the IPCR	Reviewed by the IPCR	167	21	188
Category C	6	11	71	21	109
Total	6	11	238	42	297

Source: HAL data. Nominal prices.

Totals in this table may not reconcile due to rounding.

F45 In determining whether expansion costs were incurred in the interest of consumers and so should be added to HAL's RAB, building on previous IPCR reviews, we are considering whether costs:

- are supported by appropriate evidence;
- have been categorised correctly between "business as usual" ("BAU") and "expansion" activities (to guard against potential "double counting" of costs); and
- whether there is evidence of inefficiency such as to justify their disallowance on grounds of inefficiency.

F46 Our assessment was based on a structured approach, which consisted of two main stages:

- an "initial assessment" phase which involved reviewing the evidence submitted by HAL in its Statement of Costs and supporting document to clarify the scope of our assessment, our approach and resource needs; and
- the "deep dive assessment" phase which involved reviewing the evidence submitted by HAL in more detail.

F47 More detail on our assessment approach is set out in Chapter 4 of the April 2021 Working Paper.

[22] January-February 2020 data is based on HAL's internal accounting data. For 2020, only costs incurred between January and February are in scope of our review. Based on information provided by HAL, we have been able to identify those costs at the category level (that is, at the level of categories identified in Table 4.2). For some cost categories, for example Integrated Design and DCO ("IDT"), we have undertaken our assessment at a lower level of disaggregation, specifically at the task order level. The quantitative and narrative information provided by HAL in relation to IDT task orders typically relates to Q1 2020 costs (January to March 2020). Therefore, throughout our assessment tables there are references to Q1 2020. However, we note that our findings from this assessment will only apply to costs incurred up to the end of February 2020, at the point at which we make proposals for the magnitude of costs to be added to HAL's RAB.

April 2021 initial assessment and stakeholder views

F48 In the April 2021 Working Paper, we used three categories to describe the initial findings from our assessment of HAL's expenditure. We also assigned a "RAG" (red-amber-green) status to the three categories. These gave an indication of potential for inefficiency within each cost category, based on our assessment up to that point.

F49 Tables F.3 and F.4 below show a summary of the RAG ratings included in the April 2021 Working Paper, for Category B and Category C costs respectively.

Table F.3: Summary of April 2021 working paper findings for Category B costs

Category B costs (£ million)	Total costs in scope	% of total	Deep dive	April 2021 RAG rating
Colleague costs	27.30	15%	Yes	AMBER
Programme Leadership	16.75	9%	Yes	RED
Future Heathrow	8.72	5%		N/A
Consents	19.35	10%	Yes	GREEN
Community and Stakeholder	1.73	1%		N/A
IT	4.48	2%		N/A
Ground Investigation	6.07	3%	Yes	RED
Regulation and Strategy	1.58	1%		N/A
IDT	81.92	44%	Yes	GREEN and AMBER (by task order)
Property	15.48	8%	Yes	GREEN
Surface access*	2.92	2%		N/A
Cat B opex	2.06	1%		N/A
Recategorisations and adjustments	-0.38	0%		N/A
Total Cat B costs	**187.68**	**100%**		

Table F.4: Summary of April 2021 working paper findings for Category C costs

Category C costs (£ million)	Total costs in scope	% of total	Deep dive	April 2021 RAG rating
Major Commercial Acquisitions	9.78	9%	Yes	AMBER

Residential Compensation	16.56	15%	Yes	GREEN
Commercial Property Other	2.00	2%		N/A
Seeking Agreement	7.78	7%		N/A
Total Property	**36.12**	**33%**		
IDT	33.59	31%	Yes	RED and AMBER (by task order)
Ground Investigation	9.28	8%	Yes	RED
Future Heathrow	0.11	0%		N/A
Surface Access	0.33	0%		N/A
Detailed Design & Site Prep	**43.31**	**40%**		
Colleague costs	14.88	14%	Yes	AMBER
Programme leadership	6.56	6%	Yes	AMBER
Finance	0.06	0%	Yes	AMBER
Executive Director Overheads	0.74	1%	Yes	AMBER
Consents	1.31	1%		N/A
Community & Stakeholder	0.02	0%		N/A
Programme IT	6.53	6%	Yes	GREEN (allocation concerns)
Regulation and Strategy	0.00	0%		N/A
Total programme	**30.10**	**27%**		
Total Cat C costs	**109.53**	**100%**		

Source: CAA April 2021 Working Paper at page 39

F50 We did not receive extensive feedback or views from stakeholders in response to these initial findings.

F51 HAL said it would be submitting further evidence in relation to the red and amber cost categories. HAL also argued that previous IPCR reports covering the period 2016 to 2018 on Category B expenditure had found "on the whole that all costs were efficiently incurred" and that for "the CAA to now come to any other view would appear to be misguided and ignore available evidence from their own consultants."

F52 We note that our assessment covers a different period and different costs than those reviewed by the IPCR and that the IPCR noted that there were "opportunities for HAL to operate in a more efficient manner".

F53 Airlines were generally supportive of the CAA's assessment approach, while reserving the right to comment on any future findings.

Approach to quantifying inefficiency ranges – initial proposals

F54 In developing our Initial Proposals, we have moved from the RAG ratings set out above to quantified inefficiency ranges.

F55 These ranges are based on our previous assessment and further evidence provided by HAL in response to the April 2021 Working paper (including discussions we have had with HAL subject matter experts).

F56 We have developed a framework for moving from the RAG ratings to a quantification of inefficiency, which is based on the nature of the finding in relation to each cost category. Table F.5 below sets out the approach in terms of the three proposed types of inefficiency finding.

Table F.5: Approach for quantifying inefficiency

Ineffcacy type	Findings in relation to cost category	Proposed approach for quantifying inefficiency
1	Cost categories for which we have identified specific items which have not been well evidenced or justified by HAL.	**Spending in relation to the specific item is included in the inefficiency range.**
2	Cost categories where we have identified an overspending in relation to a relatively stable budget (such as Category C Colleague Costs where there was overspending of 10%).	**Full amount overspent is included in the inefficiency range.**
3	Cost categories where we have more general concerns that do not relate to specific items. For these cost categories, budgets were often substantially revised during the year, without clear justification or change control. This made it difficult to understand whether actual spend relative to budget was efficient. Some of these cost categories are also ones where the IFS identified issues.	For these costs categories, we propose to apply a percentage inefficiency derived based on the level of overspending on the three cost categories which fall in inefficiency type 2, namely Category C Colleague Costs, Category B Financial Management, Category C Ground Investigation. The range of inefficiency for these three categories was 10% to 30% and the average amount overspent for the three categories was 15%. **We propose to use this 15% figure for these cost categories.**

Source: CAA

F57 Tables F.6 and F.7 below show our proposed inefficiency findings for cost categories identified as amber or red in the April 2021 Working Paper.

F58 The rationale for our findings set out in the two tables below should be read in conjunction with the initial findings in Appendix C of the April 2021 Working Paper, which set out the issues we identified in relation to each cost category following our initial assessment.

Table F.6: Category B

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
Colleague costs	27.3	AMBER	Limited concerns re. inefficiency in April 2021 working paper. Some concerns about allocation between Cat B and Cat C but those have generally been addressed by HAL. We propose no finding of inefficiency in relation to Cat B costs.	GREEN	N/A	0
Programme leadership – financial management activities (financial advisory)	2.6	RED	HAL provided some additional useful evidence in response to a post-submission query to explain the nature of the relevant financial advisory activities delivered by contractors. This category was identified as RED but we propose now to move to AMBER in light of the new evidence. There was a clearly identifiable overspending of £0.661m in 2019 (more than 30% overrun compared to budget) which drove our concerns from the beginning. We propose to disallow this in full given the AMBER rating.	AMBER	Type 2	0.7
IDT – TO 5.3 Environmental Impact Assessment	21.2	AMBER	HAL has clarified that the change in approach for this task order (TO) in 2019 (which drove an overspend of ~ 40%) was due to a Scoping Opinion provided by the Planning Inspectorate. This opinion was requested by HAL, but based	GREEN	N/A	0

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
			on evidence provided appears to be a standard approach for major infrastructure projects.			
IDT – TO 1.5 Masterplan design and guardianship	8.3	AMBER	Additional evidence provided by HAL only addressed one of the areas of increased scope (relative to budget) identified in the original submission. Propose to include the £295k of spend in relation to the "CPO[23] justification workstream" (not evidenced) in the proposed inefficiency range.	AMBER	Type 1	0.3

Source: CAA analysis

Table F.7: Category C

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
Major commercial acquisitions	9.8	AMBER	An outstanding payment for a farm site remains relevant as the purchases have not yet been made. We are less concerned about assets being added to the RAB, as they will generate income and / or be removed from the RAB when sold. There is £2.7m of costs for	AMBER	Type 1 and Type 3	0.4

[23] Compulsory Purchase Order.

Cost category	Costs in scope (£ million)	April ’21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
			Home Office IRC[24] studies where HAL has not yet made the case for efficiency. It is hard to make the case that the full amount is inefficient, so we propose to use the benchmark of 15% inefficiency.			
Colleague costs	14.9	AMBER	HAL overspent the Cat C budget over the period we reviewed. In our assessment, we identified issues around recruitment ramp-up in 2019 despite the consultation on scenarios and the use of costly contractors. HAL provided some assurance-type evidence in its submission, but not enough to change our findings. It is also worth noting that the IFS attached the low rating 4 (Concerns regarding Management Practice and Potential for Inefficiency) for certain elements of colleague costs. Therefore, we are proposing to disallow the overspend in 2019 and Q1 2020 of £1.34m, which is 10% of colleague costs in this period.	AMBER	Type 2	1.3
Ground investigation	15.3	RED	HAL did not provide additional evidence / assurance in its submission to explain why the	AMBER	Type 2	0.6

[24] Immigration Removal Centre.

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
(including Category B spend)	Of which: 6.1 (Category B) 9.3 (Category C)		GI spend did not reduce in line with the level of GI activity (which was zero from the second half of 2019). It referred to the IFS report which did not identify concerns in this area. We sent two post-submission queries to ask for further information. HAL stated that delivering borehole locations is only one part of the GI activity and the ongoing monitoring and assessment of delivered locations would still incur expenditure. In relation to the contractor, HAL said that there were Health and Safety issues with how the contractor conducted its work which led to the temporary halt in activities initiated by HAL. Therefore, HAL held back payments due in 2019 until all of those issues were resolved and then settled in Q1 2020. Given this evidence we are of the view that HAL has not provided sufficient evidence to address our overall concerns, we propose to disallow the Q1 2020 Cat. C overspend of £0.618m.			
Programme leadership	6.5	AMBER	Additional information provided by HAL did not address all of our concerns, and specifically	AMBER	Type 3	1

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
			not those around mid-year budget changes in 2019 and overspend of about 20% in Q1 2020. In line with the challenge to the Cat. C Colleague costs and the internal benchmark of 15% challenge, we propose the same efficiency challenge for this category.			
Programme IT	6.5	AMBER	The AMBER rating related to issues around HAL updating the budget after the end of the year not allowing for a transparent audit trail. This is not a priority given the IFS' assessment of this cost category so we propose not to pursue this category further.	GREEN	N/A	0
IDT – TO 3.1 Terminals aprons and satellites & TO 3.7 Airline occupancy, capacity & forecasts	2.6	RED	There was no budget for these TOs in 2019. HAL has said that this work was not necessary pre-DCO, but that it was a requirement from the airlines. HAL has provided some evidence that this was a key issue for airlines. It has not however demonstrated that it could not have proceeded to DCO without doing this work, as it has argued. Therefore, this category remains AMBER, and we propose a 15% disallowance based on the internal benchmark.	AMBER	Type 3	0.4
IDT – TO 4.6 Motorways,	3.3	AMBER	Our key concern is around significant additional scope added in 2019 (relative to	AMBER	Type 3	0.5

Cost category	Costs in scope (£ million)	April '21 RAG status	Rationale for updated RAG status	Updated RAG status	Inefficiency type (if not GREEN)	Proposed disallowance (£ million)
junctions and local roads			budget). The rationale for this scope was not well evidenced. HAL has provided some justification and explanation, but there are still some outstanding issues. Therefore, this category remains AMBER, and we propose a 15% disallowance based on the internal benchmark.			
IDT – TO 3.4 Connectivity	2.8	AMBER	We initially identified that due to the approach to contracting this TO with no budget, it is difficult to assess efficiency. HAL as provided some further explanation. In light of the IFS not identifying any specific issues either, we propose not to make a finding of inefficiency.	GREEN	N/A	0
TO 9.1 Immigration removal centre	1.8	AMBER	No budget was originally allocated, and a lot of this activity seems to have been driven by external factors (e.g. Home Office requirements). We propose not to make a finding of inefficiency.	GREEN	N/A	0

Source: CAA Analysis

F59 Based on the proposed inefficiency findings in the tables above, the total range of inefficiency in relation to the costs in scope of our review is between £0 and £5.2 million. The final value within that range will depend on the how much additional evidence and information HAL can provide in relation to the remaining AMBER categories in the tables above.

F60 Overall, we have identified a number of issues related to HAL's management of expansion, in particular in the way HAL has set and modified budgets for the expansion work, and with HAL's information recording in relation to expansion. However, it is difficult to translate some of these concerns into quantified inefficiency findings, based on our approach for quantifying inefficiency.

Next steps and implementation

F61 We welcome the views of stakeholders on any of the issues raised in this appendix and will consider these carefully as part of our work to develop final proposals.

F62 We will conclude on the inefficiency figure in our Final Proposals, based on feedback to the findings from this assessment and any additional evidence that is provided to us. The costs will be added to the RAB based on our assessment less the adjustment for inefficiency.

F63 As we have consistently stated, should the expansion programme re-start, we expect HAL to have a much more robust approach to planning work and defining budgets, as well as clear change control processes for varying budgets. We also expect HAL to set out in advance a clear process for capturing data and information in relation to costs it incurs. Knowledge management in relation to expansion activities should not rely on specific individuals. HAL needs to have in place effective handover and data capture processes, to ensure that there is enough information in the future about how HAL ran the programme.

Appendix G

Financial resilience and ring fencing

Introduction

G1 This appendix sets out our Initial Proposals for changes to the financial resilience and ring fencing rules in HAL's licence. These proposals have been refined in the light of stakeholders' views on the discussion of these matters in the April 2021 Way Forward Document.

Background: the need for change

G2 HAL is part of a wider group of companies that supports a relatively high level of debt. Within this wider group of companies, HAL's credit quality and financial stability is enhanced by the arrangements in its "financing platform".

G3 The financing platform is the primary route by which HAL raises very significant volumes of debt finance. The structure used includes Heathrow Funding Limited and Heathrow Finance plc. This structure provides a degree of extra protection for HAL and reduces the probability of it experiencing financial distress. Even so, this wider group has come under financial pressure during the current covid-19 pandemic. While Heathrow Funding Limited has been able to retain an investment grade credit rating for its Class A and Class B debt,[25] at present, the debt of Heathrow Finance plc is sub-investment grade.

G4 Nonetheless, in setting price controls we make our own assumptions on a "notional" financial structure for HAL so consumers only fund the cost of efficient financing arrangements and HAL retains responsibility for the financial stability of the licensee. The financial projections in these Initial Proposals relate to this notional structure, rather than HAL's actual financing.

G5 Even though HAL experiencing financial distress is "a low probability event", it would potentially have a high impact. As noted in our previous consultations on this subject,[26] we consider it is likely that consumers would suffer detriment if HAL were to experience financial distress. While the analysis that we have undertaken indicates that the risk to consumers of the airport closing in such circumstances is low, consumer detriment could still arise from disruption to services and/or reductions in investment. Overall service quality could also decline as a result of management distraction or overload.

G6 As we have noted consistently, the provisions in HAL's licence on financial resilience are not extensive and do not themselves protect HAL's cash or assets

[25] Details of the arrangements comprising HAL's financing platform can be found at: https://www.heathrow.com/company/investor-centre/offering_related-documents

[26] See especially, the April 2021 Way Forward Document, the June 2020 Consultation and the August 2019 Working Paper.

for the benefit of consumers. While these financial ring fencing conditions relate to HAL, they also reach out to the wider group through the requirement for HAL to obtain an undertaking from its ultimate controller. However, the regulatory protections are significantly less extensive than those in other sectors subject to economic regulation and there is no “Special Administration” regime[27] for airports to provide a “backstop” against insolvency.

G7 That said, we also note that:

- consumers obtain some protection against the risks of financial distress from the provisions in HAL’s “financing platform” which, to a significant extent, cover the same ground that regulatory rules would otherwise do;[28] and
- the interests of consumers and investors are, at least in normal times, aligned in relation to HAL’s ongoing financial stability.[29]

HAL’s financing platform therefore provides some protection for consumers, albeit that its primary aim is to protect the interests of bond holders.

G8 We also consider that the:

- existing obligations in the licence are neither as clear as they could be, nor have they kept pace with other developments in the licence since the Q6 price control, specifically the introduction of the “economy and efficiency” obligation in Condition B3 of HAL’s licence;
- current arrangements in relation to the certification of sufficient resources do not ensure that the CAA is provided with appropriate and timely information;
- the identity of the ultimate controller is not as clearly defined as it should be;
- the scope of information that HAL’s group companies must hold as a result of the ultimate controller undertaking is not as clear as it should be to ensure that the ultimate controller undertaking functions effectively to protect the interests of consumers; and
- the licence does not assure appropriate prominence for the “ultimate controller undertaking” in HAL’s broader corporate governance structure, especially with new directors.

G9 In this light, we consider that appropriate, targeted and proportionate intervention is needed now to protect the interests of consumers through a small number of limited changes aimed at the following:

---

[27] That is to say that there are no special provisions in law protecting airports from the usual insolvency law rules on the liquidation of company assets as are observed in other sectors, such as water and energy.

[28] For example, the financing platform contains rules restricting HAL’s activities, and level of indebtedness, as well as credit rating requirements backed by a “dividend lock up” and restrictions on asset disposals, each of which might be observed in a “regulatory” ring fence.

[29] We also note that the interests of investors and consumers might not necessarily be aligned in times of financial distress.

- improving the information and "early warning" measures in HAL's licence so that, if HAL gets into difficulties, the CAA has better information on which to decide whether to intervene in consumers' interests;
- clarifying the requirements and scope of the ultimate controller obligation;
- ensuring that there is proper knowledge of the ultimate controller undertaking within HAL's broader corporate structure; and
- ensuring that the drafting of the licence (including the sufficiency of resources obligation and associated certificates and ultimate controller obligation) is clear, consistent and, where relevant, reflects changes to the licence since Q6; while
- avoiding affecting HAL's financeability by not making changes that would cut across its existing financing platform; and
- avoiding the financial resilience regime transferring responsibility for financial stability from HAL to the CAA or blurring our approach to setting price controls where we focus on notional rather than actual financing.[30]

The development of these Initial Proposals

G10 The June 2020 Consultation built on earlier consultations and working papers in 2017 to 2019 and narrowed the scope of the reforms under consideration, including by stopping work on credit rating obligations and cash/dividend lock ups because these were most relevant to the previous challenges of expansion.

G11 At the same time, the financial resilience and ring fencing conditions are also a clear expression of the CAA's long-standing policy that the directors and shareholders of HAL are responsible for the financial stability of the licensee. This approach is also consistent with the CAA's approach of:

- setting the price control on the basis of a "notional" licensee, rather than on the basis of HAL's actual finances; while
- only intervening in limited exceptional circumstances where the interests of consumers require it.

G12 Our approach was refined further for the April 2021 Way Forward Document but did not reach any firm conclusions as to what, if any, changes should be made. That document discussed possible changes to:

- make minor changes to the sufficiency of resources obligation (and associated certificates) to ensure internal consistency within the licence by requiring HAL to have sufficient assets to operate the airport in accordance with the licence;
- requiring separate certificates for financial and operational resources (in place of the existing combined certificate) and additional supporting evidence;

[30] See Chapter 8 for discussion of the notional approach.

- support these certificates with evidence on traffic and other scenarios (with sensitivities) to address our experience of the differing level of detail HAL has provided with its certificates in 2020 by setting out the type and level of detail that we require, as this has not been clear in the past;
- require HAL to provide the CAA with the same information as it provides to its bondholders;
- clarify the ultimate controller obligation (i) so that it is clear it does not apply to shareholders and (ii) to ensure subsidiaries hold the records HAL reasonably needs for its business; and
- require HAL to remind the ultimate controller annually of its obligations.

Stakeholders' responses

G13 Three respondents commented on our approach in this area, with only HAL and British Airways (BA) making detailed comments. AOC/LACC broadly agreed with the approach we had set out in the April 2021 Way Forward Document.

G14 HAL could not see a justification for the increased regulatory burden it saw in the changes discussed. It considered that it was not sufficient for the CAA to argue that the additional burden was low. Overall, HAL rejected our approach on the grounds that it did not clearly evidence that:

- there is an issue that needs to be solved;
- the intervention will benefit consumers; or
- the proposed approach is proportionate.

G15 On the specific measures discussed by the CAA, HAL:

- could not see a clear need for separating the certification of operational and financial resources;
- argued that the CAA should make an additional change to the time horizon of the Certificate of Adequacy of Resources to align it with the (shorter) going concern report for Heathrow (SP) Limited;
- queried the usefulness of requesting and assessing traffic and other scenarios in support of the certificates;
- argued that the licence condition on provision of information discussed in the April 2021 Way Forward Document was disproportionately broad; and
- considered an annual reminder of the ultimate controller undertaking unnecessary and that it would not have the desired outcome.

G16 The main points made by BA were to:

- agree with the CAA in placing importance on managing the risk that consumers would suffer detriment if HAL experienced financial distress;

- agree that it would be proportionate to improve the flow of information, allowing the CAA to promptly take any necessary action that may be required; and
- support the proposed changes as reasonable, balanced and pragmatic.

G17 Having noted the importance of balancing compliance costs and consumer benefit, BA considered that providing to the CAA the financial market information which HAL publishes would not be onerous and could be seen as a simple "act of courtesy". It felt that these changes would help to provide better oversight of operational matters without increasing the regulatory burden significantly. It considered that it would be relatively straightforward for HAL to present passenger sensitivities in support of its resources certificates and suggested that sensitivities on a terminal basis might also be appropriate.

Our views

G18 We have considered our approach to the financial resilience and ring fencing rules in the light not only of stakeholders' comments, but also in the context of our experience of their operation since the commencement of the covid-19 pandemic in early 2020. This experience has shown that the present regime, while generally fit for purpose, could usefully be improved in the interests of consumers by making refinements to it to address the issues in paragraphs G2 to G8 above.

Sufficiency of resources and certification

G19 It is clear to us that the obligations in HAL's licence to:

- maintain sufficient resources;
- certify the directors' expectations for having such resources; and
- inform the CAA if the directors no longer hold the expectation in the last certificate they gave;
- work together to protect the interests of consumers. Their combined effect is to provide the CAA with both:
- comfort with that the licensee is not anticipating distress (whether financial or operational); and
- provide early warning of distress should it become an issue.

G20 We consider that these obligations should be consistent with the rest of the licence. To this end, we consider that their drafting should refer to the operation of the airport in accordance with the obligations in the licence generally. We consider that some simple drafting changes will achieve this.

G21 The obligations to maintain sufficient resources, coupled with the certification obligations cannot, however, be expected to anticipate all future risks on their own and could not have been expected to have helped HAL to predict the impact of the covid-19 pandemic. This emphasises the importance to consumers of the ongoing obligation to inform the CAA if the directors no longer hold the expectation in the last certificate(s) given.

G22 Nonetheless, the information contained in the certificates protects consumers' interests by providing assurance to the CAA and, if the possibility of distress arises, the certificates, combined with the ongoing obligation to inform the CAA of issues, also enables the CAA to enter in to dialogue with the licensee in a timely way. The CAA can then review the position and determine whether action may be needed to protect consumers. This supports the continuity of AOS at Heathrow, lessening the chance of disruptive distress.

G23 Our experience of the operation of these conditions since the start of 2020 is that, HAL has provided significant financial and other information to the CAA and engaged in ongoing dialogue with the CAA through the current pandemic, including in the context of its request for a RAB adjustment. However, it would not be appropriate for the CAA to rely on the "goodwill" of successive management teams at HAL to do so. This, coupled with the inevitable information asymmetry between regulator and regulated company, would expose consumers to an increased risk that an unforeseen issue might arise that could damage their interests.

G24 We also note that the certificate of adequacy of resources provided by HAL in 2020 did not give significant information about the impact of developments on the operation of the airport.

G25 Bearing the above in mind we remain of the view that it is appropriate to split the certificates to give financial and operational issues equal weight as each is of concern to consumers. We consider that, in other respects, the certificates should remain in broadly the same form as at present.

G26 We have considered HAL's arguments that the "forward look" provided by the certificates should be shortened to align with the 12 to 18 month period assessed as part of the "going concern" statement given in Heathrow (SP) Limited's accounts. Putting aside the fact that the licensee is HAL, not Heathrow (SP) Limited, we note that this seeks to re-run a debate held in the development of the Q6 determination.[31] The CAA noted at that time that, where an annual certificate covers 24 months, the minimum oversight is approximately 12 months on the day before the next certificate is produced. So, if an annual certificate were provided covering only 12 or 18 months, the CAA would have very little forward visibility towards the end of those 12 months.

G27 This logic is equally true now as at the time of Q6. It is clear from this that the ongoing obligation to inform the CAA[32] would be significantly and inappropriately diluted if this 24-month period were to be shortened.

---

31 See CAP1151 (www.caa.co.uk/CAP1151), at paragraph 2.129, the CAA noted HAL's concerns and said it understood that HAL's banking and bond covenants require it to maintain 12 months' liquidity. However, it considered that the CAA's licence condition for adequate resources covers something slightly different: it is not a liquidity requirement but rather that management has the reasonable expectation that it has adequate financial and other resources.

32 This is the obligation in condition 2.3 of HAL's licence to inform the CAA if the directors of the Licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under Condition E2.2.

Supporting information for the certificates of sufficiency of resources

G28 Having considered HAL's arguments, we now consider that there is relatively little regulatory benefit in requiring HAL to produce and submit more information than it does at present in the following two situations:

- "business as usual" scenarios where HAL's directors expect to have sufficient resources for the following two years. This is because the information will not disclose matters of importance to the interests of consumers; or
- any scenario in which HAL's directors do not expect to have sufficient resources. This is because the CAA should already be aware of the issue through HAL informing the CAA of it either (i) as the problem develops, through the most recent certificate being "qualified" by matters that the directors draw the CAA's attention to, or (ii) for faster-developing problems, as a result of the licence requirement for the directors to inform the CAA that they no longer have the reasonable expectation expressed in that most recent certificate. As such, in the event that HAL's directors were to give an annual certificate indicating that they do not expect to have sufficient resources, the CAA should already be aware of the problem in question and be taking active steps to inform itself and address it appropriately.

G29 As a result, we consider that a proportionate approach for our Initial Proposals is to require additional information in support of the resources certificates only in circumstances where the licensee is providing a "qualified" certificate drawing the CAA's attention to specific matters. Making this change will mean that HAL will be required to provide information in support of the certificates only when it is most useful to the CAA in protecting the interests of consumers.

G30 Further, given that (as HAL notes) the nature of any issues raised by such a certificate cannot be predicted, we consider that we should be less prescriptive than requiring the traffic scenarios discussed in the April 2021 Way Forward Document. As a result, our Initial Proposal for the supporting information to be provided with the certificates is to require HAL to provide a "central" case with "high" and "low" sensitivities relating to the specific matter(s) to which the directors are drawing the CAA's attention. The licensee should also describe the impact of the sensitivities on its resources. This approach targets the obligation much more closely on the matter of concern to the CAA, without requiring the provision of extraneous or potentially irrelevant information.

G31 We consider this approach is both more flexible and more targeted than that described in the April 2021 Way Forward Document, and would ensure that the licensee's directors retain responsibility for issues as they arise, rather than providing traffic scenarios that might not be relevant. For the same reason, we do not consider that it would be appropriate for the CAA to specify that HAL provide terminal-level information. Adjusting our approach in this way also ensures that the obligation is proportionate to the benefit that it seeks to bring for consumers' interests.

Provision of financial market information

G32 We have considered the arguments made by both HAL and BA in relation to the provision of financial market information to the CAA to put it in the same position as market participants. In this context, we note the extensive information that HAL publishes on its website and through the London Stock Exchange Regulatory News Service ("RNS"), to comply with its market obligations and financing platform.

G33 While we will monitor the RNS, as HAL is in sole control of when material is released through the RNS, it is better placed to know when such material becomes available. As such, as this material is of clear relevance to HAL's financial position, it is appropriate to require HAL to notify the CAA that it has released such material. We also welcome HAL's offer to add the CAA to the mailing list for its "Investor Centre" updates, but do not consider that it is appropriate for the CAA to rely solely on the goodwill of the licensee from time to time for this. As such, we propose a simple licence obligation to require this. We consider that this approach targets the obligation on a clear set of information and, as such, is proportionate to the benefits to consumers of the CAA receiving this information in a timely manner.

Ultimate controller obligation

G34 The "ultimate controller undertaking" set out in condition E2.7 is an important tool for ensuring that consumers' interests are not undermined by actions taken elsewhere in the licensee's corporate structure. As such, it is important that:

- the identity of the ultimate controller is clear;
- the ultimate controller and HAL's group companies can readily identify the information that they must hold under the ultimate controller obligation so they can ensure that this information is available to the CAA; and
- the directors of the ultimate controller are aware of the existence and content of the ultimate controller undertaking.

G35 However, as our previous consultations have discussed, the present obligation neither identifies the ultimate controller with sufficient clarity, nor makes sufficiently clear to what information it applies. We consider that these issues can readily be addressed without changing either the identity of the ultimate controller or the intensity of the obligation on HAL in practice. We consider that we should do this by making clear that the:

- ultimate controller is identifiable by reference to terms defined in the Companies Act 2006; and
- clarifying that the information that the subsidiaries of the ultimate controller need to hold are those records that the licensee may reasonably need to carry on the activities permitted under its licence.

G36 As for whether directors of the ultimate controller are sufficiently aware of the existence and content of the ultimate controller undertaking, we have considered HAL's comments on the relationship between the directorships of FGP TopCo (as the present ultimate controller of HAL) and HAL itself though HAL's broader corporate structure. Taking into account HAL's comment that FGP Topco Limited is an entity with directors on the HAL Board who are actively involved in Licence discussions throughout the year, we have decided that an annual reminder of the ultimate controller undertaking to those directors is not needed. Rather, the objective of ensuring that the relevant directors are aware of the nature and extent of the ultimate controller undertaking can be discharged effectively, by ensuring that HAL writes to any new director of the ultimate controller on appointment to its board, making them aware of the undertaking. Doing so would make this part of their "induction" into the role. We consider that this is a proportionate approach to raising the profile of this obligation in the particular circumstances of HAL's governance structure.

Our Initial Proposals on financial resilience and ring fencing

G37 As noted in paragraphs G2 to G8 above, we consider that action is needed to further the interests of consumers because the current regulatory rules to which HAL is subject are not as effective as they might be to ensure that the CAA obtains the information that it needs. So, our Initial Proposals are to make incremental and proportionate improvements to the financial resilience arrangements that address the issues we identified in paragraph G9 above in the light of the aims set out in paragraphs G10 to G12.

G38 We also note that when we set the Q6 price control, we considered our approach to financial resilience and ring fencing in the round. We consider that this approach remains appropriate. This approach also includes considering the regulatory rules in the context of HAL's financing platform.

G39 Having considered these matters and for the reasons set out in the preceding paragraphs of this appendix, the CAA considers it appropriate to propose the amendments to HAL's licence outlined in Table G.1.

G40 In doing so, the CAA has had particular regard to the need to:

- secure that HAL can finance its activities, by taking care not to cut across HAL's financing platform because this would provoke an expensive and disruptive refinancing;
- promote economy and efficiency on the part of HAL by not imposing obligations on HAL that would be costly to comply with; and
- secure that reasonable demands for AOS are met by promoting the financial and operational stability of HAL and the ability of the CAA to become aware of and address any concerns that might arise in a timely manner.

Table G.1: Initial Proposals on financial resilience and ring fencing

Proposal	Description	Proposed approach to drafting
<u>Sufficiency of resources</u> Address lack of internal consistency within HAL's licence and to address changes made since Q6.	Simple change to make clear that HAL is required to maintain sufficient resources that are: • both financial and operational; and • sufficient to support the operation of the airport "*in accordance with the licence*".	Existing obligation in condition E2.1 of HAL's licence to be retained with small additions to refer explicitly to operational resources and include the words "*and do so in accordance with this Licence*" after "at the Airport".
<u>Resources certification</u> Separation of operational and financial certificates to: • promote the provision of information to the CAA at a consistent level of detail for each; and • clarify the certificates.	The certificates of sufficiency of resources required in condition E2.2 to be split into separate certificates for each of (i) operational and (ii) financial resources. Each certificate to be drafted to certify that the resources are sufficient to provide airport operation services at Heathrow in accordance with the licence, with additional changes for clarity.	The certificates will, save for being tailored into separate certificates for each of (i) financial and (ii) operational resources, be in broadly the same form as at present, except for some changes and re-ordering to improve the clarity and readability of the certificates and the addition of the words "*in accordance with the licence obligations to which it is subject*" for consistency with the amended sufficiency of resources obligation in condition E2.1. The "forward look" of the certificates will remain at two years.
<u>Resources certification</u> Provision of additional information to ensure that the CAA has appropriate information to enable it to consider whether it needs to act to protect consumers' interests.	The existing requirements for supporting evidence under condition E2.4 are to be retained. A new provision will be introduced to require HAL to provide additional information where it provides a certificate drawing to the CAA's attention matters that may cast doubt on it having sufficient operational or financial resources for the following two years.	The new condition will be drafted relatively simply to require HAL to provide supporting information in relation to the matters that it is drawing the CAA's attention to in the resources certificate. This should be: • a "central case" on the matter in question, with high/low sensitivities; and • the impact of each of these on the sufficiency of each of its financial/operational resources.

Proposal	Description	Proposed approach to drafting
Information provision Ensuring that the CAA has the same information as is provided to investors.	Require HAL to inform the CAA when it places information for investors on the "investor centre" section of its website.	A simple rule requiring HAL to inform the CAA by email when it places investor information on its website.
Ultimate controller obligation Clarifying the scope of the obligation.	Clarification of identity of ultimate controller so that it does not include the shareholders of HAL's corporate group.	Insert a definition of ultimate controller to make clear that the ultimate controller is the holding company of the licensee which is not itself a subsidiary of another company and using the definitions of "holding company" and "subsidiary" in section 1159(1) Companies Act 2006.
Ultimate controller obligation Clarifying the appropriate scope for the obligation and ensuring the CAA has access to information it may need.	The ultimate controller undertaking should ensure that both the ultimate controller and HAL's affiliates (such as group service companies) provide HAL with information that that they hold which the CAA may need on request. The obligation will be limited to ensure group companies did not have to hold information that they would not otherwise hold for their functions within HAL's group.	A relatively simple provision to be added to the ultimate controller undertaking in condition E2.7 requiring the ultimate controller to ensure each subsidiary of the ultimate controller holds the records that HAL may reasonably need to carry on the activities permitted under its licence. Combined with the existing obligation in condition E2.7(b), this should clarify the obligation and ensure that the companies in question have the information available for the CAA contemplated by the condition E2.7(b) without creating additional burdens for HAL or its group companies.
Ultimate controller obligation Ensuring that FGP TopCo directors are aware of the ultimate controller undertaking.	Requirement for HAL to write to inform new directors of the ultimate controller of the undertaking given by the ultimate controller when they take office.	A simple obligation that ensures that the directors of the ultimate controller are aware of the undertaking from the point at which they start taking decisions that may affect HAL.

G41 In developing these amendments, the CAA has also had regard to the principles set out in section 1(4) CAA12. In particular, it considers that

- action is needed for the reasons and to progress the aims set out in paragraphs G2 to 12, and G18 to G36; and
- its proposals are proportionate, having been designed to achieve the aim of addressing the matters set out in those paragraphs in ways that address the need for action without creating any significant increase in the regulatory burden on HAL.

G42 Of particular relevance to our assessment of the proportionality of our proposals are, that they will:

- only require additional information in limited circumstances, otherwise relying on materials currently produced for market participants; and
- not cut across (and therefore be consistent with) the obligations in HAL's financing platform; but
- will still promote the CAA having the information it needs in circumstances where it needs more information to determine its appropriate course of action in the interests of consumers.

G43 We also consider that the changes we propose have been designed to ensure that the obligations on HAL are clear and internally consistent by addressing those inconsistencies that have developed within the licence since Q6 and areas where the obligations on HAL are not sufficiently clear.

Views invited

G44 We invite stakeholders' views on the issues raised by this appendix and, in particular, on the possible amendments to HAL's licence described in Table G.1.

Appendix H

Draft assessment of proposed H7 capex incentives framework against the CAA's duties

Introduction

H1 This appendix sets out our analysis of the proposed H7 capex incentives framework, as set out in Chapter 12 of this document, against the CAA's duties as set out in CAA12.

H2 The CAA's primary duty in CAA12 is to "*further the interests of users or air transport services regarding the range, availability, continuity, cost and quality of airport operation services*." In performing this duty, the CAA must "have regard" to a number of "secondary duties". Of particular relevance to changes to the regulatory framework on capex incentives, including licence conditions our approach to capex incentives are "*the need to secure that all reasonable demands for airport operation services are met*" and "*the need to promote economy and efficiency on the part of each holder of a licence*." The CAA must also have regard to the principles that regulatory activities are carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases where action is needed (we refer to these in this as the "better regulation principles"). [33]

H3 Our duties are described in more detail in Appendix A. The relevant secondary duties we have identified that we need to have particular regard to for our assessment of the capex incentives framework are:

- the need to promote economy and efficiency on the part of HAL;
- the need to secure that all reasonable demands for the provision of AOS are met;
- the need to secure that HAL can finance its provision of AOS at Heathrow airport; and
- the better regulation principles.

H4 In the August 2020 Working Paper, we undertook an assessment of our proposed approach against a set of high-level criteria. We consider that these criteria are aligned with our duties and have set out in Table H.1 how they map to the relevant secondary duties.

[33] See, generally, section 1 CAA12. Where changes in the regulatory framework are to be implemented through licence conditions, section 18 CAA12 allows the CAA to insert such conditions into HAL's licence as it considers "necessary or expedient" having regard to its duties under section 1.

Table H.1: Mapping of high-level criteria for implementation against the relevant CAA secondary duties for this assessment

High-level criteria for implementing a capex incentives framework (the August 2020 Working Paper)	Relevant secondary duties for this assessment
1. Build on the approach to core and development capex and governance used for Q6, implementing improvements to address issues identified in practice and introducing new incentive arrangements, where appropriate, to reduce significantly, or eliminate, the need for *ex post* efficiency reviews by the CAA. It should also preserve the vital role of airlines in helping to assess HAL's project proposals, delivery and quality standards, and costs.	• The need to promote economy and efficiency on the part of HAL. • The better regulation principles, and specifically, consistency, so far as appropriate with the approach in Q6, transparency, proportionality and targeting action at a case where it is needed.
2. Provide clear, simple and symmetrical financial incentives for capex overspending and underspending, that are proportionate, allocate appropriate risks to HAL, and minimise difficulties associated with cost allocation and the administrative burden of implementation.	• The need to promote economy and efficiency on the part of HAL; • The need to secure that HAL can finance its activities; and • The better regulation principles, and specifically transparency, proportionality, and targeting action at a case where it is needed.
3. Not place unreasonable risks on HAL so that the overall capex programme is financeable in a cost effective and efficient way. The incentives must also retain flexibility for HAL to design and implement the H7 capex programme, allowing for appropriate and efficient changes in scope during H7.	• The need to secure that HAL can finance its provision of AOS. • The better regulation principles, and specifically proportionality.
4. Ensure that any revenue adjustments arising from the incentives lead to the charges paid by airlines reflecting efficient levels of capital spending. Efficient costs should be linked to the delivery of project standards (including appropriate outputs and deliverables).	• The need to promote economy and efficiency on the part of HAL. • The better regulation principles, and specifically proportionality, and targeting action at a case where it is needed.

H5 One of the key better regulation principles is that of targeting an intervention at a case where action is needed. We start this assessment by setting out the rationale for intervention before proceeding to the rest of the assessment.[34]

Rationale for intervention

H6 We started developing proposals for forward looking (or *ex ante*) capex incentives in 2019, having identified a number of issues with the existing approach to the governance and incentivisation of efficient capex during Q6 and iH7.[35]

H7 Our approach to capex governance and capex incentives for HAL has evolved over time. The experience from Q5 of setting a fixed baseline for capex was found in practice not to reflect the dynamic nature of the industry and led to large variances against forecast.

H8 In response to the issues identified with the Q5 framework, in Q6 an updated capex framework was implemented, using the "development to core" process to introduce a degree of flexibility. Over the course of the price control period, projects can transition from development to core capex by moving through project "Gateways". Decisions to move projects from development to core are agreed by HAL and airlines. This flexible approach enables those development projects that were not yet fully specified or sufficiently costed at the time of stetting the price control to be developed further and, where appropriate, delivered during the price control period.

H9 While there are benefits to the Q6 framework, we have also identified issues based on our own analysis and feedback from stakeholders, including airlines and the IFS.[36]

H10 The key issues identified with the Q6 framework are summarised below.

- The Q6 approach does not provide sufficiently strong commercial incentives on HAL to ensure projects are delivered on budget.
- Under the Q6 approach, it is not always clear to airlines whether the benefits/outputs from projects have been delivered.
- *Ex post* assessments can be challenging and are likely to require expert judgement and a broad evidence base to identify inefficiencies across the capex portfolio.

[34] Therefore, the assessment in Table H.2 does not include an assessment against the better regulation principle of 'targeted at a case where action is needed' as this issue is dealt with in paragraphs H.10 and onwards.

[35] For example we discussed the merits of introducing ex ante incentives in the January 2020 Consultation and paragraphs 7-12 of the August 2020 Working Paper.

[36] The IFS presented a working draft to HAL, airlines and the CAA in March 2020 on learning points from H7. The IFS also produced an end of Q6 report for the CAA in July 2020.

- While HAL faced a form of *ex ante* incentive, in that it did not recover the financing costs associated with any overspending or underspending against the agreed G3 capex baseline, the strength of this incentive varies over the regulatory period (becoming weaker over the course of the price control). Therefore, it is not targeted at encouraging cost efficiency and could create perverse incentives on HAL to delay spending.
- Some airlines have noted that the incentives to ensure that projects are delivered on time are not strong enough under the existing approach. The IFS also noted that the triggers do not address the delivery of portfolio benefits and that the criteria for trigger payments can be subjective and could be improved.

H11 We also note that there are inherent difficulties with conducting *ex post* reviews arising from:

- the passing of time since the projects under review completed which are exacerbated in the case of long-running projects; and
- the inevitable asymmetry of information between the regulated company and regulator.

H12 We first started developing proposals for forward looking capex incentives at a time when HAL was actively working toward a DCO application for the third runway. A key objective of our policy for the H7 price control is to create appropriate incentives for HAL to make capital investments efficiently. We consider that this remains a priority even with our focus changing to a “two runway” airport as the difficult circumstances that the aviation sector is experiencing as a result of the impact of the covid-19 pandemic mean that efficiency and value for money will be particularly important.

H13 Implementing forward looking capex incentives is important for H7 for the following reasons:

- we want to build on the approach to core and development capex and governance used for Q6, implementing improvements to address issues identified in practice (see above) and introducing new incentives, where appropriate, to reduce significantly, or eliminate, the need for *ex post* efficiency reviews by the CAA;
- efficiency of capex in H7 will be particularly important given difficult circumstances that the aviation sector has faced as a result of the impact of the covid-19 pandemic, and there is an increased focus on affordability of charges for consumers;
- we want to provide clear, simple and symmetrical financial incentives for capex overspending and underspending, that are proportionate, allocate appropriate risks to HAL, minimise difficulties associated with cost allocation and do not create an undue administrative burden;

- we do not want to place unreasonable risks on HAL so that the overall capex programme is financeable in a cost effective and efficient way. The incentives should also retain flexibility for HAL to design and implement the H7 capex programme, allowing for appropriate and efficient changes in scope during H7;
- we want to provide broad based incentives for HAL exercise tight cost control if an external event impacts on delivery of capex, to make sure the adverse impact of such events on costs is as low as reasonably practicable; and
- we want to ensure that any revenue adjustments arising from the incentives lead to the charges paid by airlines reflecting efficient levels of capital spending. Efficient costs should be linked to the delivery of project standards, including appropriate outputs and deliverables.

Assessment of the proposed capex incentives framework against our duties

H14 In this assessment, we are comparing our proposed H7 capex incentives framework against the Q6 capex efficiency framework (the counterfactual). More detail on our proposed H7 capex incentives framework is available in Chapter 12 of this document and in Appendix D.

H15 We note that some of the more detailed implementation issues in relation to our H7 framework are yet to be finalised. We are in the process of working with HAL and airlines to seek their views on some of these issues. Where this is the case, the assessment in this Appendix is based on our current preferred option, and we have noted where our assessment could be impacted by changes in our preferred option.

H16 We have set out below (Figure H.1) a summary of the counterfactual and our proposed H7 framework.

Figure H.1: Overview of the Q6 capex efficiency framework (the counterfactual) against our proposed H7 capex incentives framework

Approach in Q6	Our proposal for H7
Core and development framework with vital role for airlines	Similar to Q6, retain core and development framework with vital role for airlines
Ex post assessment of inefficient capex at end of period	*Ex ante* incentives on over/underspend linked to quality of deliverables (no *ex post* review of costs for H7 capex projects)
Ex ante financing cost incentive (around 13% on average)	*Ex ante* incentive rate to be higher than Q6, same symmetrical rate applied to all of HAL's capex plan
Trigger payments penalise HAL for late delivery of projects	Trigger payments to be more targeted and offer a modest reward for early delivery, also consulted on whether it is appropriate to set a penalty for late delivery of a capex category
Charges reflect development and core capex allowances, updated during period	Similar to Q6, charges reflect agreed changes to capex baselines, updated during period
Gateway process and governance at portfolio and project levels, with IFS providing the role of an expert independent reviewer	Similar to Q6 with continued role of IFS, but with enhanced governance and reporting of capex categories and delivery objectives / obligations
Capex envelope set at start of price control	A mechanism so that HAL can request changes to the overall capex envelope but only in the event of significant changes in the external environment

Source: CAA

H17 The table below sets out our assessment.

Table H.2: Assessment against the CAA secondary duties

Relevant CAA duties for this assessment	Counterfactual (Q6 approach)	CAA proposed H7 capital incentives framework
The need to promote economy and efficiency on the part of HAL.	Currently, the efficiency of HAL's capex is assessed through *ex post* reviews, conducted at the end of the regulatory period. The CAA undertakes a review of HAL's capex, to determine what proportion of actual capex incurred should be added to HAL's RAB. Recent reviews have demonstrated that it is difficult and contentious to establish efficiency using *ex post* In addition, finding and quantifying evidence of inefficiency does not necessarily mean that the remaining expenditure has been incurred with the same level of efficiency that might be reasonably expected from an appropriately calibrated set of forward looking incentives.	An *ex ante* approach to capex expenditure, as proposed in Chapter [X] of this document and as summarised in Table [X] of Appendix [X], would promote greater economy and efficiency on the part of HAL compared to the Q6 approach, because: • If HAL over-spends on a project or programme, a proportion of the over-spending would not be added to the RAB (it would be disallowed). This would create a stronger incentive for HAL to exercise greater cost control during the regulatory period, when projects are at risk of going over budget, in order to minimise the potential disallowance at the point of reconciliation. • HAL would also be able to earn a 'bonus' in relation to any under-spending relative to the baseline, which would be added to the RAB. Currently, the maximum value that can be added to the RAB in relation to a project or programme is the actual spend incurred (subject to the CAA's *ex post* efficiency review). Under our *ex ante* proposal, HAL would have a stronger incentive than currently to reduce costs, as it can then earn a higher amount through outperformance (assuming all the outputs have been delivered). Overall, compared to the counterfactual, this approach provides a stronger incentive during the period for HAL to undertake capex efficiently. Stakeholders have commented that an issue with an *ex ante* approach is that HAL would have an incentive to artificially inflate baselines in order to be able to "beat" the incentive more easily. We consider that this risk is

	This means that potentially, inefficient capital expenditure could be added to the RAB, if it is not disallowed through the *ex post* review, and then is included in charges to airlines and ultimately consumers.	mitigated by airline involvement in the process of agreeing G3 estimates (which will directly feed into the capex category baselines). We are also proposing more transparent reporting of capex baselines for H7 which will allow the CAA and airlines to track and better scrutinise baseline adjustments HAL has argued that an *ex ante* approach would lead to higher costs for consumers, as HAL would increase risk allowances in projects, to mitigate the increased risk it is exposed to. We note that our proposed approach is to use G3 estimates to set capex category baselines that HAL's performance is measured against, and that these estimates are currently set at a P50 level.[37] .There should be no need for HAL to increase risk allowances beyond the P50 level, as at a P50 level, HAL should expect to perform at baseline across its capex portfolio, not requiring additional risk allowances. HAL has also argued that a move to *ex ante* incentives could increase the time, and, therefore, money, needed for the development stage of projects. While a disproportionate increase in development costs would not be in the interest of consumers, we note that more optioneering and detailed planning during the development stage of projects before they go through "Gateway 3", could drive overall lower costs by optimising designs and minimising cost overruns later in the process. We will monitor development costs during H7 relative to those seen during Q6 / iH7, to understand whether they have increased, as a percentage of overall capex costs, and whether there have been benefits from this, for example, in terms of the overall level of cost overruns at a portfolio level).

[37] This is the value at which there is a 50% chance of the project coming in above this cost and a 50% chance of it coming in below this cost.

		Having considered, these points, we consider that the benefits of moving to ex ante incentives will outweigh the potential risks, and, so, will promote economy and efficiency on the part of HAL more effectively than the existing arrangements.
The need to secure that all reasonable demands for the provision of AOS are met.	The development to core framework allows HAL and airlines to bring forward capital projects during the regulatory period, where they identify a need for intervention. This flexibility within the framework means that HAL is able to secure that all reasonable demands for the provision of AOS are met. HAL is able to recover costs associated with these projects through charges during the period, which also means it is able to secure that all reasonable demands for the provision of AOS are met. CAA efficiency adjustments are applied at the start of the next regulatory period, through the RAB.	Our proposed *ex ante* approach retains the existing development to core framework. This means that HAL would still be able to identify capital interventions and bring them forward, with the agreement of airlines (or at their request), to meet reasonable demands for the provision of AOS. Under our proposals, HAL would continue to be able to set airport charges in period based on updated baselines that reflect its evolving capex requirements which means it will be able to secure the funding so that all reasonable demands for the provision of AOS are met. Any adjustment for under or outperformance would be applied at the start of the next regulatory period, through adjusting the RAB. As a result, we consider that *ex ante* arrangements will retain sufficient flexibility, especially when coupled with airline involvement in the development to core process to secure that investment needed to support reasonable demand for AOS will be met under the proposed incentive scheme.

The need to secure that HAL can finance its provision of AOS.	If the CAA, through its *ex post* review, identifies a proportion of capex as inefficiently incurred, that capex is removed from the RAB at the start of the next regulatory period. During the period, HAL is able to add actual capex to the RAB, and earn a return in relation to that expenditure (through the WACC) which allows it to finance its activities, and therefore provision of AOS, through debt and equity. At the end of the regulatory period, there is the potential for some proportion of historical spend to be removed from the RAB going forward, which would have an impact on HAL's revenues in the next regulatory period (through the allowed return HAL can earn on its RAB). This impact is considered by the CAA as part its analysis of	An *ex ante* regime could result in both disallowances and 'bonuses' for HAL, depending on whether it has under- or out-performed the capex baselines set for each capex category. If HAL overspends relative to the baseline, the impact on HAL would be similar as in the counterfactual. However, we note that under our proposed approach, HAL can both under- and out-perform baselines so that the asymmetry of the current incentive is removed. As such, the proposed arrangements should represent a "fair bet" for HAL. HAL's performance would be assessed against baselines which are set on the basis of G3 budget estimates, which are at the P50 level. In the light of this, on expectation, the financial impact of the *ex ante* incentive on HAL should be zero. HAL has argued that under our proposed *ex ante* regime, it would be exposed to more risk overall, which would result in a higher WACC. This is because, in HAL's view, there are a number of factors outside of its control that can have an impact on costs, and HAL would price this risk in when proposing a WACC. Overall, we do not consider that moving to an *ex ante* framework would lead to an increase in the WACC, for the following reasons: - We acknowledge the possibility that *ex ante* incentives will expose HAL to forecasting error associated with factors outside its control. However, we consider that this risk is offset by the removal of a large element of regulatory discretion (through *ex post* reviews), which we consider drives a similar level of risk exposure under the current framework. Not all regulatory discretion is removed under our proposal, as the CAA would still review whether HAL has delivered the agreed delivery obligations associated with capex categories.

	affordability and financeability at the time of setting the regulatory settlement, to ensure that the overall package for the next regulatory period does not create any unreasonable risk for HAL. A feature of the status quo is that the risk to HAL is asymmetric, as the CAA can only make a disallowance if it identifies inefficiency. In addition, under the current approach there is uncertainty around what proportion of spend will be disallowed by the CAA, which could create a perception of greater regulatory uncertainty and risk.	However, this review would be narrower in scope compared to the current *ex post* review which looks both at what has been delivered, and for what cost. Therefore, the overall level of regulatory discretion under our proposed H7 approach is lower. - We have also noted that HAL is exposed to asymmetric risk under *ex post* reviews which would be removed under *ex ante* incentives. We do not consider that asymmetry or “skewedness” of returns directly affects the WACC. Nonetheless, we expect that moving to a more symmetric incentive regime will have value for investors. Overall, for the three reasons set out above, we consider the impact on the WACC would be neutral under our proposed *ex post* framework. Our proposals would, therefore, not have a negative impact on HAL’s ability to finance the provision of AOS at Heathrow. More generally, in terms of HAL’s exposure to risks outside of its control, we are of the view that should events occur that have an impact on a project which are beyond HAL’s control, this could be reflected in baselines and delivery obligations through the “scope change” process set out in Appendix D, if it is reasonable to do so. In addition, currently, if there is an external event that impacts a project, there is no incentive on HAL to exercise tight cost control to make sure the impact of this external event on costs is as low as possible, because HAL does not expect to be penalised for overspending in relation to such events. Under an *ex ante* incentive framework, these incentives on HAL would be strengthened, resulting in overall lower capex. As a result, we consider that the introduction of these arrangements will provide for investment that is financeable.

The better regulation principles: is the CAA's approach transparent?	The CAA undertakes an *ex post* assessment of capex, which it consults on publicly (including proposed disallowances). This ensures the assessment process has a reasonable level of transparency, as a summary of the CAA's approach and findings are available for stakeholders to review.	Under the proposed *ex ante* framework, the CAA would consult on its assessment of whether delivery obligations have been met by HAL in relation to the capex categories it has delivered during the period. This would ensure an equivalent level of transparency as in the counterfactual. The level of adjustment (based on the comparison between actual spend and the baseline) will be a transparent calculation. We have also set out in our consultation that we expect changes to the scope of capex categories (and delivery objectives / obligations) to be clearly documenting and recorded during the period. In addition, the proposed H7 framework also removes the asymmetry of the Q6 framework and removes a large element of regulatory discretion associated with the CAA's current *ex post* review of capex. This increases the level of transparency (as well as improving the accountability) of the regulatory framework in place for capex efficiency. As such, we consider that the proposed arrangements are more transparent than the existing arrangements which rely on challenging *ex post* reviews the outcome of which cannot be readily predicted in advance.
The better regulation principles: is the CAA's approach accountable?	The CAA undertakes an *ex post* assessment of capex, which it consults on publicly (including proposed disallowances). This ensures the assessment process has a reasonable level of accountability, as the CAA's findings are available for all	The CAA's capex incentives policy is part of the overall price control settlement for H7, which can be appealed to the CMA, So, our approach is accountable. The CAA would undertake a review of whether Delivery Obligations had been delivered for the capex categories defined by HAL, considering any adjustments to baselines and Delivery Obligations which were made during the regulatory period. This review, and its findings, would be consulted on by the CAA, thus ensuring accountability of the CAA's proposals as the

	stakeholders to see and potentially challenge.	CAA's findings are available for all stakeholders to see and challenge, and provide their own input and evidence. The process of moving capex from development to core will be retained, so ensuring that capex projects remain accountable to airline stakeholders. Overall, therefore, and also taking into account the removal of the large element of regulatory discretion associated with *ex post* incentives, the level of accountability is the same or greater than the counterfactual.
The better regulation principles: is the CAA's approach proportionate?	The current approach involves the CAA undertaking an assessment of a sample of capex projects and is informed by the definition of efficiency set out in the Capital Efficiency Handbook and the DIWE framework. This approach considers a wide range of factors, as set out in paragraph 1.26 of the September 2020 Working Paper: these factors include how the work was procured, the extent to which HAL was able to control relevant expenditure, possible duplication of activity, the extent to which expenditure was proportionate to the	Under the proposed *ex ante* approach, only a proportion (determined by the symmetric incentive rate) of over or underspending will be disallowed from the RAB or added as a bonus (depending on whether HAL has over or underspent). This limits the extent of HAL's risk exposure, including because, at a portfolio level, HAL can both under and out-perform baselines so that the asymmetry of the current incentive is removed, while providing stronger incentives to exercise cost control compared with the current approach. Furthermore, under the proposed *ex ante* framework, the CAA will no longer undertake *ex post* reviews of projects; we will review whether delivery obligations have been met (with possible adjustments to baselines for under-delivery). If the delivery objectives are well defined and meet the criteria we have set out in Chapter [X] of this document, the process of reviewing them at the end of H7 will be more limited in scope compared to the existing process of reviewing all aspects of a sample of capex projects, so ensuring the proportionality of our approach. Some capex categories (and their delivery obligations) could require a more in-depth review for example, where HAL and airlines disagree on whether an obligation has been met, which is also the case currently.

	outputs which that expenditure was intended to, and/or did, deliver. While this assessment is undertaken only on a sample of projects, it has a significant scope, as set out above.	We also note that *ex post* reviews for some projects / categories might be required by exception, such as for projects already underway ahead of H7. As a result, the proposed approach will be proportionate to the delivery of an effective incentive across HAL's capex portfolio in terms of both the level of incentive applied and the level of regulatory intervention required for its operation.
The better regulation principles: is the CAA's approach consistent?	The existing approach to capex incentivisation has been developed over time and in consultation with stakeholders, including HAL and airlines. It has a number of benefits and is consistent with our duties and the objective of promoting HAL's efficiency.	It also builds on, and so is consistent with, a number of elements of the Q6 framework, for example, retaining the current approach for development and core spend, which was developed for Q6. We are ensuring that we retain the elements of the current approach that we consider are effective in incentivising HAL's efficiency, so ensuring consistency so far as is appropriate, while improving in areas where issues have been identified. Finally, the general approach of adopting *ex ante* incentives (in general rather than the specifics) is also consistent with parallel approaches adopted by other regulators, such as Ofgem and Ofwat to incentivise capital efficiency. As such, the proposed arrangements are as consistent as is appropriate with those that currently apply while still delivering improvements over those areas in the operation of those incentive arrangements.

H18 Under the proposed *ex ante* framework, HAL will have clearer and stronger incentives to drive efficiency in its capex during the regulatory period, which will over time lead to lower charges for airport users. The assessment we have set out in Table H.2 above demonstrates that our proposed *ex ante* capital incentives framework performs as well or better than the existing capex efficiency arrangements in place since the start of Q6 (the counterfactual) across all the relevant secondary duties and the better regulation principles.

H19 In this light, and having considered the comparative merits of incentivising capex under the *existing ex post* arrangements and the proposed *ex ante* arrangements, changing the incentive arrangements for HAL in the H7 price control to *ex ante* incentives will, better enable the CAA to discharge its primary duty to "*further the interests of users or air transport services regarding the range, availability, continuity, cost and quality of airport operation services*."

H20 We welcome views from stakeholders on any of the issues set out in this appendix.