

# Strategic themes for the review of Heathrow Airport Limited's charges ("H7")

A discussion document

**CAP 1383**



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## CHAPTER 1

# Introduction

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### Purpose of this document

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- 1.1 The current regulatory controls on the charges and services that Heathrow Airport Limited (HAL) offers to airlines, and ultimately to consumers<sup>1</sup>, are due to expire on 31 December 2018. The CAA has now launched a review (called 'H7')<sup>2</sup> of the appropriate regulatory arrangements that should be put in place after that date.
- 1.2 This discussion document seeks views from all interested parties on the process, strategic themes, and the relevant issues that should shape the CAA's methodology for the H7 review. We have published a number of Technical Appendices to support this discussion document, which are available from the CAA's website.<sup>3</sup>
- 1.3 Following our consideration of feedback to this discussion document, we intend to publish a Policy Update document in the autumn that sets out our latest thinking on the methodology for the H7 review.

### H7 programme milestones

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- 1.4 The periodic review of charges and services is a major programme of work. The CAA's decisions have significant implications for the consumers that use Heathrow, HAL, airlines, cargo owners and many other interested parties. It is important that the CAA's decisions are well supported and subject to appropriate consultation.
- 1.5 The CAA's current programme has a number of key milestones following the issue of this document (Figure 1). The broad aim of the process is to begin discussions with interested parties on the framework and strategic

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<sup>1</sup> For the sake of simplicity we use the term 'consumers' to mean both present and future passengers and cargo owners.

<sup>2</sup> 'H7' where the 7 denotes it will be the 7<sup>th</sup> period for which Heathrow Airport is subject to price control arrangements since it was privatised in 1986.

<sup>3</sup> Strategic themes for the review of Heathrow Airport Limited's charges ("H7") – Technical Appendices, CAP 1383A, available from: [www.caa.co.uk/CAP1383a](http://www.caa.co.uk/CAP1383a)

themes that should govern H7 and then move over time to more detailed consideration of specific issues.

**Figure 1: Key milestones for the H7 review**

Date	H7 Milestone
March 2016	Publication of strategic themes discussion document
April – June 2016	CAA led workshops with interested parties
Summer 2016	Establishment of H7 Consumer Challenge Forum
Autumn 2016	CAA Policy Update on H7 methodology
January 2017	HAL publishes its draft Business Plan
Jan – June 2017	Constructive Engagement process between HAL and airlines
September 2017	HAL submits revised Business Plan to the CAA
December 2017	CAA Initial Proposals
June 2018	CAA Final Proposals
1 January 2019	New regulatory arrangements come into effect the day after the present controls are due to expire

## Views are invited on this document

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- 1.6 If you have any views on this discussion document, and in particular on the key questions set out in chapter 7, please email them to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by **no later than noon on Friday 29 April 2016**. We cannot commit to take into account representations after this date.
- 1.7 If you would like to discuss the issues raised in this document before the deadline please contact Stephen Gifford ([stephen.gifford@caa.co.uk](mailto:stephen.gifford@caa.co.uk)) or Rob Toal ([robert.toal@caa.co.uk](mailto:robert.toal@caa.co.uk)).
- 1.8 Representations will be made available on the CAA's website. Any material considered confidential should be clearly marked as such. Please note that we have powers and duties with respect to disclosure of information under Section 59 of the Civil Aviation Act 2012 (the Act) and the Freedom of Information Act 2000.

## Chapter 2

# Key contexts for the H7 review

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## Interaction with potential new runway capacity<sup>4</sup>

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- 2.1 The CAA has argued for some time that given present and likely future capacity constraints, without building another runway in the South East of England, consumers will suffer from higher prices, reduced choice and lower service quality.
- 2.2 The H7 review takes place against the backdrop of the Government developing its response to the work of the Airports Commission (the Commission) on new runway capacity in the South East of England.
- 2.3 The Commission reported in July 2015 recommending a new northwest runway at Heathrow, alongside a significant package of measures to address its environmental and community impacts. Since July 2015, the Government has been reviewing the work of the Commission and confirmed in December 2015 that:
- it agrees with the Commission that the South East needs more runway capacity by 2030;
  - it agrees with the Commission's shortlist of three options, all of which it concluded were viable; and
  - the location decision for new runway capacity is subject to further consideration on environmental impacts and the best possible mitigation measures. The Government indicated that the package of further work is expected to conclude over the summer 2016.
- 2.4 The CAA acknowledges that the H7 review will need to proceed, at least for a number of months, with a degree of uncertainty given the Government has not made a decision on the location of new runway capacity.
- 2.5 The CAA has designed the process for the H7 review to accommodate work on the regulation of new runway capacity. The CAA published in February 2016 a Policy Update on the regulatory treatment of the planning

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<sup>4</sup> See [Technical Appendix 4](#) for further background.

costs associated with new runway capacity.<sup>5</sup> Assuming the Government makes a decision on location over the summer of 2016, the CAA presently intends to publish a decision on its approach to planning costs in the autumn of 2016, alongside a broader consultation on the regulatory framework for construction costs associated with new runway capacity. At the same time, the CAA expects to publish its Policy Update on its H7 methodology to ensure there is alignment between H7 and policy on new runway capacity. Given its financial and operational significance, a decision on a new runway may necessitate some changes to the emerging views on H7 contained in this document.

2.6 Despite the current uncertainty over new runway capacity, the CAA considers that it is important that all interested parties engage with it at an early stage on the appropriate methodology for H7 because:

- there are some strategic themes and priorities for the H7 review that may not change or be significantly altered by the Government's decision on new runway capacity;
- there is likely to be a significant period of time where regulation will be required between 31 December 2018, when the current regulatory controls on HAL's charges and services are due to expire, and the earliest date from which any new runway capacity becomes operational (not expected until at least 2025 if the Government adopts the Commission's recommended Heathrow option); and
- interested parties may have their own views on how the CAA best accommodates uncertainty over new runway capacity within its H7 programme.

2.7 We will keep our H7 process under review pending decisions by the Government on new runway capacity. If it proves necessary we can consult with interested parties with a view to extending the current regulatory settlement.<sup>6</sup>

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<sup>5</sup> Recovery of costs associated with obtaining planning permission for new runway capacity: policy update, CAP 1372, available from: [www.caa.co.uk/CAP1372](http://www.caa.co.uk/CAP1372)

<sup>6</sup> Note that the CAA has the power under the Act to propose an extension to the current regulatory arrangements.

## Market power assessment<sup>7</sup>

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- 2.8 The Act requires the CAA to regulate an airport operator if we have made a determination that that operator has met the Market Power Test (MPT) in relation to an airport. The MPT has three limbs:
- Test A – the relevant operator has, or is likely to acquire, substantial market power (SMP) in a market.
  - Test B – competition law does not provide sufficient protection against the risk that the relevant operator may engage in conduct that amounts to an abuse of that SMP.
  - Test C – the benefits of regulating the relevant operator are likely to outweigh the adverse effects.
- 2.9 In 2014 we published a Market Power Determination (MPD), which concluded that HAL had met the MPT in relation to Heathrow Airport (see Box 1 overleaf).

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<sup>7</sup> See [Technical Appendix 2](#) for further background.

**Box 1: HAL 2014 Market Power Determination**

The CAA concluded in January 2014 that HAL had SMP in the relevant market and that this was expected to persist (i.e. Test A is passed). This conclusion was based on the following factors.

- The most likely source of any SMP that HAL has stems from its position as the operator of the UK's only hub airport and the combined package that Heathrow offers of strong demand, including premium passengers, cargo and connecting passengers. This makes Heathrow attractive for both UK based and inbound airlines.
- The airline network effects available at Heathrow mean that very few airlines would be able and willing to switch sufficient capacity to constrain HAL from increasing its charges.
- HAL's good surface access options, the inherent attractiveness of the London market, and its strategic importance to airlines combined with the capacity constraints in the London system act to reduce the available alternatives to airlines.
- The strength of airline demand to operate from Heathrow means that HAL would be effectively insulated from the effects of any switching away as a result of higher airport charges.

In addition, the CAA considered that any change in Government policy after the release of the Commission's final report would take some time to be implemented and that any significant capacity expansion would not be expected until at least 2025.

The CAA also considered that as a result of SMP there was the risk that HAL would be likely to increase prices and/or to reduce service quality and that an 'ex post' competition law approach would not be well adapted to pre-empting such conduct (i.e. Test B is passed). Furthermore, taking account of the interests of current and future consumers, particularly their demands in terms of a stable supply of high quality airport services at reasonable cost, the CAA concluded that the benefits of licence regulation would outweigh any adverse effects (i.e. Test C is passed).

Source: Market power determination in relation to Heathrow Airport – statement of reasons, CAP 1133, available from: [www.caa.co.uk/CAP1133](http://www.caa.co.uk/CAP1133)

- 2.10 The CAA is not currently intending to conduct a further MPD for HAL as it does not consider that there has been a material change of circumstances since 2014 when it made its previous MPD. The CAA's initial view is that HAL will continue to hold SMP for a number of years beyond January 2019 and will continue to require ongoing economic regulation.

## The CAA's primary statutory duty

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- 2.11 The Act gives the CAA a single primary duty ***to further the interests of users of air transport services*** in respect of its economic regulation functions. Under the Act, users of air transport services are defined as present and future passengers and those with a right in property carried by the service i.e. cargo owners.<sup>8</sup> For the sake of simplicity we use the term 'consumers' to mean both present and future passengers and cargo owners.
- 2.12 The scope of the CAA's primary duty concerns the ***range, availability, continuity, cost and quality of airport operation services***. The CAA must carry out its functions, where appropriate, in a manner that will ***promote competition in the provision of airport operation services***.
- 2.13 In discharging this primary duty, the CAA must also have regard to a range of other matters under the Act. These include:
- the need to secure that HAL is able to finance its licensed activities;
  - to secure that all reasonable demands are met;
  - to promote economy and efficiency;
  - the need to secure that HAL is able to take measures to reduce, control and 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
  - better regulation principles.
- 2.14 More generally we will have regard to the CAA's vision of: ***making aviation better for those that choose to fly and those that don't.***<sup>9</sup>

## Regulatory best practice

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- 2.15 We are keen to take into account relevant best practice and lessons from other UK economic regulatory regimes, where it is appropriate to do so.

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<sup>8</sup> Given that over 95% of cargo at Heathrow travels in the bellyhold of passenger aircraft, we consider that the interests of cargo owners will in many ways be aligned with those of passengers.

<sup>9</sup> Our five year strategic plan: <https://www.caa.co.uk/Our-work/Corporate-reports/Strategic-Plan/Our-five-year-strategic-plan/>

Within that context, we commissioned a study looking at innovations that have appeared recently in price reviews carried out by Ofcom, Ofgem, Ofwat, Office of Rail and Road and the Competition Commission / Competition & Markets Authority.

- 2.16 The report, by First Economics, is being published alongside this document<sup>10</sup>, to help interested parties understand current regulatory practice in the UK. As well as an increased focus on consumers, one of the other main findings from this work is that regulators are increasingly focused on encouraging regulated companies to compile challenging and high quality business plans at the outset of the price review process.
- 2.17 Other developments include a move to outcome-based measures, a shift in focus from operational expenditure (opex) and capital expenditure (capex) to total expenditure (totex) and modifications to the way the financial building blocks are calculated, such as indexing the cost of debt and using the Consumer Price Index (CPI) index instead of Retail Price Index (RPI).
- 2.18 We are also keen to draw lessons and experience from economic regulation of aviation in other countries, both in Europe and beyond. We would welcome views on particular examples we should take into account.

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<sup>10</sup> First Economics (September 2015). A Review of Recent UK Price Review Innovations. Available at: [www.caa.co.uk/CAP1383b](http://www.caa.co.uk/CAP1383b)

## Chapter 3

# Overview of Heathrow

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- 3.1 In setting regulatory controls on HAL's charges and services, the CAA considers that it should have regard to the commercial characteristics of the airport. These include the nature of the passengers that use the airport; the airlines and cargo owners that use the airport; the level of airport charges compared to benchmarks and the level of investment undertaken by HAL.<sup>11</sup>

## Passengers' characteristics

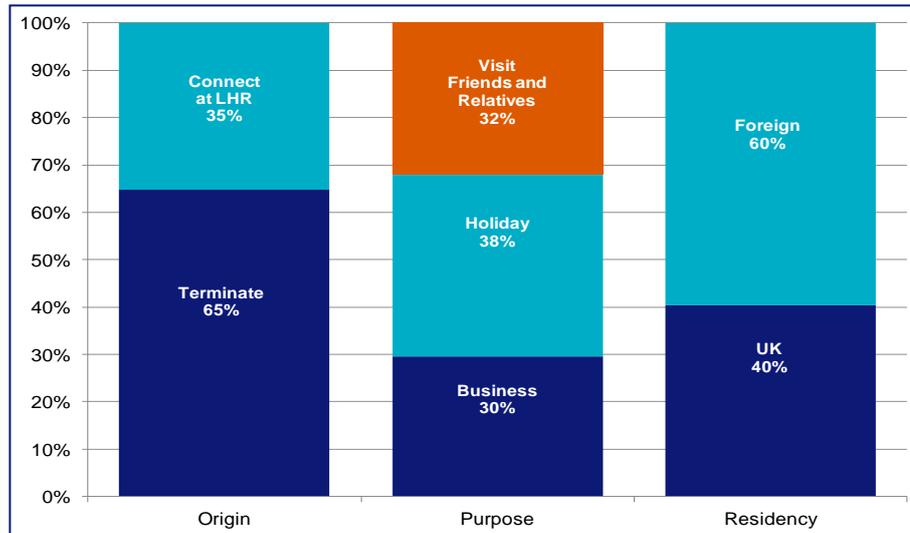
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- 3.2 Heathrow is by far the largest UK airport. It accounts for around 30 per cent of total passengers handled by UK airports and half of the passengers served in the London area.<sup>12</sup>
- 3.3 Of the 73 million passengers handled by Heathrow in 2014, just over a third used the airport to connect flights, with the remainder arriving by surface transport modes (Figure 2). Around 30 per cent of passengers travelled for business purposes, 38 per cent for holiday and 32 per cent to visit friends and relatives. A total of 60 per cent of passengers were non-UK residents.

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<sup>11</sup> See [Technical Appendix 3](#) for further background.

<sup>12</sup> London area airports are Heathrow, Gatwick, Stansted, Luton, London City and Southend.

**Figure 2: Heathrow passenger profile**

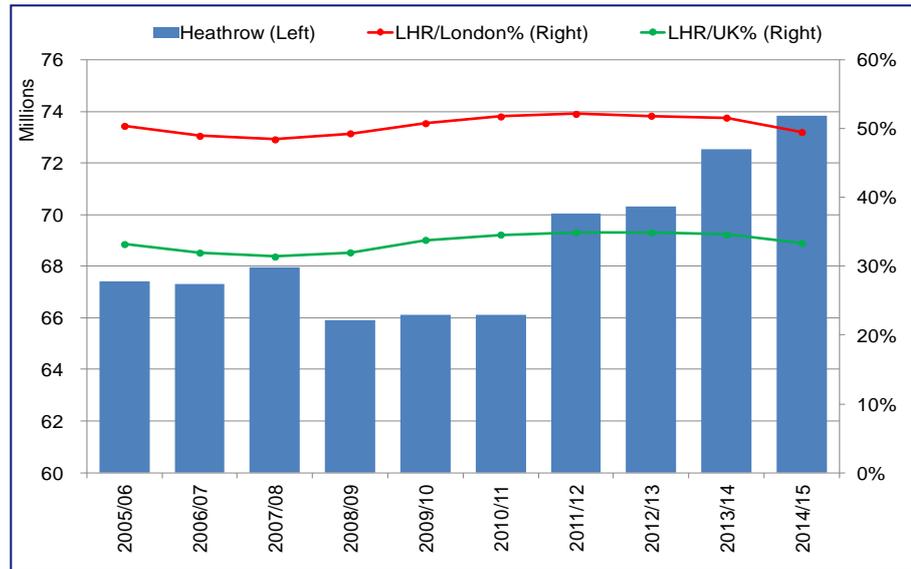
Source: CAA Passenger Survey 2014

- 3.4 Heathrow is the largest air cargo hub in the UK, despite serving very few cargo-only (freighter) flights. Heathrow alone, accounts for 63 per cent of cargo handled at UK airports, a share that has been increasing gradually: for example, in 2006 it accounted for 53 per cent. Over 95 per cent of cargo at Heathrow travels in the bellyhold of passenger aircraft.

## Passenger growth

- 3.5 Passenger numbers at Heathrow have shown some growth in recent years (Figure 3), following a downturn between 2008/09 and 2010/11. 2014/15 was Heathrow's busiest ever year with over 73 million passengers using the airport, which represents 49 per cent of London terminal passengers<sup>13</sup> and 33 per cent of UK terminal passengers.

<sup>13</sup> Passengers who arrive from or departing from an airport, as oppose to transfer/connecting passengers to change from one flight to another (and therefore stay at the airside of the airport).

**Figure 3: Heathrow, London and UK passenger numbers**

Source: CAA

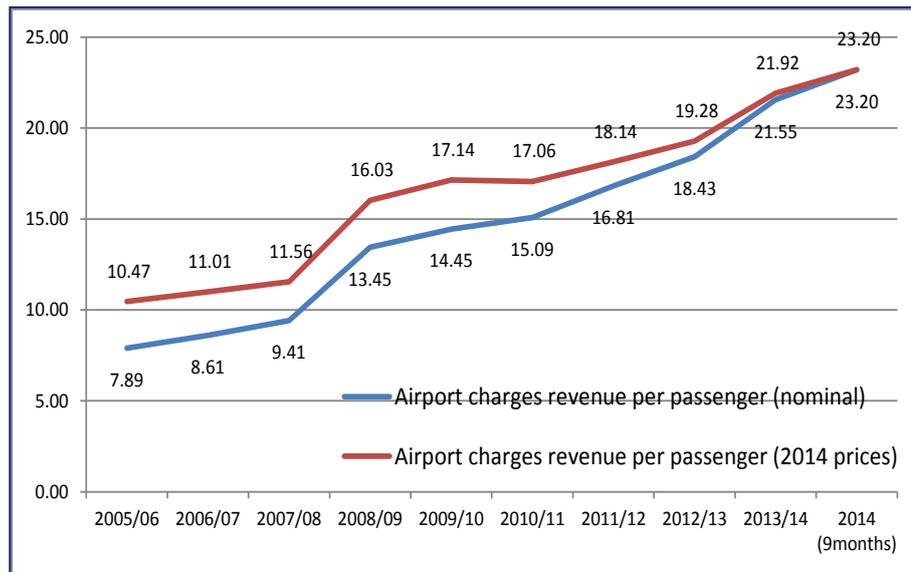
## Airline characteristics

- 3.6 Airline competition plays an important role in making sure that the benefits of economic regulation are passed on to consumers. Although we do, in general see strong competition between airlines on many routes to and from London airports, there are constraints. In particular, lack of airport capacity is increasingly influencing the level of airline competition. One potential barrier to competition is the need for new entrants and growing airlines to acquire slots at congested airports, which is a particular issue at Heathrow.
- 3.7 The airline base at Heathrow is comprised of almost entirely full-service airlines, contrasting with a mix of full service, charter and low cost at Gatwick and an almost entirely low cost airline base at Stansted and Luton. Airlines at Heathrow also serve a large number of passengers connecting at Heathrow, with about 35 per cent of its passengers connecting there. This compares with about 8 per cent at Gatwick and 4 per cent at Stansted.
- 3.8 British Airways is the largest airline at Heathrow, accounting for 51 per cent of flights and 49 per cent of the airport's passengers in 2015.
- 3.9 Heathrow is exceptionally highly utilised. Runway utilisation above 95 per cent has been a consistent feature of the airport for the past 15 years. As a consequence, slot productivity has been improving as airlines have gradually been utilising larger aircraft on longer flights.

## Airport charges to airlines

3.10 Over the last decade, airport charges revenue per passenger has increased significantly at Heathrow from just under £8 per passenger in 2005 to just over £23 per passenger in 2014 (Figure 4).

**Figure 4: HAL’s charge revenue, £ per passenger**



Source: HAL regulatory accounts

3.11 HAL’s charges to airlines are relatively high by international standards and over double that of Gatwick (Figure 5).

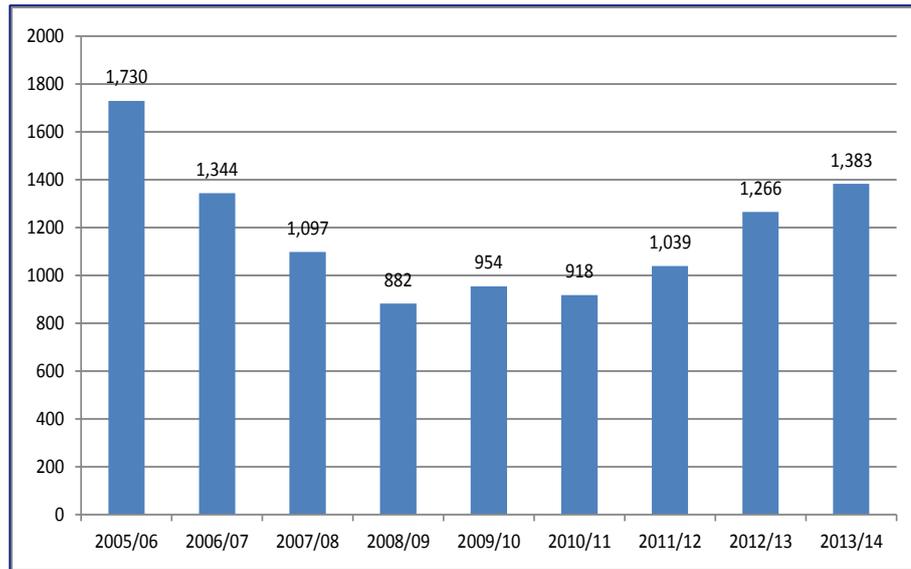
**Figure 5: International comparison of airport charges**



Source: ICF analysis with data derived from Leigh Fisher reports; CAA analysis

## Airport investment

3.12 Increases in charges at Heathrow over the last decade have largely been driven by the extensive investment programme at the airport, which includes the construction of the new terminals 5 and 2 as well as major upgrades to terminals 3 and 4 and a number of other significant capital projects. Over the 2005/06 to 2013/14 period HAL invested £10.6 billion (in 2014 prices) in the airport (Figure 6), with a further £3 billion of capital expenditure forecast to be spent over the 2014 to 2018 period.

**Figure 6: HAL capital expenditure, £ million 2014 prices**

Source: HAL regulatory accounts

## Chapter 4

# Strategic themes for H7

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- 4.1 Following our initial engagement with HAL, the airlines and the CAA's Consumer Panel, we propose to adopt the following strategic themes to help shape the H7 review.
1. Empowering consumers and furthering their interests.
  2. Incentivising the right consumer outcomes.
  3. Increasing airport resilience.
  4. Promoting cost efficiency and financeability.

## Empowering consumers and furthering their interests<sup>14</sup>

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- 4.2 We propose to go much further than we have previously to put consumers at the heart of our airport economic regulation (Box 2).

**Box 2: Steps to make the H7 process consumer-focused:**

1. Establish an independent Consumer Challenge Forum (CCF) to play an important role in the process and to advise the CAA on the acceptability to consumers of HAL's overall business plan.
2. Work closely with the industry to ensure that the rich body of consumer research that exists is used to inform the H7 process so that the regulatory outcomes are grounded in an evidence-based understanding of the things that consumers value.
3. Firmly put the onus on both HAL and airlines to demonstrate that their ambition and plans for the airport will deliver outcomes that consumers value.
4. Understand better the perspective of cargo owners.
5. Consult with the CAA's Consumer Panel at key stages of the H7 process.

- 4.3 The CCF would have some similarities to the customer challenge group (CCG) approach used by Ofwat for its most recent price review (PR14),

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<sup>14</sup> See [Technical Appendix 5](#) for further background.

but also some key differences that reflect the particular characteristics of airport regulation, not least the important role played by airlines.

- 4.4 Our current thinking is that the CCF's primary focus should be on the process for developing evidence-based, consumer-focused outcomes (and the framework for incentivising and monitoring their delivery) which will set the parameters for the more detailed discussions on HAL's business plan that take place between HAL and airlines during constructive engagement (CE).
- 4.5 We see the CCF as playing more of an assurance role in H7 than the representative role played by the CCG in PR14. The CCF is therefore an enhancement to existing processes rather than any replacement of CE between HAL and the airlines. We will consider the precise scope, format, detailed roles and responsibilities of the CCF with HAL, the airlines and the CAA's Consumer Panel, with a view to having the Chair of the CCF appointed and terms of reference agreed by summer 2016.

## **Incentivising the right consumer outcomes<sup>15</sup>**

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- 4.6 We currently regulate the quality of services provided by HAL through the Service Quality Rebates and Bonuses (SQRB) scheme. The SQRB scheme covers a number of aspects of service quality such as central search, wayfinding, cleanliness and equipment availability. This approach enables us to monitor and enforce the standards that airlines and passengers should expect from HAL in exchange for the airport charges that the airlines pay.
- 4.7 The SQRB scheme has, therefore, had an important function since its introduction in 2004. A typical shortcoming of price cap regulation is that the strong incentive to reduce costs may inadvertently incentivise reductions in service quality. The purpose of a scheme regulating the quality of service is to counterbalance this effect in order to protect consumers' interests.
- 4.8 In developing the initial framework for H7, we are reviewing the SQRB scheme and considering whether revisions can be made which improve value for consumers. In the context of our primary duty under the Act, we are interested in exploring whether the link with consumer preferences and priorities can be strengthened.

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<sup>15</sup> See [Technical Appendix 6](#) for a more detailed discussion.

- 4.9 In particular, we are considering the merits of a move towards more outcomes-based regulation in line with current practice in a number of regulated sectors in the UK. Outcomes in this context refer to the broader range of higher level consumer objectives that HAL's actions are intended to help deliver.
- 4.10 Our initial view is that HAL, working closely with airlines, may be best placed to initially propose in its business plan any outcome measures that could be used to form part of the H7 regulatory framework. This assessment should be based upon and informed by a robust, comprehensive and transparent understanding of consumer preferences.
- 4.11 The CCF will have an important role to play in gaining assurance that HAL's business plan and the associated outcomes are demonstrably focused on the needs of consumers. This approach should provide a strong foundation for these issues to be considered in greater detail in the CE phase of the H7 process between HAL and the airlines.

## Increasing airport resilience<sup>16</sup>

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- 4.12 We are keen to focus on increasing airport resilience and reducing disruption, which has been a major area of concern at Heathrow for a number of years. Disruption can be caused by a number of factors such as bad weather, infrastructure failure, airspace issues, scheduling practice, interruptions to key supplies such as fuel or electricity, closure of terminals (for example for security reasons), road or rail closures or industrial action. The way capacity is managed at present can lead to increased flight times. Disruption can lead to delays and cancellations causing uncertainty and, in some cases, distress to consumers.
- 4.13 Heathrow already operates at the margin of full capacity so there is little room to spread the impact of disruption across the day. Even minor disruptions can have knock-on effects throughout the day and Heathrow subsequently has a high number of delays compared to other European airports.<sup>17</sup> As London's major hub airport with a large number of international carriers there is a greater number of stakeholders to coordinate. That and the large proportion of transfer passengers mean that there may be fewer options for accommodating those who have been

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<sup>16</sup> See [Technical Appendix 6](#) for a more detailed discussion.

<sup>17</sup> CODA Digest Q3 2015, [www.eurocontrol.int](http://www.eurocontrol.int)

delayed.

- 4.14 We are undertaking wider work to understand the causes of resilience issues at UK airports and assessing the extent to which it is an issue for passengers now and in advance of any new runway capacity or major airspace improvements becoming available. This wider work will help inform the CAA's approach to increasing airport resilience in H7.
- 4.15 Through the H7 review we would like to explore more innovative ways to reduce and manage disruption due to capacity constraints by incentivising better performance and better use and management of capacity. We will challenge HAL and the airlines to consider ambitious options for better managing capacity and mitigating and reducing the likelihood of disruption.

## **Promoting cost efficiency and financeability<sup>18</sup>**

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- 4.16 Comparative analysis of efficient airport costs and revenues will continue to form an important part of the regulatory process. We are contemplating splitting the benchmarking phase into two parts. An initial baseline analysis of opex and capex would be undertaken in 2016 to inform the earlier stages of the process. This would then be updated towards the end of the H7 review to ensure that the CAA's final proposals and decisions reflect latest airport and market developments.
- 4.17 Throughout the process we will take into account relevant best practice and lessons from other UK economic regulatory regimes, where it is appropriate to do so.
- 4.18 From our review of recent regulatory settlements we have observed that some regulators have directed significant attention towards requiring companies to compile challenging and high quality business plans at the outset of the price review process. We intend to build on this experience and will set out our expectations around what a high quality business plan looks like for the regulatory review, so that the process begins with much more realistic assumptions about future revenue requirements.
- 4.19 Recent regulatory innovations around promoting efficiency that we intend to explore include:

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<sup>18</sup> See [Technical Appendix 8](#) for further background.

- whether there is any role for a totex approach, i.e. combining capex and opex and giving equal treatment to both. The rationale is to avoid any bias towards capex solutions in HAL's business plan;
- whether 'pain and gain share' mechanisms may be suitable for example introducing stronger incentives around opex outperformance; and
- whether there is a role for earmarking a fund to support relevant technological innovation.

4.20 The CAA has a duty to have regard to the need to secure that HAL can finance its provision of airport operation services when it comes to the exercise of our functions such as setting price caps. The CAA intends for H7 to continue with its traditional approach of remunerating HAL's investment through its Regulatory Asset Base and an estimate for its weighted average cost of capital (WACC). We propose to retain the 'single till' approach to calculating allowed revenues, which has been used for all previous price controls.

4.21 We anticipate that we will test whether HAL has the ability to raise finance at reasonable terms and retain an investment grade credit rating. We expect this will be based on our assessment of efficient costs and a notional<sup>19</sup> capital structure, rather than HAL's actual capital structure.

4.22 Some regulators have recently modified the way they approach financeability and we expect to consider whether these changes should also apply for HAL's price control.

- Some regulators have introduced, or are considering introducing, indexing the cost of debt rather than relying on a single forecast at a point in time. Although we considered this issue in the course of the previous periodic review for HAL, we consider that it is appropriate to re-examine its relative merits given HAL's ongoing need to raise significant debt finance.
- In practice, regulated companies have continued to operate above the gearing levels assumed by their regulator's notional capital structures and some regulators have made adjustments to reflect this. The CAA expects to consider the merits of this.

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<sup>19</sup> The notional capital structure is adopted by economic regulators to ensure that the risks of capital structure decisions rest with shareholders rather than consumers.

- We intend to explore whether it is appropriate to move away from the standard five year period for the HAL price control.

4.23 Some regulators are considering using CPI as the measure of inflation rather than RPI. HAL has a low share of index linked debt at less than 10 per cent of outstanding secured debt. Its exposure to RPI is, however, much higher than this owing to a significant amount of swaps and other financial derivatives it has entered into. Taken together, these factors mean HAL's exposure to RPI is equivalent to over 50 per cent of outstanding debt. This background will need to be considered in exploring the case to move to CPI. The CAA will also want to take into account how the issue is being addressed by other economic regulators because many regulated utilities have a significant exposure to RPI linked debt and financial derivatives.

## Chapter 5

# Constructive Engagement

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- 5.1 Constructive Engagement (CE) has now become an integral feature of aviation economic regulation. It is a process mandated by the CAA 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. Airlines value the opportunity it provides to discuss airport operator business plans that affect their commercial operations, and airport operators see value in greater strategic consultation with their customers.<sup>20</sup>

## Operating principles

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- 5.2 We remain committed to the process of CE and consider that the H7 review provides a timely opportunity to review the objectives of CE in the light of experience and the context within which the review will take place.
- 5.3 Ideally we would like to see a settlement agreed between HAL and the airlines, but one in which we are independently assured represents a good deal for consumers. Past experience has demonstrated that such an ideal may be unattainable given the inherent conflicting commercial tensions between HAL and the airlines and in turn within the airline community itself. That said the process itself is valuable for the airport operator, the airlines and the CAA.
- 5.4 With this in mind, our main objective for CE is to provide a platform for HAL and airlines to discuss the airport operator's business plan with a view to identifying and narrowing their differences and, where agreement cannot be reached, they are both able to provide informed views into the CAA's subsequent price setting process.
- 5.5 In fulfilling this objective, we are interested in finding ways to elevate the consumer interest within CE and, in particular, the extent of involvement of the CCF. Our initial view is that a representative of the CCF should have some degree of participation in the CE process, but the detailed scrutiny of HAL's business plan should remain between HAL and the airlines.

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<sup>20</sup> See [Technical Appendix 9](#) for further background.

- 5.6 Our current view is that the operating principles we established for the last periodic review remain valid for H7, but there should be greater emphasis on the CE process being consumer focused (Box 3).

**Box 3: Operating principles of Constructive Engagement**

- **Consumer focused.** Discussions should be focused on delivering the outcomes that consumers value.
- **Accountability.** There should be a clear and agreed governance framework setting out the expected accountabilities.
- **Transparency.** Information provided for CE should be relevant and timely.
- **Collaboration.** All parties should participate constructively and in good faith.
- **No surprises.** Trust is undermined if either side suspects the other is simply playing games to exploit a regulatory process.
- **Dispute resolution.** The parties should agree clear and efficient dispute resolution procedures.

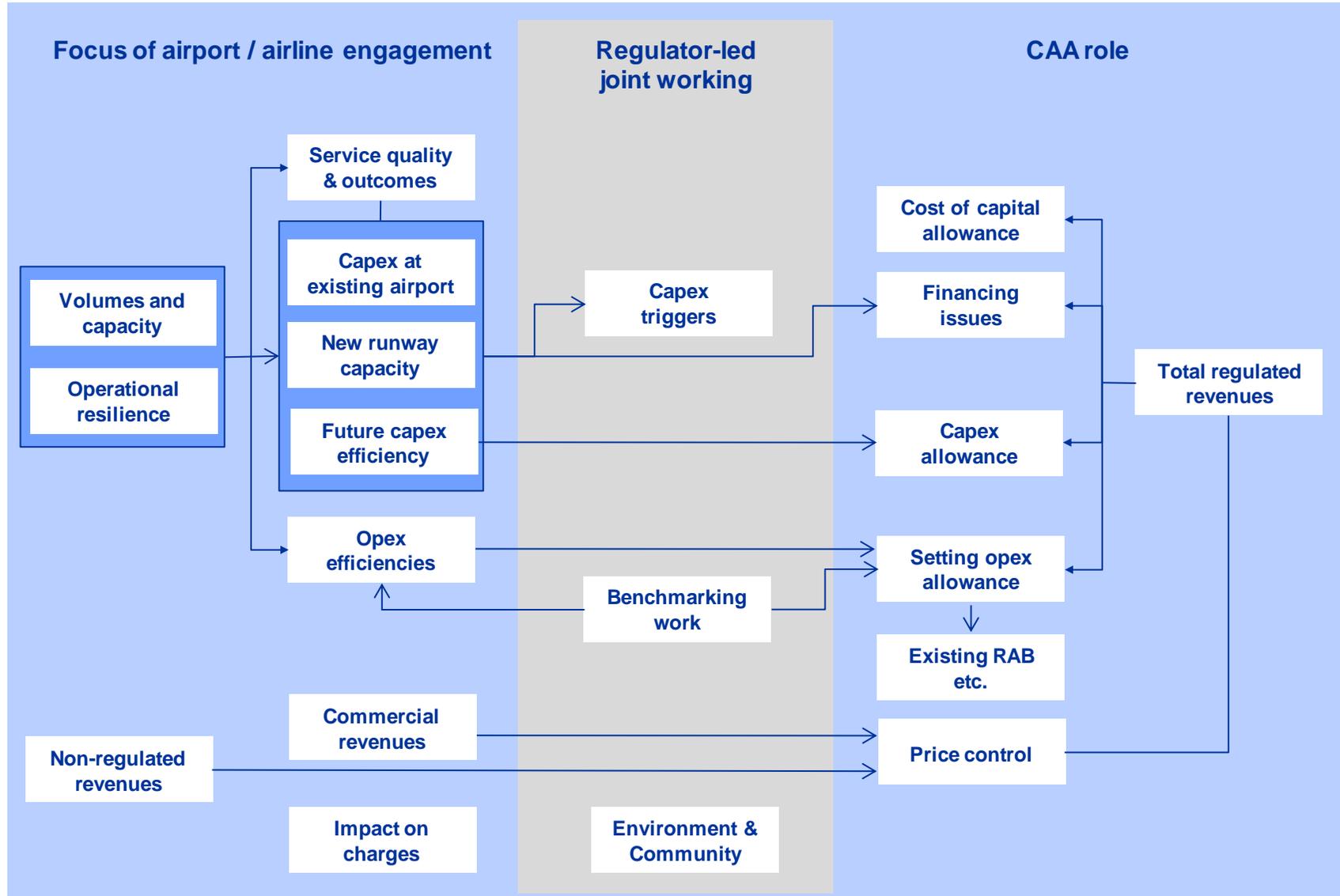
- 5.7 We see merit in the participants in the key discussions consisting of senior airline and airport representatives, who would have the ability to commit their respective organisations to conclusions derived through the process.
- 5.8 The role that the CAA plays is likely to have an important bearing on the outcome of the process. Although CE should not be regulator-led, we could play, where appropriate, a more active role on a step-in / step-out basis than was the case for the last periodic review. The CAA may play a more prominent role by attending more of the meetings and providing guidance to the parties where it is appropriate to do so. Greater involvement from us may be more practical for the H7 review than previously from an industry and regulatory resource point of view given that other airport reviews (or market power assessments) will not be occurring simultaneously.
- 5.9 The CAA expects to issue a 'CE mandate' to HAL and the airlines shortly before the process begins. This will set out in more detail the CAA's expectations.

## CE Process

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- 5.10 We currently anticipate that the formal phase of CE is likely to begin at the start of 2017 and will run for a number of months.
- 5.11 The CAA's current view is that the greatest benefit from CE in previous periodic reviews has been through the progress made around discussions of the capital plan and the scope for capital efficiency. In order for the implications of investment decisions to be considered in the round, all of the regulatory building blocks including opex and commercial revenues should be included in the scope of CE. The CAA also expects HAL to give the airlines visibility of the financial assumptions it is making, for example the WACC.
- 5.12 In addition, we think that the scope of CE should be expanded to include the development of appropriate consumer-focused outcome measures. Options and measures for reducing disruption and increasing airport resilience should also be regarded as a priority.
- 5.13 Finally, we will expect the parties to consider the implications of the environmental impact of the airport including its role in the local community.
- 5.14 The potential scope of the H7 CE process is illustrated in Figure 8.

Figure 8: Outline of possible Constructive Engagement process for the H7 review



## Chapter 6

# H7 Timetable

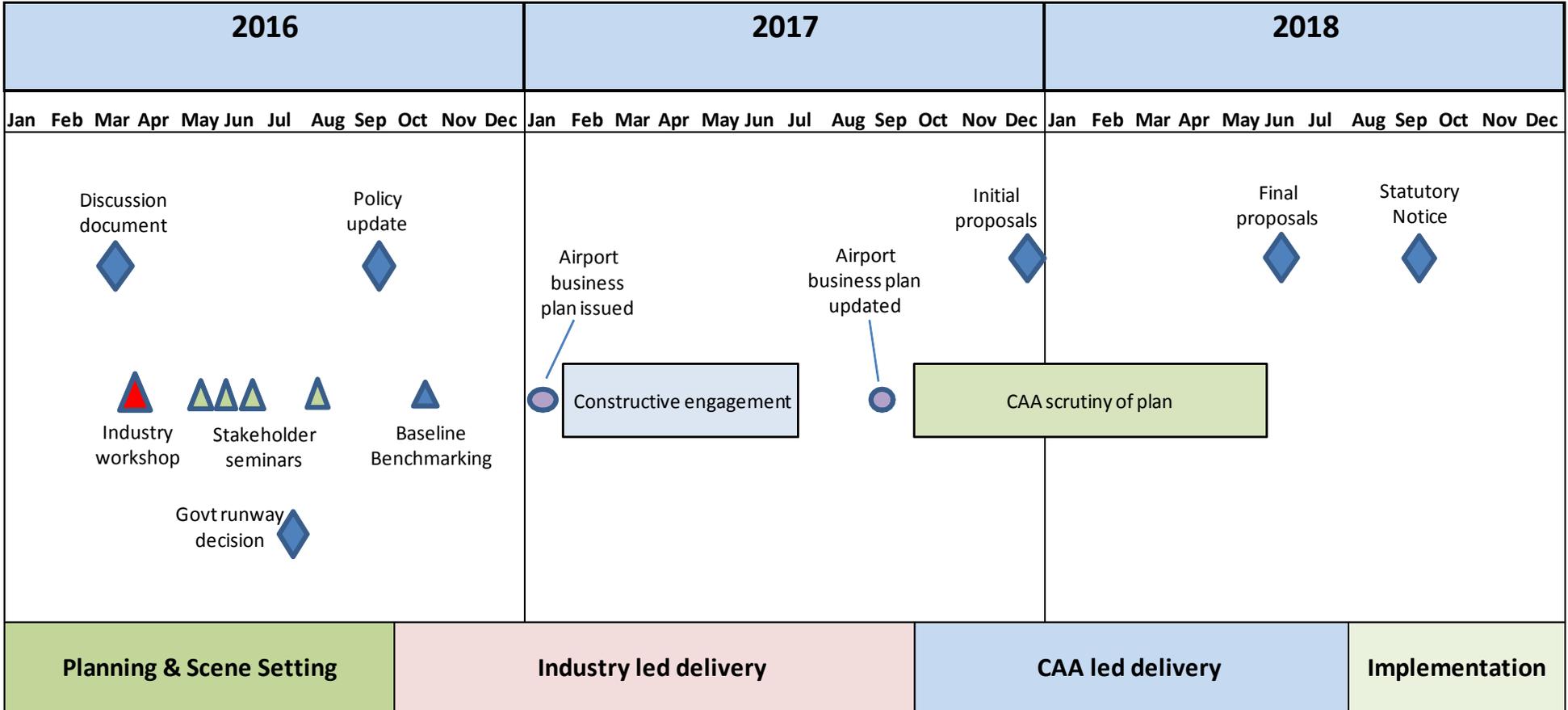
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- 6.1 We currently envisage four broad phases of work for the review, comprising planning, industry-led delivery, CAA delivery and licence modification and implementation (Figure 9).<sup>21</sup>
- 6.2 In the immediate period following the publication of this discussion document, we will be holding an industry workshop at Heathrow on 10 & 17 March 2016. We will also host a number of more focussed workshops on specific topics over the April to June 2016 period.
- 6.3 As discussed in chapter 2, the CAA will need to keep this timetable under review pending developments with the Government about expanding runway capacity in the South East of England. We may also need to amend the timetable in light of feedback from interested parties on how best to structure the CE process.

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<sup>21</sup> See [Technical Appendix 10](#) for further background.

Figure 9: High level timetable



## Chapter 7

# Key questions

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1. Do you agree that there has not been, or likely to be, a material change of circumstances to require a new MPD for HAL before January 2019?
2. How best can the CAA proceed with the H7 programme given the uncertainty about new runway capacity?
3. Is there a case for the CAA to consider extending the current Q6 arrangements until there is a higher level of certainty over the runway developments?
4. Do you agree with the proposed strategic themes for H7?
5. How can consumer engagement throughout the H7 process be improved?
6. Are the CAA's proposed steps (see Box 2) sufficient to ensure that consumers' interests are at the heart of the H7 programme?
7. Do you agree in principle that the CAA should look to move toward more outcomes-based regulation and to what extent should this complement or replace the existing SQRB scheme?
8. How can the licence regime improve airport operational resilience and mitigate disruption?
9. Do you support our broad approach to promoting efficiency and fiananceability and do you agree that the specific issues raised (CPI v RPI, debt indexation, etc) are relevant for this review?
10. Do you agree in principle with the continued use of Constructive Engagement and do you have any observations on how the process might be improved?
11. Do you agree with the proposed timetable for the review?
12. Are there any other issues you consider material to the H7 review?