

# Economic regulation of capacity expansion at Heathrow: policy update and consultation

CAP 1722



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## About this document

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This document follows on from the consultations that we published on the regulatory framework to support capacity expansion at Heathrow airport in January, June and December 2017 and April 2018. It consults further on the development of the regulatory framework and includes:

- an update on our approach to aligning the regulatory timetable with the overall timetable for the development of capacity expansion;
- detailed consideration of a possible new licence condition to further promote economy and efficiency on the part of Heathrow Airport Limited (“HAL”);
- details of our approach to addressing the issues that may be raised by alternative arrangements for delivering new capacity; and
- an update on our surface access policy.

It also complements our September 2018 interim update to the Department for Transport under section 16 of the Civil Aviation Act 1982 on the progress of the “Enhanced Engagement” process between HAL and airlines.

### **Views invited**

We welcome views on the issues raised in this document and, in particular, the issues set out in the executive summary and those highlighted in chapters 1 to 4.

Please e-mail responses to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by no later than 4 January 2019. We cannot commit to take into account representations received after this date.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. 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 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Robert Toal ([Robert.Toal@caa.co.uk](mailto:Robert.Toal@caa.co.uk)).

# Update and summary

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## Introduction

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1. In October 2016, the Government announced that its preferred option for the expansion of airport capacity in the south east of England was the Heathrow “Northwest runway”. The CAA has consistently stated that additional runway capacity in the south east of England will benefit air passengers and cargo owners. The timely delivery of more aviation capacity is required to prevent future consumers<sup>1</sup> experiencing higher airfares, reduced choice and lower service quality.
2. During 2017, we issued consultations in January<sup>2</sup>, June<sup>3</sup> and December<sup>4</sup> on the core elements of the regulatory framework to support capacity expansion at Heathrow airport. We published a further consultation in April 2018 that set out:
  - an update on the development of our thinking in relation to the overall regulatory framework, including our initial and early assessment of the affordability and financeability of capacity expansion;
  - proposals for HAL to engage further with stakeholders on alternative commercial and delivery arrangements;
  - more information on the process we are undertaking to establish the cost of capital for HAL, and an explanation of our initial work to integrate our preliminary work on incentives with our approach to assessing the cost of capital and shareholder returns;
  - our decisions in relation to an interim price control that will facilitate the alignment of the regulatory processes for setting price controls with the

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<sup>1</sup> In this consultation, the terms “consumers” and “users” are used interchangeably. See Appendix A.

<sup>2</sup> CAP 1510 Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable (the “January 2017 Consultation”). See: [www.caa.co.uk/CAP1510](http://www.caa.co.uk/CAP1510)

<sup>3</sup> CAP 1541 Consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow (the “June 2017 Consultation”). See: [www.caa.co.uk/CAP1541](http://www.caa.co.uk/CAP1541)

<sup>4</sup> CAP 1610 Economic regulation of capacity expansion at Heathrow: policy update and consultation (the “December 2017 Consultation”). See: [www.caa.co.uk/CAP1610](http://www.caa.co.uk/CAP1610)

wider timetable for capacity expansion and better protect the interests of consumers; and

- discussion and further consultation on the regulatory treatment of early construction costs and surface access costs.<sup>5</sup>

## Airports National Policy Statement

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3. On 26 June 2018, following the approval of the House of Commons, the Secretary of State for Transport designated the Airports National Policy Statement (“NPS”) under section 5(1) of the Planning Act 2008.<sup>6</sup>
4. The NPS sets out:
  - the Government’s policy on the need for new airport capacity in the south east of England;
  - the Government’s preferred location for a scheme to deliver new capacity; and
  - particular considerations relevant to any application for development consent to which the NPS relates.
5. The designation of the NPS is a key development in the expansion of capacity at Heathrow airport as it provides the primary framework for taking forward any application for development consent, thus clarifying what is required to obtain planning permission for new airport capacity.<sup>7</sup>
6. The next step in the planning process is for applicants to develop their plans, and then carry out the further public consultation required under the Planning Act 2008 before making an application for a DCO. Any DCO application will be considered through a public examination by the independent Planning

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<sup>5</sup> CAP1658 Economic regulation of capacity expansion at Heathrow: policy update and consultation (the “April 2018 Consultation”). See: [www.caa.co.uk/CAP1658](http://www.caa.co.uk/CAP1658)

<sup>6</sup> See:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/714106/airports-nps-new-runway-capacity-and-infrastructure-at-airports-in-the-south-east-of-england-web-version.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/714106/airports-nps-new-runway-capacity-and-infrastructure-at-airports-in-the-south-east-of-england-web-version.pdf)

<sup>7</sup> Planning permission for the main elements of capacity expansion is expected to be granted by means of development consent orders (“DCO”). More than one DCO may be granted by the Secretary of State to facilitate the development of new capacity, or different aspects of it.

Inspectorate, before a final decision is made by the Secretary of State, or a designated minister, as to whether to grant the DCO.

7. In the meantime, we will continue our work on developing the overall framework for the future economic regulation of HAL to take account of, and address, the issues raised by capacity expansion.

## Enhanced Engagement

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8. Our work on capacity expansion has been conducted in the context of both:
  - our regulatory oversight of HAL under the Civil Aviation Act 2012 ("CAA12"); and
  - our reporting to the Secretary of State on airport-airline engagement under section 16 of the Civil Aviation Act 1982.
9. The Terms of Reference for the latter asks us to review and provide advice on how well HAL is engaging with, and responding to, the airline community on its plans for capacity expansion at Heathrow airport and whether this engagement is appropriately reflecting the interests of consumers in line with the CAA's general duty under the CAA12.
10. The engagement process began in earnest in December 2016 and gathered further momentum during 2017 and 2018. We provided the Secretary of State with an "initial health check" in February 2017, followed by further updates in May 2017, September 2017 and April 2018.
11. Our most recent update was provided at the end of September 2018 and included our assessment of airport-airline engagement between May 2018 and September 2018.<sup>8</sup> The key points included:
  - HAL and the airline community had made some good progress, including agreeing the contents of a new protocol to govern the Enhanced Engagement process;

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<sup>8</sup> Our September 2018 letter to the DfT on the progress of the "Enhanced Engagement" process under section 16 of the Civil Aviation Act 1982 will be made available on the [Section 16 page](#) of our website.

- HAL had not yet adequately addressed repeated requests from the airline community and the CAA (most recently in our April 2018 Section 16 report) to provide high quality and comprehensive information on costs and efficiency;
- we noted that HAL is still developing its preferred masterplan so some uncertainty is inevitable given the maturity of the design and that HAL has committed to enhance its cost estimates as it approaches key programme gateways over the next year. Nonetheless, we said that unless there is a significant improvement in this area we would consider whether there are further steps we should take in respect of these matters to support the proper discharge of our statutory duties;
- HAL had recently announced some changes to its overall expansion schedule and now expects to launch its statutory consultation in June 2019. We emphasised that HAL needs to demonstrate to stakeholders that its new timetable is realistic, achievable and allows sufficient time for high quality engagement;
- HAL has introduced its Innovation Partners process to invite potential business partners to enter an expression of interest to develop alternative design, engineering or construction proposals to deliver capacity expansion at Heathrow airport. We noted that the process appears to have merits, but it would be for HAL to demonstrate the benefits for the airline community and consumers; and
- we welcomed the steady progress made by HAL on implementing its consumer research and engagement strategy in response to our previous recommendations. We expect HAL to continue to deliver on this strategy, engage closely and constructively with stakeholders, including the Consumer Challenge Board (CCB) and the airline community, and be responsive to Arcadis' review of the steps HAL is taking to ensure consumers' interests are reflected in its masterplan. We also welcome the focus the new governance protocol places on consumer interests.

12. We confirmed that the provision of high quality information on costs and efficiency in a timely way, together with a realistic and fully integrated end to end schedule, will be fundamental to the success of capacity expansion.

## Stakeholders' views

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13. We received responses to the April 2018 Consultation from ten stakeholders and these have been published on the CAA's website.<sup>9</sup> These responses, and our views are summarised in the relevant chapters of this consultation. Where we have addressed respondents' comments in previous consultations, we have not necessarily repeated our views in this document. Where comments are outside the scope of this consultation, they will, where relevant, be addressed in future CAA publications.

## Main issues raised in this consultation

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14. In chapter 1, we explain that, following the designation of the NPS, it has become clear that there is additional pressure on the overall timetable and that a number of HAL's deliverables have slipped back by a period of up to six months. While HAL is still planning on the basis of receiving a DCO in 2021, if there were to be any more delays, planning consent might not be received until 2022.
15. If these further delays crystallise it may be appropriate for us to set a three year, rather than two year, interim price control arrangement. In setting any such three year interim control it would be important to ensure that the arrangements properly share efficiency gains with, and protect the interests of, consumers. Our initial view is that it may be appropriate to conduct a full reset of the cost of capital for a third year of interim arrangements in addition to the review of the assumptions we have already said that we will carry out to support a two year interim price control. We have not made final decisions on these matters and will consider carefully any representations we receive from HAL or other stakeholders on these issues.
16. Chapter 1 also sets out our views on the possibility of a commercial deal between HAL and the airlines operating at Heathrow airport that could wholly or largely replace the need for an interim price control. There could be a number of significant advantages to a commercial deal (including starting to move the

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<sup>9</sup> See: <https://www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/Licensing-and-price-control/Heathrow-price-control-review-H7/>

relationships between the airport and airlines to a proper commercial footing). Nonetheless, we would need to test whether any such arrangement would properly further the interests of consumers and would reflect the interests of the range of airlines operating at Heathrow airport. Whether any agreement was supported by a wide range of airlines would be an important consideration and if an outline commercial deal emerges we will consult on whether it furthers the interests of consumers.

17. Chapter 2 assesses the case for a possible modification to HAL's licence to further the interests of consumers through a new condition promoting economy and efficiency in the operation, maintenance and timely development of Heathrow airport. It picks up on the themes raised in our consultations since 2014 on this subject, as well as stakeholders' views, and discusses the limits of the CAA's existing regulatory tools.
18. Such a licence condition could be introduced at the start of the interim price control period and would be part of the suite of licence conditions designed to incentivise efficiency. In response to HAL's concerns that such a condition would be too vague, the condition could include a list of areas of focus which could be amended over time, including making efficient and effective preparations for a DCO application and planning for capacity expansion. The condition would not seek to mandate the construction of the wider capacity expansion programme. It would also be broadly consistent with the licence conditions or obligations on regulated businesses in other sectors.
19. Chapter 3 gives a further update on our approach to addressing issues raised by potential alternative arrangements for delivering new capacity at Heathrow airport. In the April 2018 consultation we explained that our intention was that HAL should explore a full range of alternative arrangements, such as third parties designing and building significant elements of capacity expansion and/or developing alternative proposals for financing and delivering aspects of the capacity expansion programme. The aim of this approach is for HAL to exploit competitive forces to a greater extent than its business as usual approach to procurement, with these alternative arrangements being demonstrably efficient, delivered in a timely way and consistent with protecting the interests of consumers.

20. The chapter summarises the responses we received to the April 2018 Consultation and confirms that, to ensure that our efforts in this area are properly targeted, the current focus for our work on alternative delivery will be to consider both HAL's Innovation Partners process and the Arora Group's plans for airport development. We go on to discuss what our next steps should be in relation to these matters before setting out the information we expect the Arora Group to provide before we would be in a position to consider further how best to develop the regulatory framework to take account of its proposals. Nonetheless, any DCO application submitted by the Arora Group would be a matter for the Planning Inspectorate to consider.
21. Chapter 4 deals with our policy on making allowances for surface access costs to support the setting of HAL's next main price control. It proposes specific amendments and clarifications to the drafting of our existing policy to reflect the circumstances of capacity expansion at Heathrow airport and the targets and obligations set out in the NPS.
22. It confirms that we will not determine whether HAL's surface access strategy will meet the targets set out in the NPS as this is a decision for the planning process. Our focus will be on assessing what level of efficient costs are in consumers' interests and should therefore be passed through to airport charges. We also confirm that where road infrastructure (such as the M25) must be moved to allow for the construction of new capacity, we will treat this as a construction cost rather than a surface access cost.

## Capacity expansion and scarcity rents

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23. In our consultations on capacity expansion, we have consistently noted the substantial costs for consumers associated with significant delays to capacity expansion.<sup>10</sup> The Airports Commission referred to this issue in its final report,<sup>11</sup> in particular, identifying "significant scarcity rents accruing to airlines operating at

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<sup>10</sup> See, for example, the April 2018 Consultation at paragraph 1.19.

<sup>11</sup> See the Airports Commission Final Report at paragraph 6.49:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/440316/airports-commission-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440316/airports-commission-final-report.pdf)

Gatwick and Heathrow".<sup>12</sup> The issue of scarcity rents has been raised by stakeholders in response to our previous consultations.

24. HAL commissioned Frontier Economics to produce a report titled "Competition & choice 2017 – A report prepared for Heathrow" (the "Frontier Report").<sup>13</sup> This report included an econometric analysis of airline fares and used the results of that analysis to conclude that fares would "decrease by 23% relative to other London airports as a result of removing the capacity constraint". International Airlines Group (IAG) responded with a critique of the Frontier Report and their own assessment of the impact of capacity constraint at Heathrow airport (the "IAG Response").<sup>14</sup>
25. The CAA has commissioned FTI to produce a report which assesses the economic rationale and econometric analyses in the Frontier Report and the IAG Response, and identifies areas where additional analysis may be helpful to further illuminate these issues. The FTI report is published alongside this document<sup>15</sup>. We welcome further engagement from interested stakeholders on these matters.

## Next steps

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26. We intend to publish a working paper on the regulatory treatment of HAL's early Category C (construction) costs in November 2018 followed by working papers on Category B (planning) costs, and financial ring fencing early next year.
27. During the first part of 2019, we will focus on setting the interim price control/assessing any commercial deal that emerges between HAL and airlines. Over the remainder of 2019, we intend to complete our work on the broad

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<sup>12</sup> A scarcity rent is an excess of price over the cost of supply that arises when there is insufficient supply in a market such that the price must rise in order to balance supply and demand.

<sup>13</sup> See Competition and Choice 2017 – A report prepared for Heathrow at page 52. This is available on the CAA's website at:

[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Commercial/Airports/HAL%20-%20Frontier%20Competition%20and%20Choice.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/HAL%20-%20Frontier%20Competition%20and%20Choice.pdf)

<sup>14</sup> See:

[https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Commercial/Airports/Files/IA%20G%20CAP1658%20response%20FINAL.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/Files/IA%20G%20CAP1658%20response%20FINAL.pdf)

<sup>15</sup> [FTI Consulting Report to the CAA on Scarcity Rents](#)

regulatory framework for HAL, consistent with it providing a price control business plan at the end of 2019.

28. Further details of the overall timetable for capacity expansion and our timetable for developing the regulatory framework are included in chapter 1.

## Our duties

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29. In developing this consultation, we have had full regard to our statutory duties under CAA12, which are set out more fully in Appendix A.

## Structure of this document

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30. The structure of this consultation document is as follows:
- chapter 1 provides an update on our approach to timetable issues and an interim price control to apply after the end of the existing Q6 price control until the full price control for the development of new capacity is in place;
  - chapter 2 consults on a possible new licence condition to be included in HAL's licence to further promote economy and efficiency;
  - chapter 3 describes our current thinking as to how we will approach alternative arrangements for delivering new capacity; and
  - chapter 4 provides an update on our surface access policy.

## Chapter 1

# The overall timetable and the interim price control

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## Introduction

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- 1.1 In the April 2018 Consultation, we explained our approach to the proposed interim price control arrangements for the two year period of 2020 and 2021. This is the period between the end of the present price control arrangements (31 December 2019) and when we expect our proposals for HAL's next main price control to take effect (1 January 2022). We have said this interim control should be properly coordinated with the overall timetable for capacity expansion. Following the publication of the April 2018 Consultation, there have been two important developments that suggest we should consider further key aspects of these arrangements.
- 1.2 The first development is that we are aware of discussions between HAL and a number of airlines on the possibility of agreeing commercial deals over 2020 and 2021, rather than relying on an interim price control. This chapter discusses our approach to a commercial deal and the work we might do to ensure that such arrangements are in the interests of consumers.
- 1.3 The second development is that, following the designation of the NPS in June 2018, it has become clear that there is additional pressure on the overall timetable and that a number of HAL's deliverables (including selection of its preferred masterplan and the launch of the statutory planning consultation) have slipped back by up to six months. Nonetheless, HAL continues to plan on the basis of making an application for development consent in 2020 and receiving a DCO in 2021, which would then allow the main construction activities to commence. This chapter explores the implications of these changes for our timetable for developing the regulatory framework, including whether a three year interim price control or arrangement might be appropriate.

## The April 2018 Consultation

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- 1.4 The current regulatory controls on the charges for the services that HAL provides airlines are due to expire on 31 December 2019 and already include a one year extension to the previous Q6 price control. The April 2018 Consultation proposed a two year interim price control to run from the end of the extended Q6 period on 1 January 2020 to 31 December 2021 with a price path of RPI-1.5% for 2020 and a further RPI-1.5% price reduction for 2021 (subject to a financeability test).
- 1.5 In response to stakeholder preferences for an interim control that is proportionate and straightforward to implement, we proposed a top down approach which would update the assumptions used in the Q6 price control for (i) passenger numbers, (ii) operational expenditure and (iii) commercial revenues. We also proposed updating the weighted average cost of capital (“WACC”) in relation to new debt costs and the rate of corporation tax.
- 1.6 We said we would reflect the difference between (i) the RPI-1.5% price path and (ii) the underlying revenue allowances calculated by reference to these updated building block assumptions, by making a corresponding adjustment to regulatory depreciation.
- 1.7 Taken together, we considered that this approach would further the interests of consumers as it would be proportionate and targeted and would better align the main H7 timetable with that of the wider programme for capacity expansion.
- 1.8 We noted that our approach is based on an assumption that the current timetable for capacity expansion would not change significantly and that, if a material change were to occur, such as the NPS not being designated during 2018, we could review our timetable and take whatever steps were expedient to protect consumers. These could include bringing forward the main review of HAL’s price control or setting a longer interim control on the basis of reopening more of the underlying assumptions.

## Interim price control and possibility of a commercial deal

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- 1.9 In response to the April 2018 Consultation, both HAL and airlines have continued to make representations on the approach to the interim price control that we consulted on in December 2017. For instance, HAL has expressed concerns about the adjustments to regulatory depreciation and the cost of new debt. Airlines have expressed concerns about price profiling and the possible addition of early Category C costs to the regulatory asset base ahead of HAL receiving consent for its DCO. We considered these issues in formulating the April 2018 Consultation, and remain of the view that the policy summarised in the section above is appropriate.
- 1.10 Nonetheless, as noted above, we also understand that HAL has been in discussions with airlines about the possibility of a commercial deal that would wholly or largely replace the need for an interim price control. In principle there could be a number of advantages to a commercial deal between HAL and airlines, including that:
- it would provide an example of how more commercially driven arrangements could reduce the need for the economic regulation of Heathrow airport, in the same way commercial arrangements have emerged at Gatwick airport and to a significant extent reduced the need for economic regulation;
  - it could build confidence in the ability of HAL and airlines to reach agreement on difficult issues and boost confidence in the discussions supporting capacity expansion;
  - if such arrangements could be concluded quickly, they could allow all parties (HAL, airlines and the CAA) to concentrate on the important matters relating to capacity expansion, which would be very much in the interests of consumers; and
  - agreement on commercial terms should mean that any such arrangement reasonably reflects the interests of both HAL and airlines.
- 1.11 We would need to test whether any such commercial deal properly reflected the interests of a range of airlines operating at Heathrow airport (including a mix of

bigger and smaller airlines, a mix of those operating predominantly short and long haul and a mix of ownership) and furthered the interests of consumers. If we found that the commercial deal were to treat all airlines on a broadly equivalent basis and there were to be no compelling objections from airlines, we could then focus on consulting on whether any commercial deal furthers the interests of consumers.

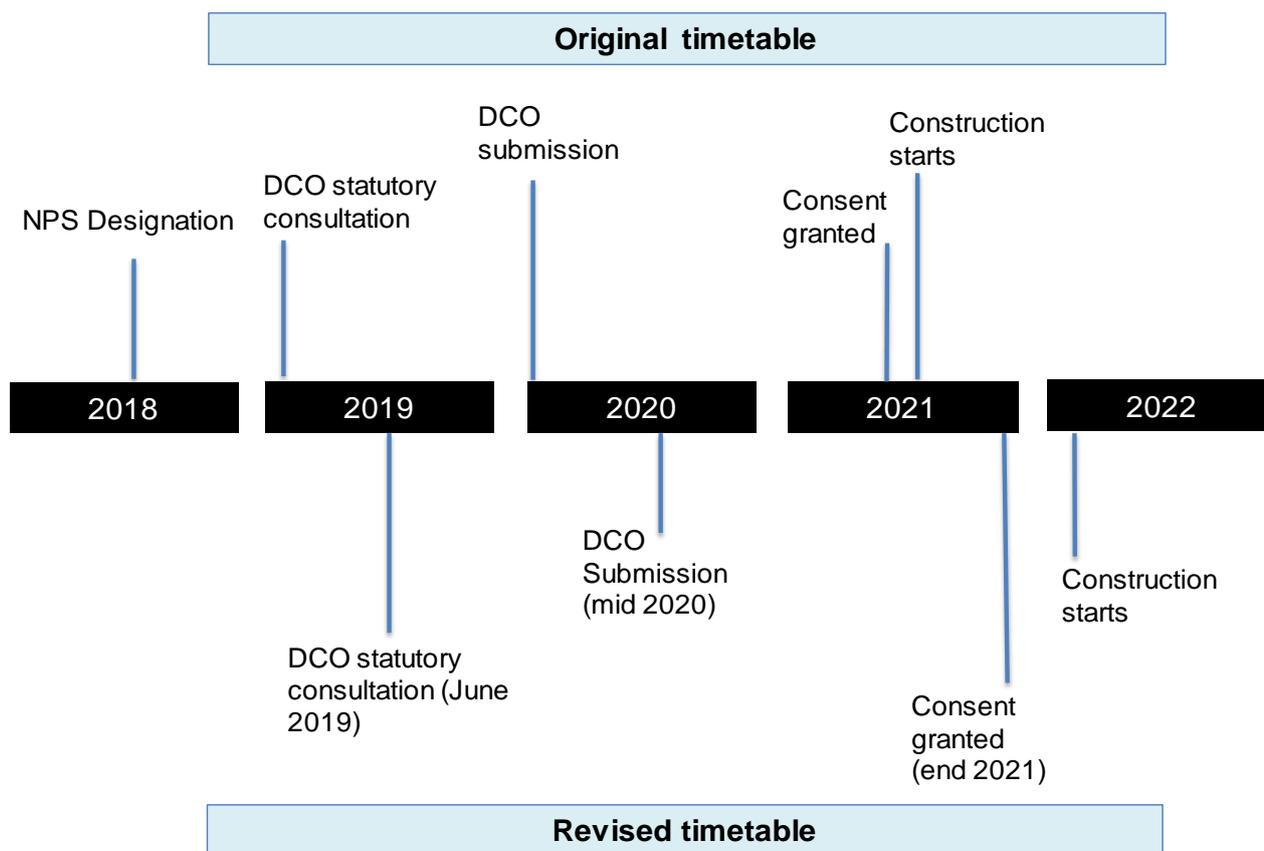
- 1.12 If a commercial deal were to emerge and we found it to be in the interest of consumers, we would not need to undertake the interim price control review on the basis we currently envisage. However, we may still need to modify HAL's licence later in 2019 to ensure that its price control arrangements are properly consistent with the commercial deal and to make any other appropriate changes to HAL's licence (including the licence condition discussed in chapter 2).

## Overall timetable

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### HAL's revised timetable

- 1.13 HAL has recently confirmed to us and to airlines that a number of factors are putting pressure on its timetable for capacity expansion, including:
- the NPS being designated later than it anticipated;
  - additional complexity with the masterplanning process; and
  - delays with the land referencing process.
- 1.14 As a consequence, HAL has undertaken a review of its proposed schedule. It recently announced changes to the time when it will select its preferred masterplan for capacity expansion and when it will issue the statutory consultation ahead of its application for development consent.
- 1.15 HAL's next public consultation, scheduled for January 2019, will focus on future airspace design options. This will be followed by a statutory planning consultation in June 2019, which will seek views on the preferred masterplan for expansion and how HAL will manage and mitigate the effects of its growth on local communities. In overall terms, we understand the impact of this revised schedule is likely to be a delay of around six months as shown in Figure 1 below.

**Figure 1: Timeline showing original and revised key milestones**

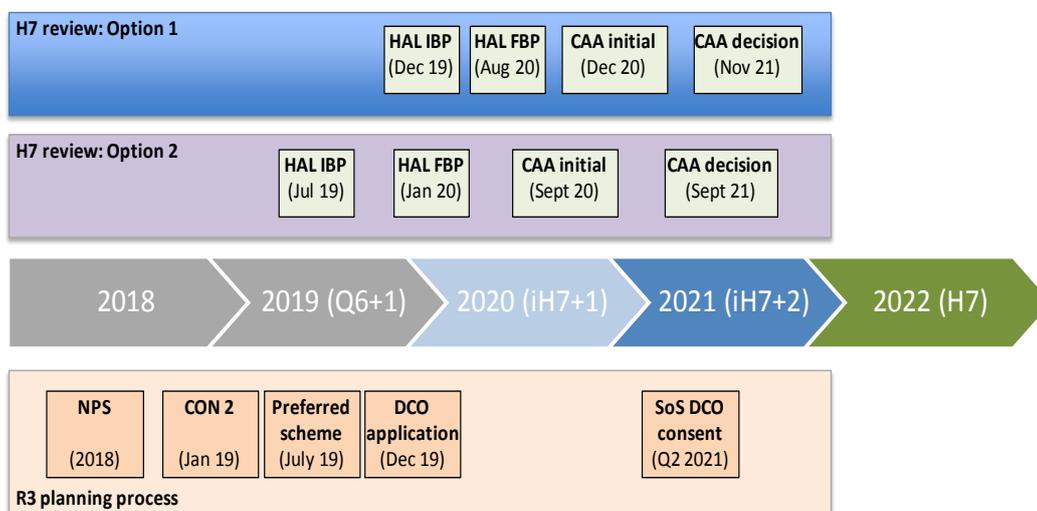
**Source: CAA analysis of information provided by HAL**

- 1.16 In a submission to the CAA on these matters dated 28 September 2018, HAL has said that it believes the schedule to be robust but the complexity and consultative nature of the process could result in further changes to the schedule. It hopes that any further changes will be relatively minor. It has also said that it will continue to review and update this plan at regular intervals.

### **Implications for the regulatory timetable**

- 1.17 We have previously set out the advantages of aligning the timetable for the development of the regulatory framework with the wider programme for capacity expansion. The April 2018 Consultation set out the following timetable options for developing the regulatory framework.

**Figure 2: Options for milestones for the H7 review under a two year interim price control**



**Note: “iH7” refers to the “interim price control”**

- 1.18 We also consulted on the timing of HAL’s price control business plan, with the suggestion that HAL’s initial price control business plan might either be provided in the middle or at the end of 2019.
- 1.19 The delay in HAL’s expansion schedule means that a price control business plan will not now be practicable by the middle of 2019 so we are confirming that the business plan should be provided by the end of December 2019. We have also considered whether there should be a final price control business plan or whether HAL should update information on a more flexible basis in response to constructive engagement with airlines and other stakeholders. Our present view is that one high quality business plan with information updated on a flexible basis would be most consistent with a proportionate, targeted and focused approach to regulation. HAL would need to provide this updated information on a timely basis to facilitate the CAA to set its price control for HAL in a timely manner, taking into account the legal requirements the CAA must follow when modifying the licence.
- 1.20 It is important that these changes enhance rather than diminish the role of constructive engagement. We expect HAL to consult carefully with airlines throughout the masterplanning and business plan processes to ensure that these plans appropriately reflect the views of airlines. Following the publication of the

business plan, there would be further opportunities for airlines to comment and HAL to modify and update its plans in response.

- 1.21 In light of the above considerations, we have developed the revised timetable for developing the regulatory framework for HAL as set out below.

**Figure 3: Timetable for developing the regulatory framework**

<b>Q4 2018</b>	Working paper on Category C costs
<b>Q1 2019</b>	Working papers on Category B costs and financial resilience and ring fencing
	Publication of consultancy studies on the H7 WACC and the WACC for RP3
	Initial proposals for Interim Review (or consultation on commercial deal)
	Further consultation on the regulatory framework for capacity expansion
<b>Q3 2019</b>	Final decision on Interim Review / commercial deal
	Updated consultation on the regulatory framework for capacity expansion including update on affordability and financeability
<b>Q4 2019</b>	Interim review licence modifications
	HAL regulatory business plan (December 2019)
<b>Q3 2020</b>	CAA initial proposals for H7 review
<b>Q1 2021</b>	CAA updated proposals for H7 review
<b>Q3 2021</b>	CAA's statutory notice proposing modifications to HAL's licence
<b>Q4 2021</b>	CAA's decision modifying HAL's licence
<b>January 2022</b>	New price control and licence conditions come into effect

### **Implications for the interim price control/commercial arrangements of further delays**

- 1.23 We based our approach in the April 2018 Consultation on the assumption that the current timetable for capacity would not change significantly and that, if a material change were to occur, we could review our timetable and take whatever steps were expedient to protect consumers. The changes that have been

introduced into HAL's timetable involve a delay to its milestones and deliverables, with HAL hoping to receive planning consent approximately six months later in 2021 than originally envisaged. If the timetable were to slip further, planning consent would not be expected until 2022 and we would need to consider extending the interim price control (or commercial arrangements) for a third year.

- 1.22 If such delays were to emerge, we would then need to consider how best to respond to protect consumers. The appropriate steps would depend on the precise circumstances of any further delays, but at the very least we would expect that the terms of a third year of an interim arrangement would reflect the broad approach to setting interim price controls set out in the April 2018 Consultation. We explained that the longer an interim arrangement would be in place, the greater the range of the assumptions that support the price control should be reopened to ensure that the price control would properly share efficiency gains and protect the interests of consumers.
- 1.23 The April 2018 Consultation explained that reviewing all of the incentive arrangements and all of the elements of the WACC would be unduly complex for a two year interim price control. We also noted that the PwC work we published in December 2017 provided only an early and preliminary view of HAL's WACC and that further significant work would be required before we could determine HAL's WACC.
- 1.24 In the case of the third year of an interim arrangement, the balance of considerations would change and there would be time to reset HAL's WACC for its "business as usual" activities. Bearing these issues in mind, and in order to ensure that unintended benefits do not accrue to HAL from delays in the timetable if a third year of the interim arrangements were to be required, our initial view is that it may be appropriate to conduct a full reset of the WACC for a third year of any interim arrangements, if it becomes necessary to extend the interim price control to cover this period.
- 1.25 This would be in addition to the work we explained would be necessary to support the two year interim price control which involves a review of the high

level assumptions on passenger numbers, operating costs and commercial revenues.

- 1.26 We have not made final decisions on these matters and will consider carefully any representations we receive from HAL or other stakeholders on these or related issues.

## Views invited

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- 1.27 Views are invited on any aspect of the issues raised in this chapter and, in particular, on:
- the changes to the timetable for developing the regulatory framework and whether we should have a single price control business plan submission from HAL with targeted and focused updates of this information; and
  - if it were to become clear that a three year interim price control is required, what broad approach we should adopt to establishing these arrangements.

## Chapter 2

## Promoting economy and efficiency

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### Introduction

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- 2.1 By developing the regulatory framework for HAL we can promote efficiency in a number of different ways, including designing incentive arrangements as part of HAL's price control, promoting competitive and market-based arrangements to support capacity expansion, and developing appropriate licence obligations for HAL.
- 2.2 This chapter assesses the case for a possible modification to HAL's licence to protect the interests of consumers by providing for a new condition further promoting the economical and efficient operation and maintenance, and timely development of Heathrow airport. We have discussed such an approach in a number of previous consultations:
- on granting HAL's licence in 2014,<sup>16</sup> we said that we were considering the development of a licence condition relating to HAL's capital expenditure programme, not only requiring HAL to operate, maintain and enhance the airport economically and efficiently, but also incorporating clear processes for constructive engagement;
  - the June 2017 Consultation<sup>17</sup> referred to prior discussion of this issue, noting that HAL's licence does not adopt the approach taken in other regulated sectors of setting out an overarching expectation for HAL to operate, maintain and develop its assets in an economical, efficient and timely manner.<sup>18</sup> Rather, HAL has a specific obligation only to procure capital projects in an economical and efficient manner and to publish and

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<sup>16</sup> CAP 1151 at paragraph 2.155ff: <http://publicapps.caa.co.uk/docs/33/CAP1151.pdf>

<sup>17</sup> See the June 2017 Consultation at paragraph 3.19.

<sup>18</sup> See, for example, obligations set out in the licences of Network Rail and National Grid companies as well as in gas, electricity and water legislation.

report on a procurement code of practice.<sup>19</sup> The December 2017 Consultation also discussed the possibility of protecting the interests of consumers by using a new licence condition to guard against inefficient expenditure;<sup>20</sup> and

- the April 2018 Consultation set out some more detailed thinking on how such a condition might be implemented, including the potential for use of policy guidance to aid the transparency and effectiveness and facilitate the evolution of the focus of such a condition over time. We suggested that guidance might cover expectations that consumers may have in relation to design and development work for expansion, good faith engagement with airlines and third parties, timely and efficient preparation of a DCO application, addressing resilience and information provision to the CAA, airlines and other stakeholders.<sup>21</sup>

2.3 This chapter summaries stakeholder responses to the April 2018 Consultation on these matters, builds on our earlier thinking, explains that in due course we intend to introduce a new licence condition and sets out the broad form of the condition for further consultation.

## Stakeholder views

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2.4 HAL has consistently argued that licence modifications should be proportionate and targeted at areas where action is needed and raised concerns that a new condition might significantly increase regulatory risk for HAL.

2.5 It has suggested that:

- the CAA should avoid attempts at compulsion or penalty to drive expansion: it cannot mandate investment or future certainty through licence conditions;
- a condition is not needed as its behaviour and response to previous CAA priorities demonstrates it does not lack commercial and regulatory

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<sup>19</sup> See Condition C3 of HAL's licence.

<sup>20</sup> See paragraph 1.20.

<sup>21</sup> See paragraph 3.35.

incentives to act in consumers' interests: the existing arrangements for delivery of enhancements to the airport, including the incentives that the CAA uses through the price control work well;

- any licence obligation should be aligned to the CAA's duties, including the need for transparency and the CAA should only to take action where it is needed. A "vague" condition would not be compatible with better regulation principles, as it encompassed all areas of the airport, rather than being a "targeted" intervention, so raising the regulatory burden with no demonstrable benefit to consumers. It sees a condition as unnecessary, disproportionate and potentially counterproductive;
- the CAA has effective powers and incentives to drive HAL's actions and its "initial" focus should therefore be on developing balanced incentives rather than "*prioritising work on unjustified punitive actions that seem not to take account of HAL's positive compliance record*"; and
- such conditions in other sectors (especially rail) had proved to be difficult to interpret, providing limited protection for stakeholders. Any condition adopted should be targeted and proportionate, with a clear route to compliance to ensure it produces the intended outcomes.

2.6 HAL also rejected the proposed use of policy guidance to clarify any condition because it considered that it would undermine HAL's rights of defence in relation to the legal safeguards surrounding its adoption and revision.

2.7 In response to the April 2018 Consultation, HAL stressed that the CAA's focus should be on creating a balanced package of incentives to promote the timely delivery of capacity expansion. It also said that a general licence condition relating to efficiency would not be proportionate or targeted.

2.8 Other stakeholders have generally not voiced strong views on this issue, albeit that, in response to the June 2017 Consultation, there was some support for a condition from airline representatives and others, especially if it promoted third party competition. In response to the April 2018 Consultation, airline representatives remained open to the concept of a licence condition and guidance, but wanted to see detail on:

- the need for such a condition;
- whether the CAA was proposing an appropriate balance between the proposed licence condition and providing guidance; and
- whether the proposals would have unintended consequences.

## CAA views

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- 2.9 It is important to acknowledge HAL's concerns that a generic licence condition may not be justified and may have unforeseen consequences. In this context, we are clear that a condition promoting economy and efficiency should further consumers' interest by them not being exposed to inefficient costs. The aim of such a condition should not, therefore, be targeted at mandating the construction of particular projects or capacity expansion more widely, and certainly not mandating such construction irrespective of whether it is economical and efficient to do so. Rather, we see a licence condition on economy and efficiency as part of a suite of regulatory tools to provide assurance that, taken together, should incentivise efficiency in the behaviour of HAL in the interests of consumers.
- 2.10 To this end, we consider that an economy and efficiency licence condition should be focussed on the manner in which HAL conducts its business, as opposed to precisely what it delivers. As such, it would not be a "vague" or "catch all" obligation, but would be targeted on how HAL conducts its business. When viewed in this context, we consider that such a condition is reasonably straightforward to interpret, and this interpretation could be further strengthened by the precise drafting of the condition, as discussed in the next section.
- 2.11 We agree with HAL's view that the primary driver for promoting economy and efficiency on the part of HAL in the development of new capacity will be the development and implementation of a balanced package of price control incentives. Nonetheless, it is not practicable for price control incentives fully to capture all aspects of HAL's behaviour, particularly given a programme as complex and difficult as capacity expansion and the size of HAL's business overall. We also recognise HAL's view that the commercial pressure that the airlines apply to HAL to be efficient does have an impact. However, this is not a substitute for, or equivalent to, a licence condition focusing on the manner in

which HAL conducts its business and protecting consumers directly. Absent a licence condition, the CAA's powers to monitor HAL's behaviour and address any issues that might arise are more limited.<sup>22</sup>

- 2.12 At present, we are able to promote economy and efficiency on the part of HAL through the way we set price controls, but our ability to take action under the licence between price control reviews, is more limited. As it stands, this ability exists only in the narrow field of the procurement of specific capital projects and it does not extend to wider issues such as preparatory works, design, delivery or operational issues.
- 2.13 While we did not include such a condition in the original licence granted to HAL, we did commit to developing a condition. Since then, the development of proposals for capacity expansion and the designation of the NPS have emphasised the importance of the timely, efficient development of new capacity, and created an expectation on the part of consumers that new capacity will be delivered economically, efficiently and in a timely manner at Heathrow airport.
- 2.14 We have considered carefully the introduction of a condition to promote economy and efficiency in the context of our duties under CAA12 and, in particular, our duty to further the interests of consumers. This analysis indicates that a licence condition which promotes economy and efficiency in the operation, maintenance and the timely development of Heathrow airport would be appropriate to further consumers' interests by addressing a gap in the present regime. Such a condition would:
- give the CAA direct regulatory oversight over broad aspects of HAL's conduct with or without expansion and providing a basis for intervention if unforeseen conduct by HAL causes detriment to consumers;
  - help to frame and facilitate early discussions of relevant issues between the CAA and HAL, that should help reduce or avoid the need for formal actions; and

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<sup>22</sup> For example, the CAA might need to wait until the following price control to take action on costs and would not be able to use its enforcement powers absent a licence condition in respect of which to use them.

- provide a clear expectation for HAL in developing its business assurance processes that those processes should ensure that they help it to meet the needs of consumers.

2.15 Our analysis of such a condition in the context of our duties under CAA12 is set out in Appendix B. This indicates that a licence condition to promote economy and efficiency would be in accordance with our statutory duties.

## Developing the licence condition

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2.16 The drafting of the licence condition should help address some of HAL's concerns that the condition would be too vague and not sufficiently targeted. Nonetheless, there needs to be a sufficiently broad approach to allow the condition to capture circumstances not foreseen and dealt with in setting HAL's price control. This new condition would sit alongside existing specific obligations on HAL's procurement of capital projects. We consider that the drafting of the condition may be broadly along the lines of the following:

*“The Licensee shall conduct its business in an economical and efficient manner so as to secure the:*

*(a) operation and maintenance; and*

*(b) timely enhancement and development*

*of Heathrow airport.”*

2.17 To enhance certainty and reflect the specific circumstances of HAL, the condition could identify areas where economy and efficiency might be of particular importance, while making clear that a focus solely on these would not be sufficient to discharge its overall responsibility.<sup>23</sup> If the obligation were introduced

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<sup>23</sup> By contrast, we do not consider that it is necessary or desirable for the condition to refer to consumers directly, for example by including the words “to meet the reasonable expectations of consumers” because this might lead to debate about the scope of the condition. While similar wording is used in Network Rail's licence, equivalent provisions in other sectors do not follow this approach. We consider that furthering interests of consumers will be central to the operation of such a condition because the general duties of the CAA under CAA12. We consider that these general duties are sufficient to ensure that the condition achieves this, for example, in relation to enforcement action.

for the interim price control (broadly covering the period from the end of 2019 to the grant of a DCO for the development of new capacity), these could include:

- preparing a DCO application with due regard for the requirements of the NPS;
- designing new capacity to be economical and efficient in relation to not only the cost of delivery but the ongoing costs for HAL and its customers of operating and using the new capacity; and
- engaging with airlines and other stakeholders to deliver their needs, including providing timely and accurate information.<sup>24</sup>

2.18 These expectations would then need to be revised to respond to the circumstances of the next main price control review and the granting of a DCO. A revised condition could, for example, refer to issues such as the efficient, timely construction and operating the existing airfield with a higher number of flights, if this is permitted under a future DCO. It could refer to other aspects of HAL's performance in addition to these issues. These changes would require a formal modification of HAL's licence and HAL would have the opportunity to consider the reasonableness of the overall package and appeal to the Competition and Markets Authority if it considered such a reference to be appropriate. This approach could substitute for the guidance discussed in the April 2018 consultation and would have the advantage of being fully integrated into HAL's licence.

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<sup>24</sup> For example, the condition could read as follows:

*"In complying with its duty under condition [ ], the licensee shall*

- (a) plan any application for development consent it makes under the Planning Act 2008 with due regard for the requirements of the Airports National Policy Statement;*
- (b) design any new capacity to be economical and efficient in relation to both the cost of delivery and the ongoing costs for the licensee and its customers of operating and using that new capacity; and*
- (c) engage with airlines and other stakeholders to deliver their needs, including providing timely and accurate information.*

*Compliance with these requirements shall be without prejudice to the general nature of the obligation set out in condition [ ], and compliance with these requirements shall not, be sufficient to exhaust the licensee's general duty under that condition."*

- 2.19 Bearing this approach in mind, we consider that an obligation of this kind would be sufficiently clear such that compliance should not be unduly onerous: HAL should already have business assurance processes in place to ensure that its activities are meeting the interests of its airline customers, so this obligation should help bolster the importance of those processes. This may assist the effectiveness of those existing processes by emphasising the importance of economy and efficiency within HAL.

## When should this obligation be introduced?

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- 2.20 If introduced alongside the arrangements for the interim price control period, we consider that such a condition would bring its benefits during the period when:
- the DCO application is being developed; and
  - regulatory incentives on HAL will be comparatively weak.
- 2.21 At this time, HAL will not yet be subject to the full package of price control incentives for the development of new capacity which will be introduced subsequently as part of the main H7 price control. Nonetheless, by focusing the condition on issues such as preparing a DCO application and the design of new capacity, HAL should not be exposed to undue risks or uncertainties. We expect the condition would then be modified at the next main price control review to reflect the grant of a DCO and the circumstances of the new price control. Rights of appeal to the CMA would then cover any changes to the licence condition as well as to the new price control.

## Formalising constructive engagement through the licence

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- 2.22 As noted above, at the time the licence was granted to HAL, we considered the development of a condition in relation to constructive engagement. The CAA notes that:
- even though we have raised this issue in consultation, stakeholders have not advocated that a condition should be developed in relation to the process or delivery of the outcomes of constructive engagement;

- there is a risk that prescriptive rules in the licence in relation to the form of constructive engagement may be too inflexible to deal with stakeholders' needs and expectations, especially in the context of the evolving processes for new capacity; and
- the development of the Section 16 Enhanced Engagement process currently helps to provide the framework for engagement processes.

2.23 Consequently, we do not at present consider that there is merit in bringing forward proposals for a licence condition relating specifically to these matters.

## Views invited

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2.24 Views are invited from stakeholders on any of the issues raised in this chapter and, in particular, on:

- the merits of a licence condition on economy and efficiency, as discussed in this chapter and Appendix B;
- the initial drafting of the licence condition as set out in this chapter, including the areas of particular focus identified for the period of the interim price control; and
- the introduction of such a condition at the end of 2019.

## Chapter 3

# Alternative delivery arrangements

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## Introduction

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- 3.1 In previous consultations, we have explained the advantages of HAL exploring alternative commercial and delivery arrangements for capacity expansion at Heathrow airport. Our intention was that HAL should explore a full range of alternative arrangements, such as third parties designing and building significant elements of capacity expansion and/or developing alternative proposals for financing and delivering aspects of the capacity expansion programme. The aim of this approach is for HAL to exploit competitive forces to a greater extent than its business as usual approach to procurement, with these alternative arrangements being demonstrably efficient, delivered in a timely way and consistent with protecting the interests of consumers.
- 3.2 Chapter 3 of the April 2018 Consultation set out our approach to encouraging HAL to engage with potential third party promoters of alternative arrangements that could be integrated into the overall plans for capacity expansion. It also considered the development of licence obligations for HAL relating to engagement, delivery and transparency and noted that these issues should be considered alongside the development of our wider policy and the progress made by HAL in assessing and facilitating alternative arrangements.<sup>25</sup>
- 3.3 Since we published the April 2018 Consultation, it has become clear that the Arora Group's intention is to pursue its proposals for alternative delivery by making its own application for development consent under the Planning Act 2008. Such an approach may allow the Arora Group to compete with HAL to provide new capacity at Heathrow airport, as it would in essence be an alternative developer for some or all the elements of capacity expansion. In this light, we have published further information and guidance to assist parties in

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<sup>25</sup> We explore these issues further in chapter 2 and Appendices B and C of this consultation.

understanding our approach to issues relating to alternative delivery arrangements. This took the form of the Technical Information Note published in August 2018 on the integration of alternative arrangements with the regulatory framework for capacity expansion<sup>26</sup> and the guidance we have provided subsequently on the provision of information by HAL to promoters of alternative arrangements.

- 3.4 It should also be noted that the CAA is a statutory consultee under the Planning Act 2008. We have been engaging with the Planning Inspectorate on the DCO application process being conducted by HAL, and we will engage with it on any DCO application from the Arora Group. As a statutory consultee, we will be asked to comment on whether our statutory roles, including in relation to economic, safety, airspace and security regulation, suggest that there are likely to be any impediments to the grant of planning consent.
- 3.5 This chapter summarises the responses to the April 2018 Consultation and the CAA's views, provides updates on HAL's progress with its Innovation Partners process and our approach to the Arora Group's plans. It consults on next steps including a proposed approach to testing the credibility, feasibility, and deliverability of the Arora Group's plans.

## Stakeholder views

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- 3.6 HAL's response to the April 2018 Consultation made a wide range of points relating to the regulatory framework and our policy on alternative commercial and delivery arrangements, including that:
- the CAA should adopt an evidence based, focused approach consistent with the principles of Better Regulation;

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<sup>26</sup> See Economic regulation of capacity expansion at Heathrow: Technical information note on the CAA's approach to dealing with licensing issues raised by potential alternative developers of new capacity at Heathrow airport (the "Technical Information Note"): [https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard\\_Content/Commercial/Airports/Files/TechnicalInformationNote-HeathrowCapacityExpansion.pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Accordion/Standard_Content/Commercial/Airports/Files/TechnicalInformationNote-HeathrowCapacityExpansion.pdf)

- HAL has been involved in competitive and transparent processes and its plans have already been subject to intense scrutiny, for example through the Airports Commission process. Its ambition is to continue to own and operate the hub airport as a single entity;
- it remains interested in a more commercially driven approach between the airlines and airport to facilitate capacity expansion; and
- any changes to the regulatory framework or licence modifications should be made with caution, with it being clear that changes meet proper objectives and that they are appropriate and proportionate.

3.7 Airline respondents expressed strong support for the introduction of more competitive pressure and discipline into the capacity expansion programme at Heathrow airport. They also said that the CAA should define “timely delivery” and not prioritise speed of delivery over efficiency as this could deter third party interest and involvement. They said that the CAA should do more to ensure that HAL engages in good faith and that it should be required to provide information to third parties to facilitate discussion and development of alternative commercial proposals. Airline representatives also remained interested in the idea of a separate “BuildCo” to pursue capacity expansion. Some airlines also supported additional licence obligations on HAL to require it to promote competition and protect the interests of consumers.

3.8 The Arora Group stated its intention to commit significant resources and investment to developing its own proposals for capacity expansion, including the full work necessary for its own DCO application. It said the CAA:

- has a clear statutory responsibility to enable competition in the provision of Airport Operation Services; and
- should promote an independent process that places HAL and alternative proposals side by side, and that the CAA’s suggestions for Enhanced Engagement were incorrect, unfair and not sufficiently proactive and vigorous.

3.9 Following its response to the April 2018 Consultation, it made further representations on how its separate proposals for development at Heathrow

airport could be accommodated within the regulatory framework and raised concerns about the provision of information by HAL to support the development of its proposals.

- 3.10 As part of their representations, airlines and the Arora Group (in response to both our December 2017 and April 2018 Consultations) have made a number of specific suggestions for how the CAA should carry out its regulatory duties under CAA12. These matters are discussed further in Appendix C.

## CAA views

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- 3.11 We agree with HAL that policy should be based on evidence and be consistent with good regulatory principles and practice and note that these are requirements in CAA12.
- 3.12 In this context, in the January 2017 Consultation, we emphasised the importance of HAL demonstrating that its estimates of costs are efficient and providing supporting evidence. We note that HAL is still developing its preferred masterplan so some uncertainty is inevitable given the maturity of the design. Nonetheless, we consider that HAL has made only limited progress in providing convincing information on costs and efficiency and, in these circumstances, it is appropriate and proportionate for us to continue to consider how best to provide further reassurance to stakeholders on these important matters and to make sure HAL is properly accountable. This will include further developing regulatory incentives, licence obligations and leveraging (to the extent it is practicable and reasonable to do so) on competitive forces. We regard this broad approach as transparent, proportionate and consistent.
- 3.13 It is also important that both our efforts and the regulatory framework are properly targeted. Airlines have made interesting suggestions around a BuildCo idea that might have similarities to the approach adopted in the water sector to develop the Thames Tideway project. However, airlines have provided relatively little detail on how this idea might work in practice at Heathrow airport. While we understand some of the potential advantages in such an approach, we have previously explained that we do not have powers to impose such arrangements on HAL. Bearing these considerations in mind, the immediate focus for our work

on alternative delivery arrangements is to consider the potential of HAL's Innovation Partners process and the Arora Group's plans for airport development.

## HAL's Innovation Partners process

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- 3.14 HAL has stressed that it always intended to work with commercial partners to drive innovation and support capacity expansion and that it is developing a procurement strategy in consultation with airlines for market testing in 2019. It has said that it accelerated the launch of Innovation Partners in April 2018 to support this approach.
- 3.15 HAL describes Innovation Partners as a process which seeks to identify organisations with knowledge, capability and an innovation proposal which offers additional benefits over the current expansion development plan. HAL has told us that it received 160 expressions of interest in July 2018 from 145 organisations representing a broad mix of disciplines. HAL is undertaking an assessment of these proposals as it prepares for the next phase of the process.
- 3.16 HAL has also said that, while its Innovations Partners process meets all the criteria proposed by the CAA for alternative delivery arrangements, any proposals coming forward through this process must meet certain tests. These include aligning with HAL's strategic objectives, regulatory and planning constraints and supporting the operation of a single hub airport. HAL has also said that it does not believe that it would be in the interests of consumers to fragment the core airport operation between separate owners and operators.
- 3.17 Some airlines have said that HAL's Innovation Partners process does not fully address the requirements to explore the introduction of greater competition through alternative providers. As part of the Enhanced Engagement process, we have also received some feedback from airlines that the Innovation Partners process appeared rushed, and the initial phases over complicated, which may have discouraged participation. Airlines have also noted that it is important not to exclude from consideration other credible schemes that are not submitted through the Innovation Partners process and which may be in the best interests of consumers.

3.18 In our view, the Innovation Partners process appears to have real merits, and we look to HAL to demonstrate the benefits that will flow from it to the airline community and consumers. Nonetheless, it is now clear that it does not meet all the criteria set out in the April 2018 Consultation for HAL in relation to alternative commercial and delivery arrangements. In particular, we said that while it is appropriate to consider the advantages and disadvantages of various forms of alternative arrangement (including separate terminal delivery operation and/or delivery), it would be premature to reach a judgement on these proposals at this stage in the process for capacity expansion at Heathrow airport. By contrast, HAL appears to have explicitly rejected separate terminal operation in its response to our April 2018 Consultation.<sup>27</sup> HAL should properly justify its approach to these matters, including by providing appropriate evidence.

## The Arora Group's proposals

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- 3.19 The Arora Group has indicated that it has plans both for the development of the western campus at Heathrow airport and a wider scheme for the overall expansion of the airport. It has said that it will apply for its own DCO and, if such an application were to be successful, this could create important interactions between the regulatory framework deriving from CAA12 and the regime under the Planning Act 2008.
- 3.20 In July 2018, the Arora Group wrote to the CAA about the above plans and asked for clarification on how our powers could accommodate it delivering all or parts of the capacity expansion programme at Heathrow airport (in particular, the western campus). In August, we published our response in the form of the Technical Information Note which set out further detail on our statutory powers in

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<sup>27</sup> As discussed in chapter 1 of the December 2017 Consultation, we will expect HAL to address how it has engaged with potential third party providers in its business plans for the H7 price control and if opportunities are not followed up by it, we will expect HAL to be able, in justifying its proposed costs, to demonstrate that its preferred approach better serves the interests of consumers and provides better value for money than the alternative. We will guard against the recovery of inefficient expenditure and, if there is evidence that HAL has not reasonably followed up opportunities for appropriate commercial and/or competitive arrangements, this may provide evidence of inefficiency.

responding to alternative arrangements and how we may take forward licence issues. Specifically, that note discussed our views on:

- our statutory powers to support, facilitate and regulate the development of alternative delivery and ownership mechanisms;
- the circumstances in which we might impose licence conditions on HAL that would require it to enter agreements with the independent operator of an independently owned terminal to facilitate the integration/operation of a new terminal with the airport;
- whether we could license a new participant without first conducting a new Market Power Determination (MPD) for Heathrow airport and, if a party other than HAL were to obtain a DCO, whether that party would require a licence under the Act before it could levy airport charges; and
- how we would engage with the Planning Inspectorate in relation to a third party DCO application under the Planning Act 2008.

3.21 Subsequently in August 2018, the Arora Group wrote to us about its concerns over information sharing and engagement by HAL. It said that HAL was refusing to supply it with information necessary for it to develop its proposals. Our response to this letter noted that the Arora Group's current proposals involve a strong element of competition and rivalry with HAL, because the Arora Group has proposals to take forward all of capacity expansion and apply for its own DCO, and so in essence it would be an alternative developer for some or all of the capacity expansion programme. As a result, our expectations for HAL's engagement and information provision to the Arora Group are accordingly different from those originally set out under our planning costs policy and should be seen in that competitive context.

3.22 We also said that we would expect any requests for information to be carefully targeted and justified, with a clear and reasonably full explanation of the requirements for each piece of information that is requested, including how it meets the policy set out by the CAA (including avoiding the unnecessary duplication of costs that might be borne by airlines or consumers). We noted that both the Arora Group and HAL should also be mindful of the requirements of competition law.

- 3.23 Our September 2018 interim update on Enhanced Engagement noted that the airline community has been keen to test the credibility and feasibility of the Arora Group's plans. We sought to facilitate this by asking Arcadis to conduct a "compare and contrast" review of the HAL and Arora Group plans. While there have been extensive discussions with the Arora Group on these matters, it has not proved to be practicable to agree the scope of such a review, and so only limited progress has been made on understanding the detail behind the Arora Group's plans. However, a revised scope for a review by Arcadis has now been agreed. The objective of this work is to provide a high level assessment of the Arora Group's capacity expansion plans to enable airlines and the CAA to develop a more informed understanding of the key aspects of those plans including the scope and design, costs, operability, timing and deliverability.
- 3.24 We consider it is very important that the Arora Group collaborates closely with Arcadis to make substantive progress in a timely manner, and thus support an initial assessment of the detail of its plans and whether these plans have the potential to meet airline aspirations and help protect consumers.

## Next steps

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- 3.25 If a party other than HAL, such as the Arora Group, applies for, and is granted, a DCO to allow it to develop all or part of Heathrow airport to deliver new capacity, adjustments to the existing regulatory framework both to facilitate and support these alternative arrangements may be required. As we are currently doing with HAL and its proposals for capacity expansion, it would be important to develop the regulatory framework in a timely way, both to support efficient investment and ensure consumers are properly protected. This could involve very significant work as we may have to address novel issues created by competing applications for development consent and the possibility that the Arora Group could be granted a DCO in relation to the western campus, with HAL continuing to operate and develop the rest of the airport.
- 3.26 To establish whether further detailed investigation of these issues is warranted, it will be proportionate to complete a proper assessment of the Arora Group's plans. This would involve testing the credibility, feasibility and deliverability of the

plans and the commitment of the Arora Group to work on commercial and regulatory arrangements that would protect airlines and consumers. Our present view is that such an approach should involve at least the following steps:

- timely completion of the Arcadis study described above together with the timely follow up of any particularly difficult or contentious issues emerging from the study;
- the Arora Group setting out clear and convincing plans for making a DCO application and demonstrating meaningful progress in resourcing and carrying these plans forward; and
- understanding the Arora Group's initial views on the commercial and regulatory arrangements that might support its proposals (including in relation to how they will be financed and work with the rest of the airport) and how, in principle, these could protect the interests of airlines and consumers.

3.27 If the Arora Group is able to provide convincing evidence and assurance in relation to the above tests then there may be a case for significant further work on the regulatory framework. To a large extent this would be shaped by the evidence that the Arora group provides and the views of wider stakeholders on these matters. Nonetheless, our initial view is that this work programme could encompass a number of phases:

- early considerations: there may be some issues that require early assessment to avoid the delay to progress that uncertainty may otherwise cause. For example, it may be appropriate to build on the issues in the Technical Information Note to set out the very broad shape of a possible regulatory framework for an alternative provider and how this might interact with arrangements for HAL;
- intermediate considerations: some issues might best be considered once we have further details of any alternative scheme and firmer evidence that it is progressing towards a DCO application. Examples of this might be the development of our approach to regulatory incentive mechanisms that might apply to a third party; and

- later considerations: some issues may not arise for a considerable time and may not be capable of being finalised until the outcome of competing DCO applications is known. For example, if there were to be a regulated interface between an alternative provider and HAL, this would need to be sufficiently flexible to evolve to meet the emerging challenges of developing and operating infrastructure in coordination with infrastructure being operated and developed by HAL. This would require work that could go on throughout the construction and operation of new capacity.

3.28 While we consider this a helpful framework within which further to develop our policy, we also note there are important caveats to this approach. Many factors of capacity expansion at Heathrow airport remain uncertain, and we will continually review our approach to ensure we are responding to the changing landscape and that our approach remains flexible enough to ensure that we further the interests of consumers.

3.29 At this time, it is particularly important for the Arora Group to help us understand more about the credibility, feasibility and deliverability of its proposals, in line with the tests discussed above.

## Views invited

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3.30 We welcome views on any aspect of the issues raised in this chapter and, in particular on:

- our broad approach to alternative delivery arrangements and focus on understanding more about the proposals from the Arora Group; and
- the steps identified above (the work of Arcadis, progress on the DCO application and understanding initial views on the commercial/regulatory proposition) for testing whether we should commit further resources to the detailed work necessary to consider how best to develop the regulatory framework to take account of DCO applications from competing parties.

## Chapter 4

# Surface Access

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## Introduction

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- 4.1 Capacity expansion at Heathrow airport will lead to substantially more travel to and from the airport by passengers, visitors and staff, and will generate significant additional demand from service providers and freight operators. Supporting these increases in demand may require significant investment in transport infrastructure. It is, therefore, important that our approach to making allowances for surface access costs in HAL's price control is consistent with protecting consumers and the timely and efficient delivery of capacity expansion.
- 4.2 The NPS requires HAL to show how it will mitigate the impact of expansion on local communities and the wider environment, including demonstrating that capacity expansion will not affect the UK's ability to comply with its legal obligations on air quality and ensuring that access to the airport is high quality, efficient and reliable.<sup>28</sup> HAL must also develop a surface access strategy to:
- promote sustainable modes of transport;
  - reduce congestion and environmental impacts;
  - reach a target of 50% of all journeys to and from the airport being by public transport by 2030, increasing to 55% in 2040; and
  - decrease staff car journeys by 25% and 50% in the same timescales.
- 4.3 The NPS also specifies that any changes to the M25 motorway required for the construction of the third runway must include sufficient provision to accommodate flexibility and future proofing.
- 4.4 This chapter deals with our policy on making allowances for surface access costs to support the setting of HAL's next main price control and our broad approach to costs associated with diverting the M25 motorway to allow for capacity

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<sup>28</sup> <https://www.gov.uk/government/publications/airports-national-policy-statement>

expansion. A revised version of our surface access policy is set out in Appendix D.

## The April 2018 Consultation and May 2018 working paper

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- 4.5 The April 2018 Consultation confirmed that, while the main principles of our surface access policy remained appropriate and consistent with our duties under CAA12, some areas needed clarification and updating. In addition, we:
- a) confirmed our view that it is not in consumers' interests to pay for surface access schemes that are not required for capacity expansion or for the efficient operation of the airport, and confirmed the importance of the "user pays" principle;
  - b) explained that the total cost of expansion (including surface access costs and costs of obligations arising in the planning process) must be subject to efficiency, affordability and financeability tests;
  - c) said we expected HAL to minimise the scope for unexpected costs to arise late in the process;
  - d) noted the advantages in greater coordination of surface access work between stakeholders, and that all parties should seek to agree common methods to assess costs and benefits;
  - e) suggested that we should take into account multi-modal surface access strategies required to meet wider legal or planning obligations around air quality or congestion targets through a holistic review of the costs and benefits of HAL's overall surface access strategy to ensure that it is met at the lowest overall efficient cost;
  - f) proposed that our analysis should include the impact of journeys made by visitors and staff, and additional traffic arising from service providers and freight operators at the airport, since these indirectly benefit consumers through the essential services they bring; and
  - g) we acknowledged Transport for London's (TfL) view that, where a contribution by HAL is justified, it may not always be appropriate to recover the residual costs (i.e. after taking account of the direct

contributions from users) on the basis of the proportion of benefits accruing to airport and non-airport users. We asked whether it would be appropriate to include an additional test to establish whether airport users properly fund the efficient incremental costs of a surface access scheme that is necessary for purposes other than airport expansion.

- 4.6 Points (a) to (c) above are dealt with in the section below on overall approach, points (d) to (f) in the section on multi-modal strategies and point (g) in the section on the benefits test.
- 4.7 In our working paper in May 2018,<sup>29</sup> we noted that regulatory allowances for any future proofing of the highways network should be strictly limited to initiatives that are supported by clear and compelling analysis. This should demonstrate that airport users should bear only efficient costs of investments, and only where investment is:
- essential for airport operation and/or necessary and appropriate;
  - consistent with our overall objectives of ensuring that capacity expansion is affordable and financeable.
- 4.8 We also confirmed that highway diversions needed only to allow the physical development of new airport infrastructure, rather than to improve access, would be considered as construction costs, not surface access schemes. These matters are dealt with below in the section on highway diversions.

## Our overall approach

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### Stakeholder views

- 4.9 HAL broadly welcomed our surface access policy. There was also support from airlines, but they emphasised the importance of the user pays principle and expressed concern about the potential costs of surface access arrangements.
- 4.10 Another respondent said that:

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<sup>29</sup> See: <http://publicapps.caa.co.uk/docs/33/CAP1674WorkingPaperH7R3WACC.pdf>

- the user pays principle should apply at the point of use; and
- every effort should be made to avoid any shortfall between the costs and contributions from direct users.

### CAA views

- 4.11 We confirm our broad approach to surface access and the importance of the user pays principle (that direct users should contribute as far as reasonably practicable to the costs of surface access arrangements).
- 4.12 The regulatory allowances we make for surface access costs should also be seen in the context of the overall expansion programme and the importance of affordability and financeability in the round. Therefore, the costs HAL includes in its plans for surface access should be consistent with the wider tests of efficiency, affordability and financeability.
- 4.13 Consistent with the above, it will be important that the allowances we make for surface access costs in setting HAL's next main price control reflect only the efficient costs and meet the other criteria set out in our surface access policy. Bearing this in mind, HAL will need to demonstrate both that:
- its overall strategy provides the most efficient solutions to meet essential operational and planning requirements; and
  - individual schemes are efficiently costed and provide value for money.
- 4.14 We expect HAL to deliver convincing plans for surface access, supported by evidence, as part of its masterplanning and business planning processes as well as with its DCO application. We will seek to test the costs that HAL proposes in a similar way to other aspects of the capacity expansion programme, but will also seek to lever on the expertise and assessments of other stakeholders to the extent it is reasonable to do so.

## Multi-modal strategies to meet required environmental targets

### Stakeholder views

- 4.15 There was support from a range of stakeholders for taking a holistic approach to assessing the costs and benefits of surface access schemes.

- 4.16 HAL considered this important to meeting its modal shift and air quality targets in a way that promotes overall efficiency. It said that its surface access strategy would include a range of interventions (in addition to capital investment) to incentivise behavioural changes and use infrastructure more efficiently.
- 4.17 An airline questioned whether the CAA should assess whether HAL's approach will meet planning and legal obligations and called for clarity on roles and responsibilities to ensure that the CAA's approach does not increase costs. One airline was concerned at our view that the oversight of the design and delivery of surface access arrangements was not part of our statutory role.
- 4.18 TfL cautioned against too narrow an interpretation of our duties, saying it should not prevent the airport taking steps to reduce its environmental and public health impacts beyond what might be the strict legal and planning requirements. It noted the importance of rail in encouraging significant sustainable mode shift and addressing air quality but highlighted the limits on how far the costs can be placed on direct users.
- 4.19 Highways England said there needed to be robust multi-modal traffic modelling to develop a clear understanding of the traffic impacts of both expansion and mitigations on the strategic road network. Another respondent suggested that the CAA should be more involved in the development of schemes rather than just looking at the efficient costs.
- 4.20 Another respondent said it considered the projects HAL is proposing will not make enough provision for growth even if Heathrow airport had only two runways, and substantial additional surface access capacity would be needed to prevent overcrowding and congestion. It also suggested that any road congestion charges should be used to fund additional public transport capacity and that shortfalls in funding should not be funded by the taxpayer.

### **CAA views**

- 4.21 We welcome the support expressed by respondents for holistic, multi-modal strategies to encourage modal shift to meet the targets set out in the NPS. We agree that such strategies and initiatives should support the provision of necessary surface access infrastructure in a way that is efficient.

- 4.22 We do not consider it is our role to determine whether the surface access strategy will meet the targets set out in the NPS as this is a decision for the planning process. Our role is to assess what level of efficient costs are in consumers' interests and should therefore be passed through to airport charges. It will be for HAL to demonstrate to us that, in developing its strategy, it has assessed a full range of options to achieve the most economic and efficient solutions to meet the targets. This should be supported by robust modelling and appropriate assurance.
- 4.23 We also do not consider it is our role to oversee the design and delivery of third party projects such as the proposed rail projects, as these are matters for the Office of Rail and Road (ORR) and the DfT. Our role in these projects is to ensure that any contribution that HAL seeks to pass through to airport charges is consistent with our surface access policy.
- 4.24 Where we can work collaboratively with, and reasonably lever on analysis or assessments completed by, other stakeholders (including but not limited to the ORR, the DfT, Network Rail and TfL) we will do so. More broadly, we welcome respondents' agreement on the importance of significant coordination and collaboration by stakeholders on surface access issues. HAL will need to demonstrate that it has actively sought airlines' and other stakeholders' views on its surface access strategy and we would give significant weight to any consensus reached on efficient costs.
- 4.25 We also encourage stakeholders and airlines to engage with HAL on proposals for surface access.
- 4.26 Some stakeholders have suggested we go further than encouraging collaboration. We do not consider that we have the vires, expertise or evidence to support the establishment of a separate entity to coordinate surface access arrangements, or to make allowances beyond those necessary to support targets identified as part of the planning process.
- 4.27 Consistent with taking a holistic approach to surface access arrangements, we confirm that our policy and approach will cover provision for journeys by

passengers, visitors and staff, and additional traffic arising from service providers and freight operators. These journeys:

- make up a significant part of the overall surface access demand, contributing to the impact on the environment;
- will be included in any determinations in the planning process; and
- are essential to the efficient operation of the airport and so bring benefit to airport users.

## Benefit tests

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### Stakeholder views

- 4.28 HAL said it would welcome further discussions with us on the attribution of residual costs as part of a wider conversation around benefits modelling.
- 4.29 Airline representatives stressed that any contribution to a third party scheme that will benefit non-airport users should be in line with the user pays principle and the other promotor should have an obligation to promote the use of the new asset by non-airport users to ensure efficient use. One airline said that airlines should not be expected to bear residual costs of surface access schemes that provide wider benefits to non-airport users.
- 4.30 TfL referred to its previous comments that it may not always be appropriate for contributions to third party schemes, developed for wider purposes than airport expansion, to be set based on narrow calculations of relative user benefits. As part of a holistic approach to assessing surface access costs, it suggested that the surface access policy should consider:
- whether the scheme would have been prioritised for delivery solely on its benefits to non-airport users; and
  - the proportion of the scheme cost that is primarily needed to unlock the scheme for the benefit of airport users.

### CAA views

- 4.31 We remain of the view set out in our April 2018 Consultation that our surface access policy should provide for sufficient funding such that non-airport users do not cross-subsidise the provision of infrastructure that has the sole purpose of connecting the airport to the wider transport network.
- 4.32 This could be achieved by testing for any such cross subsidy in the application of the benefits test and ensuring that the total contribution from airport users (including both revenue from fares and the contribution from the airport) is sufficient to cover the incremental costs of infrastructure that has the sole purpose of connecting the airport to the wider transport network.
- 4.33 We consider that such an approach would provide a better assessment of relative contributions between airport and non-airport users and have updated our approach in our revised surface access policy set out in Appendix D.

## Highway diversions

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### Stakeholder views

- 4.34 Highways England noted our statement that we did not consider it is in consumers' interests to pay for investments that are not required for capacity expansion. It said that investments to future proof the strategic road network as part of the expansion programme would fit within the criteria of necessary surface access provision to allow expansion. It said it would not agree to proposals that did not provide for such future proofing because of its own statutory and licence obligations to provide effective stewardship of the strategic road network.

### CAA views

- 4.35 We expect HAL to seek to agree with Highways England the most cost effective and efficient solutions for the M25 motorway and to demonstrate that these provide value for money for consumers. This should include an assessment of a range of options, the development of future proofing only to the extent that it is justified by cost benefit analysis and evidence that cost estimates reflect only efficient levels of costs.

- 4.36 As we noted in the May 2018 working paper where road infrastructure must be moved to allow for the construction of new capacity, we will treat this as a construction rather than a surface access cost.

## Views invited

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- 4.37 Views are invited from stakeholders on any of the issues raised in this chapter and in particular on the updated surface access policy set out in Appendix D.

## Appendix A

## Our duties

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1. The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
2. CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
3. CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
4. The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
5. 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.

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

## Appendix B

# Assessment of a licence condition promoting economy and efficiency against the CAA's duties

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## The CAA's duties in developing licence modifications

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2. This appendix sets out the CAA's analysis of a possible licence condition promoting economy and efficiency against its duties under CAA12.
3. CAA12 gives the CAA a broad discretion to include in licences such conditions as it considers are "*necessary or expedient*" having regard to its duties.<sup>30</sup>
4. The CAA's duty in s1 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 the introduction of a licence condition are "*the need to secure that all reasonable demands for airport operation services are met*" and "*the need to promote economy and efficiency and on the part of each holder of a licence.*"<sup>31</sup>
5. The CAA must also have regard to the principles that regulatory activities (including licence modifications) are carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases where action is needed.<sup>32</sup>

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<sup>30</sup> Section 18.

<sup>31</sup> Section 1(3)

<sup>32</sup> Section 1(4)

## Analysis of a licence condition promoting economy and efficiency against the CAA's duties

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### Is an obligation necessary or expedient having regard to the CAA's duties?

6. At present, the CAA primarily discharges its duties to further the interests of consumers by addressing the need to secure that all reasonable demands for airport operation services are met, and promoting economy and efficiency by HAL, through the manner in which it carries out its price control reviews and subsequently sets price controls. The only more “direct” obligation on HAL in this area is the obligation in HAL’s licence to procure capital projects in an economical and efficient manner.<sup>33</sup>
7. Even taking into account the Secretary of State’s ambition to keep airport charges close to current levels in real terms, we anticipate that HAL’s charges will be higher as a result of it developing new capacity than they otherwise would have been absent expansion. To protect the interests of consumers by ensuring that costs (and therefore charges) are no higher than they need to be to support the development of new capacity, consumers are entitled to expect that HAL will be required to conduct its business (including the development of new runway capacity) in an economical and efficient manner, thereby avoiding inefficiency and unnecessary costs to which they could be exposed.
8. The CAA considers that the approach of setting price control incentives for HAL that it has adopted up to now cannot ensure that HAL is incentivised to behave in an economical and efficient manner in relation to all aspects of its business.<sup>34</sup> While it might be possible for the CAA to design incentives covering all HAL’s expenditure to drive efficiency in the delivery of new capacity, reliance solely on incentives would require:

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<sup>33</sup> See Condition C3 of HAL’s licence

<sup>34</sup> See the following paragraphs for the reasoning behind this position.

- a) incentives covering the whole of HAL's activities, designed in such a way that they could be relied on, without more, to drive economy, efficiency and timeliness in all aspects of HAL's existing business and developing new capacity;
- b) incentives that did not create any risk of gaming or unforeseen inefficient consequences; and/or
- c) certainty that *ex post* reviews would be fully effective in protecting consumers from the costs of any inefficiency.

- 9. We consider that a) and b) above would require a level of detailed information being provided to the CAA, and a degree of foresight by the CAA, which are not realistic in the development of any price control, even aside the complexities and uncertainties that the development of new capacity will bring. In the short to medium term these protections are also less effective since, at least until the next main price control is in place, HAL will have limited incentives in relation to expenditure for planning and developing new capacity.
- 10. While *ex post* efficiency reviews may have a role to play in regulating HAL, they are most suitable for protecting the interests of consumers by disallowing inefficient costs rather than dealing with broader issues. We also consider that, because *ex post* efficiency reviews are typically conducted during the next price control review, they may not provide timely protection to consumers and are not accompanied by the broader range of tools, such as the use of orders, that enforcement action can bring.
- 11. Given these limitations, we consider that it is necessary for the CAA to consider the use of a licence condition which sets overall expectations for the way HAL conducts its business. We consider that such a condition may be of assistance in facilitating the oversight of HAL's approach in "real time", rather than after the fact. We note that this is an approach adopted in

other sectors subject to economic regulation alongside the use of incentives.<sup>35</sup>

12. In addition, we do not consider that commercial pressure from HAL's airline customers will necessarily suffice to ensure that HAL acts efficiently in the interests of consumers, not least because airlines do not have any power of veto over HAL's actions, nor do they have any investigatory or enforcement powers which might enable them properly to assess whether any perceived concern they may have is well founded.<sup>36</sup> Further, as commercial parties, they cannot be expected to take a fully objective or independent view of HAL's activities.

13. Since HAL's licence was granted in 2014, the importance of effective regulatory oversight, and the expectation of consumers in relation to new capacity, have increased, in particular by:

- the designation by the Government of the NPS which, among other things, creates an expectation on the part of consumers that new capacity will be delivered at Heathrow airport;<sup>37</sup>
- the emphasis on the importance of economic regulation set out in the requirement of the NPS that:

*"The applicant should demonstrate in its application for development consent that its scheme is cost-efficient and sustainable, and seeks to minimise costs to airlines, passengers and freight owners over its lifetime."*<sup>38</sup>

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<sup>35</sup> For example, gas and electricity networks, water and railways.

<sup>36</sup> See also paragraph [2.14].

<sup>37</sup> The NPS built, in part on the work of the Airports Commission which, while focussed on the benefits to the wider economy, rather than the interests of consumers, estimated the potential costs of failing to address capacity constraints to be very considerable, including significant costs for users. See chapter 3 of the Airports Commission Final Report:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/440316/airports-commission-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/440316/airports-commission-final-report.pdf)

<sup>38</sup> See NPS at paragraph 4.40.

- the consequence of our policy for the interim period, until we can formulate the package of full incentives for the next main price control, where a proportionate approach involves the top down assessment of some of the key assumptions underlying the price control, rather than a full review of all the incentive arrangements; and
- the feedback we have received from airlines and others in their responses to our consultations that they do not consider that HAL's behaviour is always efficient.

14. As we note above, there is a risk that incentives, however carefully designed, may not give the CAA any ability to investigate HAL's behaviour if it appears to act inefficiently or unreasonably. This could include failing to plan for capacity expansion or prepare a DCO application. Such an investigation could be used, for example, to determine why a particular outcome had occurred and whether any remedies would be appropriate in the interests of consumers. Nonetheless, we do not consider that such remedies could include making an enforcement order to mandate the main construction programme for capacity expansion. This will need to be subject to a full funding and incentive package as part of the main price control review, together with any wider licence modifications deemed appropriate at that time.

15. In this context, we note that, where they are conducted by companies subject to economic licensing, one of the common features of a number of the large construction projects across the UK projects is that the company delivering the project is subject to an underlying obligation to develop and maintain its infrastructure in an economical and efficient manner.<sup>39</sup> It is not practicable to directly assess the contribution that the presence of such mitigations has in protecting the interests of consumers. Nonetheless, we note that the presence of these obligations facilitates the ability of the regulator (and industry participants) to ensure good "discipline" by the

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<sup>39</sup> See for example, infrastructure projects being undertaken by National Grid and Severn Trent Water.

regulated company as well as facilitating regulatory action in the event that unforeseen circumstances emerge.

16. We also note that companies in the sectors with these conditions have not appeared to experience difficulties financing their regulated activities as a result of such conditions. The identification of a non-exhaustive list of areas of focus as discussed in chapter 2 should also reduce the scope for uncertainty and any adverse impact on HAL's cost of capital. In these circumstances, the condition should also be consistent with our secondary duty to secure that a licensee can finance its regulated activities.
17. As a result, we consider direct regulatory oversight is needed on HAL to operate, maintain and develop Heathrow airport in an economical and efficient manner and this should be reflected in HAL's licence. We consider that a licence condition could be necessary to address a gap in the present regime, to reflect the changed circumstances and enhanced expectations of consumers and that such a condition may be used to facilitate the CAA making forward looking orders alongside the existing incentive arrangements (including *ex post* reviews of capital expenditure).

## Transparency

18. We discharge this requirement in respect of the policy development process through this consultation and the consultations we have already conducted on this issue. In the event that we decide to proceed with a new licence condition, we will also be required to carry out the statutory consultation required under CAA12 before modifying the licence.
19. As for transparency of the substance of any obligation, we are keen to ensure that it is clear that such obligation applies to the manner in which HAL conducts its business, that is it addresses "how" HAL operates, rather than prescribing "what" HAL should do (albeit that a condition may identify particular areas of focus). This is important to ensure that HAL remains responsible and accountable for the commercial, operational and investment decisions it makes, while providing adequate oversight to the CAA to enable it to protect the interests of consumers.

20. Noting HAL's comments on the need clearly to define the objective targeted with a clear route to compliance, we consider that the best way to address this for the condition to identify a non-exhaustive list of particular areas of focus. These expectations can then be amended using the procedures under CAA12 from time to time to ensure that they remain relevant to HAL's activities over time. This approach also addresses HAL's concerns in relation to its rights of defence arising from the suggestion in the April 2018 Consultation that we use clarificatory guidance alongside any condition.

### **Accountability**

21. The procedures for licence modifications set out in CAA12 ensure that CAA's approach is accountable because each of HAL and the airlines will have the ability to appeal against any licence modification we propose.
22. Similarly, any enforcement action that the CAA might undertake in the future will need to be conducted in accordance with the CAA's duties under CAA12 and would be subject to judicial oversight. Combined with careful consultation on the modification and the identification of the areas of focus discussed above, we consider that this ensures the accountability of any such action and therefore addresses HAL's concerns over its rights of defence.

### **Proportionality**

23. On the basis of the evidence and submissions that the CAA has seen so far, we consider that it is likely that the desired level of protection for consumers that a licence condition may bring cannot be delivered through less restrictive measures.
24. In considering this, the CAA has considered three questions. These are whether a licence condition would:
- be suitable or appropriate to achieve the objective pursued;
  - be necessary to achieve that objective or could it be attained by a less onerous method; or

- impose a burden imposed disproportionate to the benefits secured.

25. Taking these questions in turn:

- Is it suitable and appropriate? A licence condition would be suitable or appropriate to achieve the objective pursued as it would be designed to set expectations as to the manner in which HAL carries out its activities and to sit alongside the CAA's other incentives to drive economical and efficient behaviour by HAL. This has significant parallels with other regulated sectors that combine overarching obligations with specific economic incentives.<sup>40</sup> The approach that the CAA is currently considering and set out in more detail in chapter 2 would provide additional clarity over the equivalent obligations in some other sectors by providing a non-exhaustive list of areas of focus;
- Is it necessary to achieve that objective or could it be attained by a less onerous method? The fact that a condition of the kind under consideration in chapter 2 would be of general application to HAL's business, when coupled with the changes to the context of HAL's business, and difficulties of using other regulatory tools outlined above indicate that less onerous methods would not set such an overarching expectation or reflect the expectations of consumers across the full range of HAL's activities.<sup>41</sup> Further, we consider that, absent a licence obligation, it is harder for the CAA to take timely action in relation to matters that come to its attention relating to the conduct of HAL. In addition, narrower obligations or incentives may either have "gaps" or be subject to inefficient "gaming" by HAL. We also note that the airlines have no power of "veto" over HAL's

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<sup>40</sup> See for example, the obligations on water companies in s37 Water Industry Act 1991, s9 Gas Act 1986, s11 Electricity Act 1989 and condition 1 of Network Rail's licence, condition c16 of the standard conditions of electricity transmission licences together with the price controls set out in their respective licences.

<sup>41</sup> The less onerous tools that we have considered in this context include reliance on specific incentives, after the fact reviews, commercial pressure from airlines and the manner in which the CAA conducts the price control process discussed in this consultation.

expenditure so pressure from them may only have a limited effect. As the approach discussed in chapter 2 proposes that the emphasis of the condition should evolve over time, the CAA is able to ensure that it remains targeted and proportionate as it is amended in the light of HAL's anticipated activities, other developments and stakeholders' experience;

- Is the burden imposed disproportionate to the benefits? The CAA considers that it should not be unduly onerous for HAL to comply with the obligation, largely through ensuring its business assurance procedures and investment approval processes are fit for purpose (which themselves should be appropriately designed to drive economy and efficiency). To the extent that HAL considers that it is already subject to the pressures to act efficiently, the imposition of such a condition should not create an additional onerous compliance burden.<sup>42</sup> Having considered the types of planning and reporting obligations observable in other sectors, we are not currently minded to develop less flexible specific planning and reporting obligations in parallel with an economy and efficiency obligation. This is on the grounds that such obligations may not be sufficiently flexible to reflect the changing circumstances of capacity expansion and so might impose inappropriate burdens without significant benefits.

We also consider that the approach we are currently considering, of identifying non-exhaustive areas of focus for HAL in complying with the condition in the coming price control period will ensure that the condition will remain focused appropriately on the challenges facing HAL over time. This approach would also address the need for the CAA to avoid imposing or maintaining any undue burden under section 72 of the Regulatory Enforcement and Sanctions Act 2008.

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<sup>42</sup> Separately, we are considering whether it may be appropriate to incorporate compliance with the licence into HAL's annual sufficiency of resources certification as part of our work in relation to financial resilience and ring fencing. We will set out more detail of our developing thinking in this area in a forthcoming working paper.

## **Consistency**

26. As explained above, a licence condition in this area is clearly consistent with the CAA's duties in sections 1(1) and 1(3) CAA12. If adopted, it would complete an area of policy that has been the subject of consultation since before HAL's licence was granted. We consider that it would also be broadly consistent with:

- best practice in other economic regulatory regimes such as gas, electricity, water and rail; and
- the existing licence condition in relation to the procurement of capital projects.

## **Targeted at a case where action is needed**

27. Having considered the issues set out above, including (i) the changes in circumstances since the licence was granted in 2014 outlined above, (ii) the challenges raised by new capacity and (iii) whether a licence condition in this area is "necessary or expedient" and proportionate to address these issues, we consider that our analysis indicates that such a condition would satisfy the test for justifying a licence modification set out in CAA12. It is, therefore, appropriate for the CAA to consider whether to proceed by modifying HAL's licence to include such a condition.

## Appendix C

# Assessment of licensing proposals made by respondents

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## Introduction

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1. This appendix sets out our assessment of a number of proposals that respondents have suggested should be implemented to facilitate the development of alternative delivery arrangements. For the most part, these proposals were submitted by the Arora Group in response to the December 2018 Consultation, albeit that airlines also contributed to this debate.
2. While at this stage we are not intending to take the suggestions made by stakeholders forward this is in the context of an extensive programme of work designed to strengthen the regulatory framework for capacity expansion at Heathrow, including designing incentive arrangements as part of HAL's price control, promoting competitive and market-based arrangements to support capacity expansion, and developing appropriate licence obligations for HAL.
3. This appendix should be read in conjunction with the Technical Information Note published by the CAA in August 2018.

## Stakeholder responses

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4. In its response to the December 2018 Consultation, the Arora Group made suggestions as to both the way that the CAA should carry out its regulatory activities and that we should introduce new licence obligations on HAL.
5. The suggestions as to how we should act included:
  - enforcing HAL's existing licence obligations to procure capital projects in an economical and efficient manner more rigorously;

- incentivising HAL to introduce competitive arrangements in the context of the price control, through setting cost recovery based on the existence of alternative arrangements and benchmarking against airport operating in competitive markets;
  - modifying HAL's licence to require it to consider the most competitive solution for the delivery of airport expansion at Heathrow and/or require HAL to cooperate with a third party carrying out the development of the terminal; and
  - use its Enterprise Act 2002 powers to refer HAL to the CMA.
6. Airlines also suggested that the CAA could consider imposing a condition on HAL to enter into a lower cost third party scheme or to be allowed to recover only that cost if it does not enter in to that scheme.

## CAA views

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### HAL's existing licence obligations

7. We note the Arora Group's comments about HAL's existing licence obligations. Although it is not clear whether the Arora Group was suggesting that the CAA should take specific enforcement action, we would note that this would be a significant step and that the CAA does not at present have the evidence that would justify commencing any such investigation.
8. Nonetheless, we will keep HAL's approach to procurement and Innovation Partners process under review.

### Incentives and cost recovery

9. As we have stated on a number of occasions, we will review the evidence emerging from HAL's approach to, and conduct during, engagement with third parties on alternative delivery and commercial agreements as part of setting the price control with the intention of protecting consumers from the recovery of inefficient costs. Similarly, our approach of challenging HAL to engage with third parties and to justify its approach, is aimed at

determining how any approach (either from HAL or a third party) would better promote the interests of consumers.

10. Encouraging cost efficiency, benchmarking and developing appropriate incentives are all matters that we will consider in developing HAL's next main price control. Our work on the proposals being developed by the Arora Group demonstrates that we will also give careful consideration to alternative arrangements designed to bring additional competition to HAL's plans for capacity expansion.
11. As for the recovery of Category B planning costs that HAL has already incurred, we will publish more information on these matters in a working paper early next year.

### **A new licence obligation to drive a competitive solution**

12. While it might be possible to create an obligation on HAL to consider a more competitive solution, this is likely to be ineffective without specifying in some detail what should be the precise requirements of such consideration. In any event, we do not consider that any such obligation would be well suited to driving effective engagement because it:
  - would be relatively easy for such a process to become a "box ticking" exercise for HAL, rather than prompting than real engagement;
  - could not specify any particular outcome; and
  - would be difficult for such a set of rules to respond with the flexibility that is likely to be needed to address the genuine challenges of the development of new capacity.
13. Airlines have suggested that the CAA should require HAL to agree to a lower cost third party scheme or be allowed to recover only the lower cost if it does not enter in to that scheme. While this suggestion may be superficially attractive, again, it is not practicable to implement such an approach unless a developed, costed and workable alternative scheme is in existence. To do otherwise would be artificially to set HAL's cost recovery to the level of a hypothetical scheme which does not appear to

be appropriate or in accordance with our duties. That said, clearly, if a credible alternative scheme is developed, we will need to consider its impact on our approach, as discussed in chapter 3.

### **Reference to the CMA under the Enterprise Act 2002**

14. In considering a reference to the CMA under the Enterprise Act 2002 we would need reasonable grounds to justify making a reference. Typically, we would need to conduct a market study first in order to determine whether the available evidence suggested that such grounds existed. Despite the suggestions made by stakeholders, we do not consider that there is, at present, suitable evidence that would justify conducting a market study.
  
15. In taking any decision in relation to the use of the Enterprise Act 2002, the CAA would need to consider the impact of any such approach on consumers, not least in assessing the consequences of delay and uncertainty, noting that a market investigation by the CMA would take more than a year to complete and have an uncertain outcome.

## Appendix D

# Surface Access policy

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## Introduction

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1. In the light of the views set out in chapter 4, we propose to clarify and amend our surface access policy in the manner set out below.

## The CAA's proposed updated surface access policy

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2. This policy sets out the criteria against which the CAA would expect HAL to bring forward evidence in support of any proposal to allow surface access costs associated with capacity expansion to be funded from airport charges.
3. Criteria (a) and (b) define the total surface access costs that should be considered for funding (or part funding) from airport charges. Criterion (c) apportions costs between direct charges to users of surface access and the residual costs to be borne more widely (including by Government) and by airport users in general through airport charges. Criterion (d) apportions this residual between the airport charges and other funding providers (including Government).
4. The criteria are:
  - (a) Overall cost benefit:** airport operators should be able to demonstrate that surface access projects, (considered individually, or as part of a surface access strategy, and jointly with any airport development that they enable) would be likely to deliver benefits in excess of costs from the point of view of airport users over time. In this assessment, the relevant costs may include the costs of measures required to:
    - meet planning obligations,
    - enhance the efficient operation of the airport,

- bring the investments forward to enable them to meet the timescales for the anticipated increase in demand for surface access brought about by expansion of the airport, and
- take into account journeys made by airport staff; made in relation to cargo operations; and made in relation to providers of airport operation services at the airport.

**(b) Cost minimisation:** the airport operator ~~can~~ should demonstrate that there is a need for the surface access investment, based on the efficient operation of the airport and/or the ~~likely~~ requirements to secure planning approval for airport expansion, and that the surface access strategy and individual projects as a whole are not over specified or costed. The costs of airport access projects should be measured against a base case which includes planned future upgrades by Government to road and rail infrastructure which would be made ~~absent any further airport growth~~ assuming that the surface access demand arising from the airport is at a level which arises from its current capability. These costs may include the costs of compensating – or otherwise accommodating on capacity elsewhere – existing non-airport traffic which would be displaced by additional airport demand; a new airport surface access links;

**(c) Direct users' contributions attribution/user pays principle:** the airport operator should take reasonable steps to ensure that the direct users of surface access facilities defray the costs to be recovered through airport charges to the maximum extent practicable through the application of direct charges for the use of such surface access. Direct charges from one mode of surface access should ~~may~~ be used to offset the costs of another where this would support measures to encourage modal shift from car to public transport which may be required for the efficient operation of the airport and /or to secure planning consent for ~~to~~ airport expansion; and

**(d) Users' reasonable interests:** the proportion of net surface access costs borne by the airport operator (after direct users have contributed through direct road or rail charges) should be based on the relative benefits derived by airport users versus non-airport users of the surface access

projects required to support airport ~~expansion~~ growth (with airport users not cross-subsidising other users but funding at least the incremental costs of infrastructure that has the sole purpose of connecting the airport to the wider transport network). The relevant costs are compared to the base case of surface access investments which would be supplied by Government ~~in the absence of airport expansion~~ assuming that the surface access demand arising from the airport is at a level which arises from its current capability.

5. Consistent with the above approach, capital elements of the airport operator's residual efficient costs would be added to the Regulatory Asset Base (RAB) and, similarly, any ongoing operating cost and revenues from the surface access projects would be taken into account in the single till calculations used to set the airport operators price control. ~~added to the airport operator's operating expenditure in subsequent price controls.~~
6. The airport operator should demonstrate that its strategy and individual projects comply with these criteria through the use of quantitative techniques including:
  - *Overall cost benefit criterion*: evidence should be based on the same economic appraisal methodology as used by public transport agencies in assessing road and rail investments;
  - *Cost minimisation*: as with other capital expenditure costs associated with airport development, we would expect to scrutinise (with assistance from technical consultants) the scale and costs of surface access projects with the aim of encouraging efficient levels of investment. In addition, where the airport operator is co-funding a surface access project with other transport agencies, we would expect relevant comparator data from other projects funded by other transport agencies to be used to demonstrate the cost efficiency of the airport surface access project;
  - *Direct users' contribution ~~cost attribution~~*: we would expect airport operators to demonstrate that they had assessed a full range of technically feasible options for placing as much of the surface access

costs as possible on the direct users of these transport facilities. Evidence on users' responsiveness to charging on surface access, and the impact on overall demand for journeys to and from the airport across all transport modes, should inform the proposals for direct users' cost attribution. Where encouraging modal shift towards public transport is likely to be a planning requirement on the airport operator, evidence on the scope for generating surpluses from road schemes to co-fund public transport services should be presented;

- *Additional benefits enjoyed by users:* evidence should be based on the relative net present value of benefits to:
  - (i) airport users who are also direct users of the new surface access infrastructure; and
  - (ii) "background" non-airport users of the new surface access.

Benefits would be measured according to standard transport appraisal methodology in terms of generalised cost savings in surface travel (net of any direct charges for fares/tolls). ~~Calculations of wider benefits to the economy more broadly are likely to be more tentative but may influence the approach taken by Government and airport operators in negotiating relative shares of surface access costs.~~

- We would also expect airport operators to demonstrate that they had actively sought airlines' and other users' views on surface access options and costs. Where consensus had been reached between airport operators and airlines through such engagement, we would expect to attach significant weight to this evidence in reaching our own view on the inclusion of the proposed surface access costs within the RAB. It would not, however, be appropriate for airlines to have a veto over surface access projects being allowed into regulatory consideration for purposes of setting the price cap, because the interest of passenger as a distinct group are likely to be under-represented by airlines on their own, and the beneficiaries of growth will include airlines not currently serving the airport.