

# Economic regulation of Heathrow: working paper on capital expenditure efficiency incentives (CAP1951)

Heathrow's response

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Prepared by: Heathrow Airport Limited

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## Executive Summary

1. We welcome the CAA's working paper which brings further detail on how the CAA considers its proposals can strengthen the existing capital efficiency framework in Heathrow's H7 price control. As set out in our response to CAP1940, we support the CAA's stated approach of evolving the current capital efficiency arrangements in order to ensure our processes continue to develop and improve through the H7 period. We support proposals where they improve and streamline governance and enhance our ability to deliver the capital projects required to meet consumer needs flexibly and efficiently in partnership with the airline community. However, as we have set out on numerous occasions, we are concerned about the direction of the CAA's proposals in the round.
2. As the CAA sets out in its CAP1951 document and as it has made clear through its other publications, the aviation industry is facing huge uncertainty due to the impact of Covid-19. Not only is there extreme uncertainty around the level of passenger demand for the H7 period, there is also a fundamental uncertainty surrounding how consumer needs and preferences might change through the period. Setting a framework for the H7 regulatory period which can mitigate this uncertainty and flex and adapt to the changing circumstances we will be facing will be vital to secure the successful future growth of aviation at Heathrow. The CAA's proposals on capital efficiency run counter to this.
3. Rather than building on the flexibility provided by the current Development and Core framework, the CAA's proposals would create a rigid and inflexible process reminiscent of the conditions of Q5, which then require increasingly complex workarounds to build back in the flexibility that Heathrow and the airline community have agreed will be vital for the H7 period. This has led to confusion and frustration among all parties throughout the Constructive Engagement (CE) process. In previous documents, the CAA itself has set out that movement to a pure ex-ante framework could lead to '*increased complexity*' which would require the setting of a series of adjustment mechanisms and could, in turn, lead to a dilution of the efficiency incentives the CAA is attempting to implement.<sup>1</sup>
4. In its proposals and subsequent conversations, it appears that the CAA may not fully understand Heathrow's current capital governance processes. While we have set out clearly the reasons for and benefits of the current governance and processes, the CAA does not seem to have taken account of this. This has been a significant cause of frustration for Heathrow as we see the possibility of all progress made through Q6 in improving the capital governance framework being lost as the CAA appears to be moving back towards a less flexible and less collaborative framework.
5. In addition to increasing complexity and rigidity, the CAA's proposals remain unjustified. Since the CAA first raised its intentions to review the capital efficiency process, with a view to moving to a stronger ex-ante framework, we have requested clear and robust evidence from the CAA that a move to a stronger ex-ante incentive regime is required and that such a move would be beneficial for consumers. This evidence has not been forthcoming. The CAA has made reference to the use of ex-ante frameworks in other regulated sectors such as rail but has not clearly articulated why this comparison is appropriate, nor evidenced the benefits and how these would be transferable to Heathrow's consumers; the mere existence of ex-ante frameworks in other sectors does not mean that their application is appropriate for Heathrow.
6. Through CE sessions, we have questioned why such revolutionary changes to the capital efficiency process are needed and have tried to understand the problem the CAA is trying to solve

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<sup>1</sup> CAA, CAP1674 *Economic regulation of capacity expansion at Heathrow: working paper on the cost of capital and incentives*, page 35, paragraph 15

through its proposals. We have provided robust and quantifiable evidence of the success of the current framework. It has also been clear through CE that the airline community sees the benefit of the current framework and the flexibility it brings. The CAA's justification in response has been poor, citing its desire to avoid ex-post reviews in future, which are '*difficult and contentious*'<sup>2</sup>, and providing a view that it has been unable to evidence inefficiencies in previous projects. We therefore request that as a matter of urgency, the CAA provides clear, robust and quantifiable evidence that a move to an ex-ante capital framework is required to combat perceived inefficiencies in Heathrow's approach and would deliver better outcomes for consumers.

7. Conversely, it is our view that a move to an ex-ante incentive framework could deliver worse outcomes for consumers than the current framework. The evidence we have submitted in our IBP and supporting appendices from Frontier Economics<sup>3</sup> and Steer<sup>4</sup> clearly sets this out. While we recognise there may be some benefits to an ex-ante framework in certain circumstances, there are also risks to consider. Ex-ante incentives could increase costs to consumers through increased risk levels and increased project estimates. Additionally, an ex-ante framework could lead to less flexibility to reflect changing consumer needs through the period, leading to inefficient expenditure on projects which do not benefit consumers.
8. The current ex-post framework means that the effectiveness and efficiency of Heathrow's investments are constantly reviewed throughout the period. The Independent Fund Surveyor (IFS) regularly reviews the cost efficiency, on time delivery and outcomes of Heathrow's capital portfolio throughout the period. This allows for constant review of performance, ensures we are delivering the right outcomes for consumers and provides a substantial body of evidence with which the CAA can make its ex-post assessment.
9. The nature of Heathrow's capital portfolio is different to the nature of capital portfolios found in other regulated sectors where an ex-ante approach is implemented. Ex-ante incentives on capital expenditure in the water and energy sectors are used to incentivise capital expenditure as part of a totex framework. In addition, requirements for investment in these sectors are generally stable, meaning that it is possible to make reasonable judgements about the appropriate level of expenditure in a given regulatory period. This is not the case at Heathrow, where, especially at present, apart from standard asset maintenance projects, investment requirements are more dynamic and difficult to establish at the start of the regulatory period. Additional consideration is needed before incentives and processes from other sectors are blindly applied to Heathrow's framework.
10. We reject the CAA's assertion that its proposed framework would be an improvement on the current ex-post review process. While setting capital allowances on an ex-ante only basis may avoid ex-post reviews of costs, the CAA's proposed delivery obligations framework would continue the need for ex-post assessment of Heathrow's capital expenditure and create further uncertainty around the recovery of capital expenditure. The Q6 process has provided the CAA with a wealth of evidence with which it can complete its ex-post efficiency review. This includes detailed evidence from the IFS in over 650 reports across the Q6 period<sup>5</sup> as well as studies carried out by consultants for the CAA. Obtaining an additional level of objective and expert evidence to carry out a robust ex-post review of benefits delivery will be both challenging and increasingly costly. It seems that, rather than implementing proposals to solve a problem it has identified, the CAA is instead pushing forward a solution for a problem that does not exist.

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<sup>2</sup> CAA, *CAP1951 Economic regulation of Heathrow: working paper on capital expenditure efficiency incentives*, paragraph 10

<sup>3</sup> Frontier Economics, *Ex ante incentives for investment at Heathrow*, April 2018

<sup>4</sup> Steer, *Heathrow Airport – Assessment of CAA-consulted ex-ante capital allowance process*, December 2019

<sup>5</sup> IFS reports 2014-2018 as available on the Development Information Portal

11. The CAA is misplaced to consider its revised proposals would improve on the current framework in ensuring projects are subject to appropriate stakeholder scrutiny and hold Heathrow to the agreed costs. Heathrow already has a well-established governance forum where project details are shared with the airline community to enable agreement on projects transitioning from Development to Core. Over the course of Q6 we had no escalations to the CAA, which is a testament to effectiveness of the existing framework and the level of collaboration between Heathrow and the airlines. These projects have been delivered at close to the G3 cost estimates.
12. We have provided a wealth of evidence in response to previous consultations and alongside our Initial Business Plan (IBP). This has set out how we think the current capital governance process could best be improved upon and where any move towards an ex-ante capital framework could best be implemented without compromising flexibility, deliverability and financeability. However, the CAA appears to have chosen to ignore this and continue with its proposals regardless. The CAA has failed to respond to the evidence we have provided and has not set out how stakeholder responses have informed its thinking. As we noted in our response to CAP1940, this is a clear failure of the CAA's process and demonstrates a lack of transparency in the CAA's decision making.
13. The CAA's proposals are disproportionate and counter to Better Regulation principles. They will increase the regulatory burden and impose additional administration costs to govern the process in H7, at a time the CAA recognises the importance of simplicity and flexibility. We are concerned with the apparent lack of thoroughness or clear evidence to both support the measures proposed and set out what they are attempting to resolve or mitigate. As a result, we request that the CAA undertakes a Regulatory Impact Assessment, including an economic assessment of the expected costs and benefits of a move to a stronger ex-ante incentive framework. We believe this exercise will help the CAA to quantify the benefits and anticipated regulatory burden of its proposals to ensure that the benefits outweigh the costs.
14. We provide detailed responses to the CAA's proposals in the main body of our response. The sections of our response follow the structure of the CAA's document for ease of reading. It should be noted that any examples or scenarios used in this response are for illustrative purposes only and are not a commitment to carry out the identified programme or projects during the H7 period.

### Criteria for implementation

15. As set out above, we support the CAA's position that the H7 framework should build on the Q6 framework and should build on the issues identified by stakeholders, the IFS and Arcadis. However, we are concerned that the CAA's approach is straying from this initial principle. We are also concerned that the reasoning used by the CAA to justify changes to the framework is not evidence based or robust and has, in some circumstances, been provided outside of the agreed governance and processes.
16. In its document, the CAA identifies a number of areas of the current framework which it thinks should be improved. We have addressed these in turn below:

- a. Clear and strong incentives to encourage efficient capex and delivery of benefits to consumers

Here the CAA states that '*some airlines have said that the Q6 approach does not provide sufficiently strong commercial incentives*<sup>6</sup>. However, the CAA has demonstrated a concerning lack of transparency by not setting out the evidence provided by the airlines to support this assertion, nor does it provide evidence of its

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<sup>6</sup>CAA, CAP1951 *Economic regulation of Heathrow: working paper on capital expenditure efficiency incentives*, paragraph 2.4, bullet point 1

own to confirm that the current framework does not provide clear and strong incentives to encourage efficient delivery. All investments made by Heathrow over Q6 have been agreed with and monitored closely by the airline community through existing governance. Additionally, a sample of this expenditure has been assessed ex-post by the CAA. This ex-post assessment has only found a few instances where Heathrow may have been responsible for inefficient investment. Additionally, we have provided robust evidence setting out our performance against G3 estimates which shows that, on the whole, Heathrow has delivered projects close to the G3 estimate. We therefore request that the CAA provides clear evidence to support the view that the current framework does not provide the required strength of incentives, rather than an apparent reliance on unevidenced and anecdotal remarks.

b. Predictable and transparent incentives

We disagree with the CAA that its proposed approach would resolve a number of the issues it sees with the current ex-post framework – not least we would like to understand the evidence that has led the CAA to identify these issues. The CAA's proposed framework requires the setting of delivery objectives to be tracked and reviewed upon project completion. This means that, although costs are not being assessed on an ex-post basis, the CAA's proposals would still include a large amount of ex-post review in order to decide on a final capital amount that can be recovered through Heathrow's RAB. We consider, therefore, that the CAA's proposed approach does not succeed in providing more predictable and transparent incentives, but instead is disproportionate by requiring additional processes and merely changing the focus of the ex-post review, which the CAA states it is striving to replace. This approach still leaves an unknown level of disallowance after the investment is completed.

c. Consistent incentives

We note the CAA's challenge in regard to the consistency of incentives. As noted by the CAA, Heathrow is currently exposed to an average ex-ante incentive of 13% across the period, although this varies year by year. While we understand the CAA's appetite to create a more consistent incentive, we have been clear that any change in the level of incentive applied will need to be considered in the round when setting Heathrow's price control. Should the level or structure of the incentive change, this will need to be factored into considerations of the level of risk Heathrow is facing.

d. Incentives to deliver benefits on time

We note the consideration of how current timing incentives can be strengthened and improved. We agree that the use of triggers should be reviewed to become more well-rounded with consideration of symmetry. This review should also ensure that any new incentives are aligned with others and do not introduce double jeopardy considering that a great deal of the outcomes of investing in asset replacement are already incentivised through Heathrow's service quality regime.

e. Effective governance

We agree that governance arrangements can and should be better streamlined for the H7 period. As noted by the IFS and the CAA, Q6 has seen a long list of improvements made in regard to capital governance following the lessons learned from Q5. Contrary to the CAA's assertion through the CE process that "*HAL and the airline community have not yet adopted/embedded several key learning points from Q5 e.g. projects starting on site without stakeholder buy-in*", in its report the IFS has noted that Heathrow has either embedded or is in the process of embedding all of the lessons

learned from the Q5 process, with none categorised as ‘Development Required’<sup>7</sup>. In fact, the CAA’s assertion on projects starting on site without stakeholder buy-in is not raised by the IFS in its report. For H7, we want to build on the improvements already made development, while being cognisant of the situation all parties find themselves in with increasingly limited resources and high levels of uncertainty. We therefore support streamlining of the governance process and clarification of the roles of governance groups and attendees to avoid repetition and duplication of effort. We also agree that the role of the IFS should be reviewed, with more thought given to how the IFS can support Heathrow and the airline community given the limited resources available.

17. In our response to CAP1940 we set out our in-principle agreement to the CAA’s criteria for developing an updated capital incentive framework. We continue to agree that the aim should be to build on the current approach and improve and streamline governance for the H7 period.
18. Building on the CAA’s suggested criteria, our response to CAP1940 and taking into account feedback we have heard through the CE process, we would characterise the key criteria for establishing the approach as:
  - a. We should build on the Development and Core governance used in the Q6 price control with any changes representing an evolution of the current framework. This includes retention of the Development and Core framework and the current method for setting and adjusting airport charges, ensuring that airport charges continue to reflect only capex which transitions from Development to Core through the period;
  - b. We should aim for a clearer more streamlined approach to governance, reflecting the resourcing constraints on the industry and the need to be clear about roles and responsibilities;
  - c. Any framework must be flexible to deal with the fundamental uncertainty which is characterising the H7 period to ensure that the capital plan is able to evolve and reflect the changing needs of consumers through the period;
  - d. Heathrow and the airline community should retain the scope to agree the capital portfolio, change as necessary and only escalate to CAA in the event of disagreement to ensure that the capital plan continues to include only investment that is needed and can drive benefit;
  - e. The framework should not place unreasonable risk on Heathrow by fundamentally changing the ex-ante incentive to which Heathrow is currently exposed and should provide clear and symmetrical incentives.

### Broad approach to capital efficiency incentives

19. In our response to CAP1940 we provided our initial views on the CAA’s proposals for the capital efficiency framework in H7. In summary, we continue to be of the view that making the fundamental and revolutionary changes proposed by the CAA would not be appropriate or beneficial for the H7 period. The CAA has still not fully articulated why a change to the current framework is needed nor provided evidence of why its proposed framework would be more beneficial for consumers.
20. The CAA has also failed to answer why the timing of its proposals is appropriate for H7 and to demonstrate it has considered the unique circumstances of the next regulatory period. This has

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<sup>7</sup> Gardiner & Theobald, *End of regulatory period Q6 report for CAA*, 15 July 2020

also been an issue raised by other stakeholders in responses to CAP1940. So far, this has not been addressed by the CAA, other than making the assertion that there will likely be a smaller capital envelope, potentially making change easier; we do not consider this a convincing reason.

21. We have consistently provided the CAA with a robust evidence base setting out our concerns with its proposed move to a stronger ex-ante framework. The CAA has failed to engage with any of this evidence and has not responded to any of the concerns raised through either its consultations or stakeholder engagement as part of CE. This shows a clear failure from the CAA to follow a clear and transparent process and to ensure that the action it is taking is both targeted and proportionate.
22. While the CAA has continued to attempt to engage stakeholders on its proposals, it is evident that the CAA's thoughts and proposals remain unclear and lacking definition. As an example, we are still lacking important detail regarding the size of the ex-ante incentive proposed by the CAA in order to fully assess the financeability implications of the proposal. The CAA has also failed to produce a thorough worked example of its approach set alongside the current framework in order to allow for a detailed assessment of the impacts.
23. It is concerning that the CAA's proposals continue to be at such an early stage of development, in particular given that consultation on this topic has been ongoing since June 2017<sup>8</sup>. At the stakeholder workshop held on 6 October 2020, we raised a number of concerns with the CAA about how its proposals would interact with airport charges and the value of the RAB. The CAA was unable to answer these questions. It is unacceptable that Heathrow has no clear, implementable policy on which to base its RBP weeks before its proposed submission. The detailed information required to support the CAA's proposed approach is currently unclear. Given the short time remaining in the process for H7, it is highly conceivable that it will not be possible to meet the information needs in the time available.
24. We are clear that we do not see the need for the significant changes proposed. The Q6 framework and the introduction of Development and Core has been received well by all stakeholders. It has a successful record of incentivising efficient investment across a portfolio of c. £3bn which has delivered an increase in service levels and increased efficiency across the period.
25. In its assessment, the IFS has been clear that the changes made in the Q6 framework and the development of the process through the Q6 have addressed the majority of the learning points from Q5.<sup>9</sup> While areas for improvement were identified in the IFS' end of Q6 report, it was clearly stated that cost and time overruns for high value and high complexity projects are often caused by reasons outside of the project team's control, with low value and low complexity projects generally delivered on time and under budget. We have seen no evidence from the CAA to demonstrate why its proposed changes, in particular the implementation of stronger efficiency incentives, are required to improve on the current framework.
26. As per the previous evidence submitted to the CAA, we continue to be of the view that, even if stronger efficiency incentives were required, ex-ante incentives would only be suitable for a small subset of Heathrow's capital expenditure. As set out in the report commissioned by Heathrow from Frontier Economics<sup>10</sup>, ex-ante incentives are suitable only for projects where:
  - a. The regulated entity has a high degree of control over costs;
  - b. The cost involved does not make up a significant proportion of the firm's total costs;

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<sup>8</sup> CAA, *CAP1541 Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow*, June 2017

<sup>9</sup> Gardiner & Theobald, *End of regulatory period Q6 report for CAA*, Page 5

<sup>10</sup> Frontier Economics, *Ex ante incentives for investment at Heathrow*

- c. The duration of the project is short;
- d. Multiple projects are not interdependent;
- e. Cost categories are being benchmarked;
- f. Similar projects are repeated over time;
- g. There are suitable comparators from other companies or sectors.

27. We therefore maintain that, while we do not see the need for the transition to a stronger ex-ante incentive framework, if ex-ante incentives were imposed they would only be appropriate to implement on short, low value, routine projects, such as asset management projects. The two example projects highlighted by the CAA for potential Delivery Obligations (T5 Plus and T1 Baggage) would not meet the above criteria.
28. While we see no justification for many of the CAA's proposals, we have taken the opportunity to review the CAA's proposed process alongside the output from conversations in CE and propose our own revisions to the capital efficiency framework for the H7 period. Our proposals are consistent with the criteria set out above and the recommendations for areas of improvement from the IFS.

### Summary of our proposal

29. Our proposals build on the Development and Core framework by improving and streamlining governance and providing greater transparency on the objectives we are hoping to achieve through the capital plan. The proposals also build on the experience from Q6 of which projects require greater focus by ensuring that these remain the key focus of engagement between Heathrow and the airline community.
30. While we do not agree that stronger ex-ante incentives are required as part of the framework, our proposals show the areas for which an ex-ante arrangement could be implemented appropriately. Our proposals in this regard are in line with previous submissions and the evidence we have submitted from both Frontier Economics and Steer.
31. To ensure that ex-ante incentives can be implemented robustly for projects / programmes where they are most appropriate, we have proposed an alternative, lighter touch approach to governance. This avoids the complicated processes proposed by the CAA and ensures that Heathrow and the airline community can focus on larger, more complex projects which require closer collaboration.
32. We have first described our process using the headings set out by the CAA in its CAP1951 document and have then set it out as a process timeline with worked examples to show how the process would work through the period.

### Defining cost categories

33. We agree with the CAA that it is possible to identify categories of capex by the outputs they are expected to achieve. This could allow Heathrow and the airline community to define delivery objectives for the portfolio at a manageable level which could be tracked and reported on easily.
34. Building on feedback from the IFS, if capex is to be categorised for governance purposes, we propose that it be categorised at a programme level. This will allow us to properly set out the objectives the programme is seeking to achieve and track progress of the delivery against these objectives.



## Cost efficiency incentives

35. As set out above, and well evidenced through our IBP and previous consultation responses, it is clear that a stronger ex-ante approach is not required. Even if it were to be evidenced by the CAA that this approach was required to strengthen efficiency incentives on Heathrow and deliver better outcomes for consumers, it would not be appropriate for every project undertaken by Heathrow.
36. As yet, the CAA has not properly quantified the benefits of a move to an ex-ante framework. Stakeholders have all been clear in responses to consultations that more assessment needs to be done to understand the potential impact of stronger ex-ante incentives across Heathrow's portfolio on the risk to which Heathrow is exposed and the potential change in behaviour it could drive. Both of these impacts could have an adverse effect on airport charges and there has been no analysis on whether the potential benefits of this change of approach would outweigh these costs. The CAA has a duty to ensure that this assessment is carried out before it implements its proposals.
37. Should the CAA be able to evidence the need for and benefits of an ex-ante approach, it should be focused purely on projects related to asset management, which form part of the proposed "Protect the Business" capital spend. This programme of capex clearly meets the characteristics identified by Frontier Economics and an approach with ex-ante incentives focused solely on this type of spend is in line with Steer's view of how the framework could best be evolved to include an ex-ante approach.
38. A key feature of the H7 period is the uncertainty around the required level of passengers and asset management activity that will be required in H7. This means it is not appropriate to set an ex-ante total allowance for asset management ahead of the period as to do so would harm consumers if maintenance requirements were higher than forecast. However, it should be possible to develop baselines for these projects, or tranches of projects at the G3 Gateway.
39. We propose that a constant ex-ante incentive of around 15% would be appropriate for this programme of spend. This would provide a higher incentive rate than that applied in Q6 but avoid material changes in Heathrow's risk exposure and contracting approach, which would be driven by an incentive rate higher than this.
40. If a higher ex-ante rate were to be introduced, this would severely undermine the current Governance process with airlines leading to suboptimal allocation of capital. It would undoubtedly lead to a rise in charges, an increase in cost, and a reduction in service for consumers due to:
- a. Higher financing costs as a result of the perception of higher risk by investors;
  - b. Avoidance of undertaking projects at risk of overspend leading to reduced service for consumers;
  - c. Higher capital costs as a result of the business need to duplicate design work to ensure sufficient certainty on cost estimates at G3; and
  - d. Increased risk allowance being built into the project costing at G3.
41. The CAA itself acknowledges the challenges and potential impacts associated with the application of strong ex-ante incentives in its CAP1658<sup>11</sup> consultation and CAP1674<sup>12</sup> working paper. In CAP1658, the CAA assesses the impact of ex-ante incentive levels of 10% and 25%, noting that an incentive rate around this range would form part of a balanced package of incentives. CAP1674 goes further, stating that a moderate incentive within this range would be preferable as a stronger incentive could serve to distort regulatory incentives. This analysis and proposed range is

<sup>11</sup> CAA, *CAP1658 Economic regulation of capacity expansion at Heathrow: policy update and consultation*, April 2018

<sup>12</sup> CAA, *CAP1674 Economic regulation of capacity expansion at Heathrow: working paper on the cost of capital and incentives*, May 2018

inconsistent with the wide range of between 13% and 50% which was set out in CAP1940. We request that the CAA sets out the reasoning for this apparent change in view.

42. In order to monitor delivery of this programme, we propose quarterly updates of delivery against budget as part of the capital governance. Monitoring of performance against required outputs will be carried out through the service quality scheme and the monitoring of asset management metrics included within it. Should increases in required service standards be identified through the service quality scheme, this change in scope will be taken through capital governance processes and the cost allowance changed accordingly through the Development and Core process. We have provided more detail on the approach which could be implemented to manage this type of expenditure in our worked example provided later on in our response.
43. We do not propose that ex-ante incentives are introduced on spend related to the delivery of other programmes. Based on our evidence, larger programmes would not be suitable for stronger ex-ante incentives as they are usually broad, complex, one-off programmes of spend. We therefore propose that these projects continue to be governed through the Development and Core capital process to allow for increased airline engagement and monitoring in the governance process and to ensure that costs are not increased for airlines and consumers. This would therefore retain the average 13% ex-ante incentive over the period, as per the Q6 framework.

### Setting delivery obligations and timing incentives

44. We are concerned that the approach set out by the CAA regarding delivery obligations is unworkable. While we agree that ensuring the agreed outputs and benefits are delivered is important to protect the interests of consumers, the CAA's proposals would instead create an unwieldy process that would require our capital portfolio to be agreed at the time of the H7 business plan. There is a real risk that the assessment of Delivery Obligations at the end of the period is found in reality to be more contentious and challenging than the current ex-post analysis.
45. Our proposals in this regard build on the CAA's approach with feedback received through the CE process to set out a flexible and workable process which provides transparency on the outputs and benefits of the capital plan. As suggested by the airline community through CE, we see merit in setting out high-level Delivery Objectives for the programmes set out in our H7 RBP. This would provide transparency for stakeholders and provide Heathrow and the airline community with a joint ambition for the capital portfolio. This should set out the benefits we are working together to achieve but should not be the basis of any financial incentives.
46. These objectives can then be refined through the Gateway process and agreed with the airline community, with more detailed quality requirements being set at a project level as projects within the programme pass the G3 Gateway. These quality requirements should build on the current triggers approach and set out the agreed deliverables, quality and timescales. Our proposal therefore assumes that these new quality requirements replace the current timing triggers.
47. These quality requirements should have a financial incentive attached to them. We propose that these are symmetrical incentives and are implemented in a similar way to the current trigger process with reconciliations taking place annually through the airport charge calculation. It should be noted that we also would recommend that for H7, this revised 'trigger' process is applied with a proportional assessment of achievement. We have seen the binary nature of the trigger assessment used negatively in Q6, and we believe that a proportional approach will be fairer for all.
48. Changes to the timing and deliverables could be made by agreement with the airline community through existing governance processes. These changes would then be reflected in the reconciliation process.

49. We are not proposing to include financial incentives relating to the delivery of project benefits. As discussed through CE, the delivery of benefits can be difficult to fully and robustly estimate given the large number of factors which influence performance across the airport. This is particularly true of financial and passenger satisfaction benefits which can be heavily influenced by other initiatives or external events.
50. We do, however, acknowledge the importance of identifying expected project benefits as part of the business cases jointly agreed with the airline community. We also accept that benefits tracking is an important part of assessing the success of the capital portfolio. We therefore propose quarterly reporting of progress against the Delivery Objectives identified at the programme level through capital governance forums alongside monthly written updates.
51. For asset management projects, which could be subject to an ex-ante incentive framework, Delivery Objectives are already set through the service quality framework. Through CE conversations, the airline community has been clear that it expects Heathrow to retain measurement of asset management metrics as part of the future Outcomes-based Regulation service quality scheme. These prescribed measures and targets serve as the Delivery Objectives for the asset management programme and can be used to track delivery of Heathrow's capital programme. Additional financial incentives are therefore not needed for asset management projects.

### Setting cost baselines

52. The CAA's approach to setting and changing cost baselines has been a subject of great confusion through the CE process. We have consistently raised concerns that the CAA's proposals in this regard are not an evolution of the current process but a complete change in approach and governance versus the current framework. The CAA's proposals are not compatible with the current Development and Core framework and would require an increase in process and governance to be fully implemented.
53. The CAA's proposal of setting cost baselines for every capex category at the H7 decision and tracking these through the period would introduce inherent inflexibility into the process. We have been clear with the CAA that the H7 period will require flexibility to adapt the capital portfolio to changing circumstances and financial constraints. Introducing a process which requires the identification and costing of the complete capital portfolio at a category level for the H7 decision is not compatible with this need for flexibility. The proposals could even lead to the airport charges not being reflective of the capital invested, with cancelled projects remaining in the baseline and therefore in the airport charge.
54. We therefore propose to retain more of the current Development and Core framework for the setting and management of cost baseline through the period. Instead of setting baselines at a capex category / programme level, our proposal is to continue to set a capital envelope at the start of the period with an annual profile of expenditure, reflecting expected Development and Core expenditure. This would then be used to set airport charges for the period.
55. During the period the airport charge would be adjusted for actual capital transitioning from Development to Core at the G3 Gateway. Actual expenditure incurred would be added to the RAB, as per the current process.
56. For programmes subject to an ex-ante incentive, performance against the agreed project level G3 cost would then be reconciled at the end of the period, with the RAB adjusted in line with performance against the ex-ante incentive level set. All other projects would continue to be subject to ex-post review.

57. This approach ensures that the airport charge continues to reflect only the capital investment transitioning from Development to Core through the period. It also continues to ensure flexibility on the framework and avoids the need for the complex additional governance needed to track progress against a number of different, disaggregated baselines.

### Implementing our proposals in practice

58. In the following section, we demonstrate how our proposals could work through the process of setting the H7 price control and then through the H7 period itself.

Point in the process	Proposed capital efficiency framework
Setting the H7 price control	<ol style="list-style-type: none"> <li>1. Use of the proposed capex plan set out in our RBP and subsequent 2021 updates to set an overall capex envelope. This will allow for the H7 baseline charge to be calculated. This baseline includes:                             <ol style="list-style-type: none"> <li>a) The sum of Development expenditure and Core expenditure set out through projects to which we have already committed spend</li> <li>b) An initial view of expenditure on a programme basis</li> </ol> </li> <li>2. The RBP and subsequent 2021 updates divide proposed capex into clear, programme level categories for management of costs, deliverables, benefits and governance.</li> <li>3. Where ex-ante incentives are justified and suitable to be implemented, the incentive rate and required outputs for the programme should be set. Our current view is that this would be suitable for implementation on the asset management programme only.</li> <li>4. Delivery Objectives are set for programmes, setting out the high-level outcomes that Heathrow and the airline community will work to deliver.</li> <li>5. The Leadership and Logistics percentage is set for the period.</li> </ol>
During the period	<ol style="list-style-type: none"> <li>6. Business case, deliverables, quality and timescales are assessed and validated by the IFS with delivery against these reported on at CPB on a quarterly basis</li> <li>7. Changes to quality requirements are agreed with airlines through governance forums subject to changing needs and priorities.</li> <li>8. In the case of projects forming part of the asset management programme, if these were to be subject to ex-ante incentives they will transition through the Gateway process, with the cost baseline set at G3. We propose to group G3 requests for projects within the asset management programme into tranches, as per the IFS's programme level guidance, to reduce the number of G3 events. Performance against delivery for asset management projects will be reported at a total programme level through the period. This will take place on a quarterly basis at CPB. If there is a material change in assumptions related to asset management requirements, then a change to agreed project baselines can be requested and implemented on agreement with airlines, using the existing governance forums.</li> </ol>

	<p>9. For all other programmes the current Development and Core process would remain for the governance of associated projects. The volume of Development to Core activities would potentially reduce if asset management were part of an ex-ante framework. Another opportunity that would be considered, building on the performance of outturn versus G3 during Q6, is the option of taking scope through G3 in larger scope packages to promote efficiency.</p>
<p>Governance through the period</p>	<p>10. In order to ensure that governance is improved where required and reflects the current situation in regard to resourcing we propose that the following changes are made:</p> <ul style="list-style-type: none"> <li>a) Focus monitoring and engagement at programme level to align with capex categories and ensure airline input at a strategic level. This should build on the approach developed by the IFS and agreed with the community for FT2 and HAC</li> <li>b) Gather more formal written input from the airline community through these governance forums to provide an appropriate audit trail, ensure appropriate and detailed input early in the process and avoid repetition through different governance groups</li> <li>c) Capital working groups are continued in order to receive appropriate input and oversight from the airline community</li> <li>d) Refocus the IFS role to provide airlines with more comfort on technical scrutiny of the portfolio at both portfolio and programme level in order to streamline airline governance</li> <li>e) Increased focus on benefits reporting at programme level with quarterly formal updates to CPB and monthly written updates on benefits delivery</li> </ul>
<p>Reflection in annual airport charges</p>	<p>11. On an annual basis, airport charges are adjusted to reflect the maturing of the portfolio (actual and planned Development capex, and capex transitioning from Development to Core), as per the arrangements in Q6.</p> <p>12. Performance against the delivery of project scope and timing within the airport charges year in question is reviewed and rebates/bonuses are adjusted for through the annual charge.</p> <p>13. Actual expenditure is added to the RAB on an annual basis but is not reflected in the annual charges adjustment.</p>
<p>End of H7 process</p>	<p>14. At the end of the price control the CAA will need to carry out two reviews:</p> <ul style="list-style-type: none"> <li>a) Ex-post review of programmes which are not governed through the ex-ante framework</li> <li>b) Review of expenditure within the asset management programme adjusted for the ex-ante incentive applied</li> </ul>

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### Worked governance example

59. We have started to work through the lifecycle of two projects, one asset management project and one programme subject to the continued ex-post framework to show how this could work in practice.
60. For the routine asset replacement projects subject to a revised ex-ante framework we plan to use the programme delivery approach set out by the IFS in its proposed programme lifecycle approach to guide our governance. Under this approach, after a tranche of projects is taken through the G3 Gateway to establish a cost baseline (P2), we would engage in governance at programme level and report at that level until P3, as set out in the below diagram:

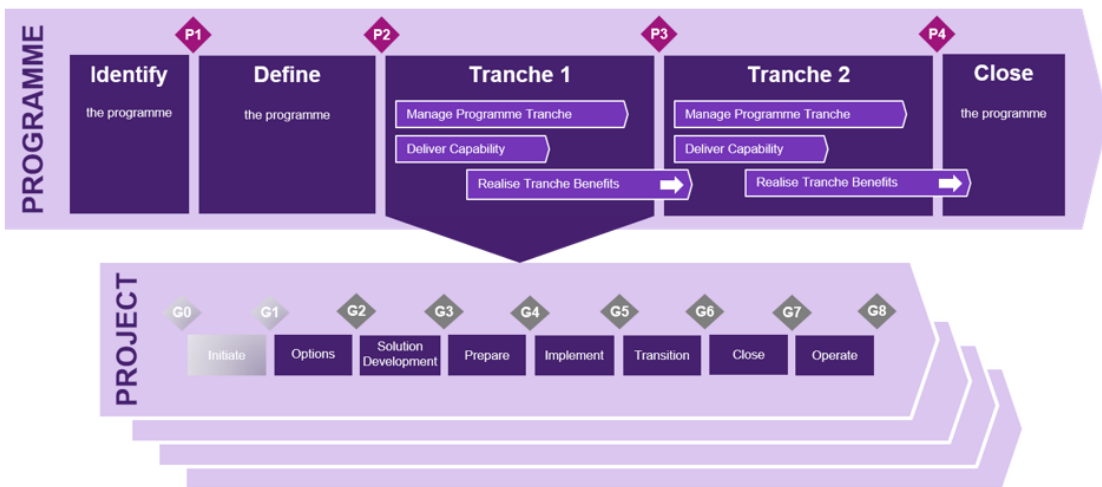


Figure 1: Heathrow Programme Lifecycle alignment to Project Lifecycle

61. This approach would build on the work initiated under the more recent Q6 programmes where the IFS started to review the FT2 and HAC programmes and produced a ‘Programme Management Assessment Criteria’. P2 would be where the regulatory incentives were set, with appropriate governance with the community. The IFS would also assess the programme maturity at P2 to provide an independent view of the assessment of costs and benefits.
62. Heathrow would then work at the project level internally to deliver the required programme Delivery Objectives. The only consultation with the airline community between P2 and P3 would be to ensure the smooth delivery of projects where there are potential interdependencies and operational impacts. This would replace the current Gateway process for projects within these programmes.
63. For more complex programmes which do not meet the criteria for the application of revised ex-ante incentives, we propose retaining a more bottom up approach to governance, as per Q6. An example of such a programme is T1 baggage prolongation:

## T1 Prolongation Workstreams



Figure 2: Constructive Engagement capital Plan session 4, 25<sup>th</sup> Aug 2020

64. As illustrated, this programme has multiple projects contained within it and they do not meet the criteria outlined earlier in this document as being suitable for an ex-ante approach, with the works being undertaken to an existing system with small possession windows and an ever changing operational environment. That said, it would be prudent to ‘bundle’ the projects into groups where possible, and this would assist also in driving efficiency in both the governance and project execution process.
65. In line with the Q6 process, the constituent parts of this programme would be taken through the current Gateway process at project level. This would ensure that airlines are involved through each stage of the project to ensure that there is no impact to airline operations and passenger experience through project delivery. It also ensures that the projects being delivered can be adapted as required to meet new requirements as and when they may emerge.

### Benefits of our proposed approach

66. We have developed our proposed approach with our proposed criteria in mind. In order to ensure that the framework drives the right outcomes for consumers and the airline community, we have assessed our proposed framework against the criteria set out:

- We should build on the Development and Core governance used in the Q6 price control with any changes representing an evolution of the current framework. This includes retention of Development and Core framework and the current method for setting and adjusting airport charges, ensuring that airport charges continue to reflect only capex transitioned from Development to Core through the period

Our proposal continues to use the Development and Core framework and builds on the flexibility it provides. We continue to propose the same method of setting and adjusting airport charges.

- We should aim for a clearer more streamlined approach to governance, reflecting the resourcing constraints on the industry and the need to be clear about roles and responsibilities

We propose a significantly streamlined approach to the governance of regular asset management projects, focusing governance at the programme level. Our proposals for improving governance focus on providing a clearer role for the IFS and ensuring we can gain clearer, written input from the airline community to inform project delivery.

- c. Any framework needs to be flexible to deal with the fundamental uncertainty which is characterising the H7 period to ensure that the capital plan continues to reflect the changing needs of consumers through the period

Our proposal retains the Development and Core framework, allowing Heathrow and the airline community to work together to ensure the capital portfolio reflects the projects necessary to improve operational performance to airlines and the passenger experience.

- d. Heathrow and the airline community should retain the scope to agree the capital portfolio and only escalate to CAA in the event of disagreement to ensure that the capital plan continues to include only investment that is needed and can drive benefit

Our proposal retains the current airline governance for all projects not subject to an ex-ante incentive. This retains the central role of the airline community and the CAA's role as an escalation point through the period. For programmes and associated projects subject to ex-ante incentives, airline governance will remain central, but will be carried out at a more strategic level to reduce the need for complex processes.

- e. The framework should not place unreasonable risk on Heathrow by fundamentally changing the ex-ante incentive to which Heathrow is current exposed and should provide clear and symmetrical incentives.

Our proposal only suggests movement to a stronger ex-ante incentive regime where the projects meet the characteristics set out by our evidence base. Our proposal of a symmetrical 15% incentive rate for these projects ensures that Heathrow is exposed to a consistent incentive at a level which would not materially alter Heathrow's risk exposure and therefore Heathrow's airport charges. We are also proposing the evolution of the current trigger incentive framework, through which triggers will be replaced by a symmetrical incentive framework which covers the delivery of both scope and timing.

## Summary

- 67. As highlighted by the CAA during the CE sessions we recognise that conversations on this topic will continue to develop through the H7 price control process. We look forward to working with the CAA and the airline community in working up the package of Capital Efficiency measures which will build on the successes of Q6, reflect the changing operating environment for all parties and ensure that the interests of consumers are protected.
- 68. Our RBP will build on the approach we have set out in this response, including incorporating any formal feedback we receive from the airline community following Constructive Engagement. Where possible in our RBP we will set out the key programmes in our H7 capital plan and associated Delivery Objectives to continue this engagement.
- 69. Through the H7 process, it will be important to ensure the CAA's policy on capital efficiency is assessed holistically as part of the wider incentive package to which Heathrow is exposed through the CAA's regulatory framework. As set out in this response, we expect there to be key interdependencies between Heathrow's service quality framework and the required deliverables



of the capital plan. It will be important to ensure that Heathrow's overall incentive package is consistent, targeted and proportionate and that the level of risk to which Heathrow is exposed is reflected in Heathrow's cost of capital.