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Re: Response to Economic Regulation of Heathrow – CAP1951: Working Paper on Capital Expenditure Efficiency Incentives

Thank you for the opportunity to respond to the CAA's consultation CAP1951, updating on the latest developments at Heathrow with regards to future capital efficiency incentives.

This submission is made jointly by the LACC and AOC on behalf of the airline community at Heathrow (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address. Individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

Please note, given the developing nature of this topic the Airline Community retain the right to review and amend any comment or position set out within.

Given the relevance, it is also worth noting here the Airline Community's disappointment with the findings of the *ex-post* capital efficiency review undertaken for Q6 to which we will provide further feedback on that specifically in due course in our response to CAP1964.

Notwithstanding the above, we fully concur with the CAA statement within CAP1951 that *"finding and quantifying evidence of inefficiency does not necessarily mean that the remaining expenditure has been incurred with the same level of efficiency that might be reasonably expected from an airport subject to strong competitive pressure¹."* and encourage the further development of the capital incentive efficiency framework to address these shortcomings.

In responding to CAP1951 we have broken our response down into three sections which covers the following:

1. Comments on the CAP1951 document itself and in particular following the headings of the CAA's Broad Approach, as set out in Chapter 3;
2. Specific feedback on other aspects we would encourage the CAA to consider as part of the ongoing policy development and next steps in the engagement; and

¹ Para 10, page 9, CAP1951

3. A summarised, initial assessment of the Airline Community views on the current capital framework where we have challenges or see opportunities for improvement. These have been cross referenced with our reading of CAP1940 and CAP1951 documents to help identify where we believe these issues are, could be, or are not being addressed (as the case may be) within the developments we have seen so far.

We look forward to working with the CAA and HAL in continuing to evolve the capital framework and associated governance.

2.0 Comments on the CAA's Broad Approach (Chapter 3, CAP1951)

2.1 Balance of Incentives

We believe it is right to seek the balance between Cost, Quality and Time and are broadly supportive of the Principles and Proposed Solutions as set out in 3.3 and 3.4 of CAP1951.

Notwithstanding the above, we make the following observations for consideration:

- (i) We understand, and would strongly support, 'quality requirements' that includes the definition and delivery of defined benefits;
- (ii) Outcomes and outputs should be set following the SMART approach and not be subjective or left open to interpretation;
- (iii) We fully agree on the need to guard against "*over specification of quality requirements to inflate the cost baseline*" and that the Proposed Solution states capex baselines will not be adjusted for over delivery unless agreed². We would note however that the CAA's Proposed Solution appears to only address "over specification" post G3. Consideration should also be given to the assessment of the appropriate solution in the first instance (covered further under 2.4 (ii));
- (iv) We note the CAA's expectation that "*Quality requirements to be appropriately specified using outcomes or outputs to measure the benefits to the consumer.*³". Whilst we fully support the intent here, we would welcome further clarification as to the proposed approach and link with Outcome Based Regulation; and
- (v) We note the comments made on timing incentives and Triggers and have addressed these as part of our response to Timing Incentives under 2.5 below.

2.2.1 Defining Cost Categories

We agree with the approach of having defined Cost Categories. This should help provide a level of certainty on the level of overall capital expenditure and prioritisation of such, whilst still allowing for the development of individual programmes or projects within them. This approach was adapted through Q6 and we welcome the further development proposed

² Table 3.1: Interactions between Cost, Quality and Timing Incentives, CAP1951

³ Table 3.1: Interactions between Cost, Quality and Timing Incentives, CAP1951

here with greater commitment from HAL in earlier definition and measurement against defined 'category' benefits.

The Airline Community feels that work carried out by HAL to date to identify and quantify Cost Categories through the BBU and subsequent Constructive Engagement process has been limited. In order for Airlines to support the Cost Category structure for H7, we would expect a far more rigorous exercise to be completed by HAL that provides a greater level of detail on scope, delivery objectives and costs and strongly encourage the CAA to ensure it is undertaken.

In addition to the above, we make the following observations for consideration:

- (i) "Maintain" Capital Category: Given current outlooks and priorities as discussed through the H7 Constructive Engagement process, it is likely that this will be the extent of the capital portfolio for H7, with any expenditure on 'improvements' or 'capacity' on an exceptional basis. We would also note that, through the project review work currently being undertaken (spanning iH7 and early H7), it is clear that this category is more of a 'portfolio' as opposed to a specific 'programme'. As such we do not believe it would be appropriate to consider as a single Cost Category. The CAA should ensure HAL sufficiently breaks this down with the appropriate level of detail.

With regards to the specific questions of 'Tramlines' or reviewing on 'Delivery Year' basis (as opposed to set outcomes) for the "Maintain" category, we can see this could help provide some flexibility within the plan but note that this needs to be better understood alongside the development of the plan for "Maintain" before being able to determine a position; and

- (ii) It will be important to retain the ability to flex across the Cost Categories. Our expectation is this would be on an exceptional basis and any changes must require the agreement of the Airline Community, as per today's portfolio approach.

2.3 Cost Efficiency Incentives

We are broadly supportive of the proposed approach to setting capital efficiency incentive rates as per Figure 3.3⁴ and concur with the logic of setting the level at the same rate across the Cost Categories, particularly during a regulatory settlement period that is likely to consist of predominately similar "Maintain" programmes.

Whilst recognising the comments within CAP1951 that this an area for further development and consultation by the CAA, the Airline Community note we believe a more extensive evaluation is required to determine the correct level of incentivisation is required regarding the levels of risk / reward. We would however reiterate that we do not believe symmetrical levels are a fair and reasonable balance for consumers, nor necessarily drive the right behaviours for the reasons set out in our response to CAP1940⁵.

⁴ Figure 3.3 Setting the Capital Efficiency Incentive Rate, Page 27, CAP1951

⁵ 'Capital Efficiency Incentives', pages 4 & 5, Airline Community Response to CAAs CAP1940, dated 18th August 2020

Finally, where we are expecting a degree of ‘similar’ projects being delivered during the settlement period, as envisaged in H7, we believe that it is entirely appropriate to consider implementing an efficiency target so HAL continue to be incentivised for continuous improvement and appropriately share such efficiencies.

2.4 Setting Delivery Obligations

We strongly support the principle of Delivery Obligations and Quality Requirements and believe this is an area that should continue to be developed.

Notwithstanding the above, we make the following observations for consideration:

- (i) *“Subsequent changes to the DOs or quality requirements during H7 would need to be agreed as part of the capex governance process.”⁶* For the avoidance of doubt, we would welcome the clarification “.....need to be agreed with airlines as part of the capex governance process.”.
- (ii) The statement *“We expect that the number and granularity of quality requirements will vary by capex category, but they should not prescribe how a solution is delivered”* is supported in principle however: (i) it appears slightly at odds with the examples given, notably on “Maintain” which is prescriptive e.g X no of stands; and (ii) given the information asymmetry, consideration should be given as to how to prevent the situation of solutions being ‘over-engineered’ and agreed at G3, only for an alternative approach to delivery or scope being undertaken that still meets the requirements but at a lower cost which HAL would then be rewarded for. We would suggest enhanced reporting as part of this consideration.
- (iii) We agree with the proposal for the CAA to act as the arbiter. Whilst the Airline Community and HAL have shown good collaboration in the development of a number of governance matters, given the nature and potential size of the financial sums at stake, we believe the CAA will need to play a much closer role, so as to enable informed assessments and decisions within a timely manner, particularly as this ‘beds in’.

We do note the scenario within CAP1951 that the CAA may act where *“parties agree but project outcomes are not deemed to be in consumers interests.”*. We would welcome clarity on how the CAA may assess this and in what circumstances.

2.5 Timing Incentives

2.5.1 Timing of Delivery

One aspect that we would welcome further consideration on is the extent to which it is within HAL’s control to bring forward or delay the development of project business cases. Q6 saw a number of challenges with key airline programmes failing to be progressed in a timely manner where HAL did not see a case for doing so, despite being within the capital plan. Notably this included automation and security queue harmonisation by way of examples.

⁶ Para 3.24, page 31, CAP1951

2.5.2 Triggers

- (i) The Airline Community strongly support the need for a scheme that both: (i) ensures HAL produce credible programmes / project plans and delivers upon them; and (ii) recompenses airlines and consumers from delayed projects / programmes that have been paid for, with returns being made to HAL, as one would reasonably expect in any other 'contractual' relationship.
- (ii) With regards to Triggers, we reaffirm our previous position that we are not agreeable to rewarding for project delivery ahead of time for the reasons set out within our response to CAP1940⁷. We would also add here in furthering this point that within the CAP1951 consultation document itself, the CAA has indicated a link between delays and cost overruns. It is reasonable to assume the converse. If the CAA are considering a 'reward' this could lead to 'double counting' if HAL are also being incentivised to under spend to / under budget. Furthermore, it is worth noting that Triggers are already set with an pessimistic bias on delivery, being it is the P80 date that is used (as opposed to P50 which is used for cost assessment).
- (iv) Under the current CAA thinking on when a Trigger may be applied as set out in CAP1951, we believe there would need to be clear guidance as to when that may be so as to mitigate the risk of airlines and HAL failing to agree / escalating the decision of *to what and when* a trigger may be applied. We believe the existing criteria as a reasonable place to start.

2.6.1 Setting the Cost Baseline and Dealing with Uncertainty

We note the CAA's description as broadly in line with Q6 and that this is an area where there will be further development and consultation. In doing so we encourage in particular the need for all parties to be clear on the level of detail and assurance that can responsibly expected at the time of setting the Cost Categories and associated Delivery Obligations and how that certainty will progress. The use of industry best practice tools could be a useful method in doing so.

2.7 Reconciliation of Incentives

The Airline Community remain supportive of reconciling incentives during the H7 period and would suggest this would be best done annually.

The Airline Community would welcome further clarity on the CAA's position with regards to the following:

- (i) How would the impact to the allowable cost baseline of only partially meeting a Delivery Obligation(s) be assessed?; and
- (ii) Were a Cost Category / programme to cost less in delivering on its Delivery Obligations, have the CAA considered the implications for that 'unspent' capex. For

⁷ 'Capital Efficiency Incentives' (iii), page 5, Airline Community Response to CAAs CAP1940, dated 18th August 2020

example, would it simply no longer be available (and reflected as a lower capex total) or could it be used elsewhere?

3.0 Further Areas for Consideration

We recognise that aspects of the proposal are being consulted on and will continue to develop. As well as the points raised in Section 2 of this response, we have included some additional aspects the CAA should also consider, if not already doing so, as part of its on-going work:

- 3.1 **Resourcing:** This is an area that will require careful consideration for all parties, particularly for the CAA where we see this requiring a greater role and more 'day to day' engagement, particularly in the early stages of its implementation;
- 3.2 **Third Party Support:** In light of 3.1 above, consideration should also continue as to the role expert, third party support can provide in both the initial and ongoing assessment of the capital portfolio. Whilst minimising expenditure will be critical for all parties as business rebuild, appropriate targeted interventions may be required;
- 3.3 **Capital Envelope Trigger:** Linked with Constructive Engagement, we think it would be important that once a 'minimum' required level of capital has been established, to consider in what scenario additional capital expenditure within H7 may be required and establishing a 'trigger mechanism' for this; and
- 3.4 **Future Engagement:** We have welcomed the workshop approach the CAA has taken for CAP1951 and look forward to its continuation as this evolves.

Building on the working example provided through Constructive Engagement, in developing policy further we would encourage (i) working examples for a variety of scenarios so as to understand the intention and consequences around areas such as: (a) programme / project development through the gateway process; (b) impact to aeronautical charges and the RAB; and (c) the Governance process; (ii) a Roles and Responsibilities matrix; and (iii) considerations of the WACC.

4.0 Airline Community Existing Arrangement Areas for Improvement

As set out in the Introduction, in compiling this response to CAP1951 we thought it would be useful to highlight areas of current challenge or opportunity the Airline Community noted and compare across with our reading of CAP1951. To reiterate, this continues to evolve but shared in the interest of seeking to improve existing arrangements.

Matter	CAP1940 / CAP1951 Airline Community Understanding	Comment
Benefit Definition, Measurement & Realisation	Intention of the Delivery Obligations and Quality Requirements	See comments within the response, particularly under 2.1 – 2.4
Post G3 'management' & overspend (slippage or stopping / continual review)	Linked to DOs and Quality Requirements	See comments within the response, particularly under Section 2
Totex and Capital 'optioneering' incl Do Nothing / Not capex	Not (obviously) covered	Recognising the different incentive structures, we remain concerned that current arrangements lend decision making to capital solutions. We would like to see arrangements in place that require a holistic (totex) review including the requirement for 'Do nothing' or 'Opex / Operational Alternatives'
Progression of Projects	Clearer with 'committed' projects with defined Delivery Obligations; appears less with pre- G3 and how the balance still lies at HAL's 'discretion' HAL progression of 'non-agreed' projects & does not pass G3	See our comments under 2.5.1 Welcome clarification as to treatment under this approach
Inherent costs in Design	Does not (obviously) address	Whilst the introduction of the IFS has been successful in assessing a number of areas (e.g process, benchmarking), it does not address the concern of 'over engineering' or inherent 'design standards' that drive the initial cost. We would encourage this as an area for further review

Matter	CAP1940 / CAP1951 Airline Community Understanding	Comment
Management and Approval of Cost Categories: (i) L&L & (ii) Risk	Does not (obviously) address	Structure and sign off process should be reviewed and agreed before H7 with better oversight and review through the regulatory period. Limited sight post G3 with regards to the outcome of the allocated risk provision including how it was managed within the project / programme and subsequent treatment
Capex (incl L&L) onto RAB	Proposal to broadly follow current process with exceptions of DO review	Seeking greater awareness and engagement on what goes onto the RAB – may be covered sufficiently with DO approach but for further development / understanding
IFS Programmatic Approach	Does not (obviously) address	We would encourage the CAA to familiarise itself with the work the IFS undertook on this and how that might integrate with the current IFS project review approach and be further developed / applied

We look forward to discussing and developing further with yourselves the points set out within this response. In the meantime, if you have any questions on this airline community response please do not hesitate to contact us.

Yours sincerely,



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