

H7 FINAL PROPOSALS ON OUTCOME-BASED REGULATION

Frontier Economics' independent review of the
CAA's Final Proposals for OBR

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1 EXECUTIVE SUMMARY

- **Approach:** In late 2021 we reviewed the CAA's Initial Proposals for Outcome-based Regulation (OBR), with a focus on how the CAA's proposals align with the CAA's own policy objectives for OBR, regulatory best practice and general economic principles around incentive design. Following this review, in December 2021 we provided an independent report to Heathrow on the CAA's proposal for OBR at H7.

The CAA published its Final Proposals for H7 in June 2022, which we have since reviewed and this report provides an update to our December 2021 report on the topic of OBR.

- **The CAA's policy objectives:** We reviewed the H7 Final Proposals for OBR against the CAA's stated principles during the consultation and guidance stage of the review. We find that the CAA's decisions do not fully meet the high-level objectives as described in its guidance, with three main consequences:
 - 1 For the most part, the CAA has not adequately taken into account consumer research in its decision-making;
 - 2 The decisions also highlight that airline views have generally been given more weight than consumer views since the disbandment of the CCB; and
 - 3 SQRB mechanisms have remained unchanged in a number of key areas where they could have been improved to better deliver outcomes for consumers.
- **Outcomes:** While the CAA has accepted Heathrow's business plan outcomes, which were based on effective consumer research, the outcomes currently serve as "add-ons" to the previous SQRB regime. The CAA does not effectively consider the role of these outcomes when focusing on what passengers really want throughout the rest of its proposals, meaning that the CAA has not treated outcomes as important inputs towards delivering effective measures, targets and incentives. In contrast, when Ofwat introduced OBR, it recognised that outcomes need be linked effectively to the other building blocks of OBR and not simply be taken in isolation. The CAA's approach is therefore not in-keeping with regulatory best practice and this represents a missed opportunity to deliver more value for consumers.
- **Measures:** An effective move towards OBR would entail that new measures reflect consumer outcomes, where possible. However, of the 20 measures with financial incentives, half relate to assets provided by Heathrow to airlines. This demonstrates that the CAA has not fully embraced its principle that "*OBR should be informed by robust consumer research*" as asset-based measures are not directly relevant to consumers.
- **Targets:** The CAA's approach to targets reflects a much narrower scope than identified in its guidance, by focusing on Heathrow's historical performance and discounting a wide range of evidence that Heathrow has considered in its research, and is not in line with regulatory best practice.
- **Incentives:** The CAA's decisions on incentives represent no significant progress from SQRB, with an unchanged approach to knife-edge incentives, a heavily downside-skewed risk profile and arbitrary rebalancing of SQRB incentive allocations. In future the CAA should take into account regulatory precedent and economic principles supporting sliding scale

incentives, as well as designing a more balanced incentive package for Heathrow which drives innovation and ambition rather than risk aversion.

Overall, the CAA's approach to introducing OBR at H7 represents a missed opportunity to embrace a shift in regulation toward a more consumer focused methodology which has happened in other sectors, in particular water. In our report we set out more detail on where the CAA's approach has fallen short and identify how it could make changes at future price controls to align more with regulatory best practice from other sectors and principles of good OBR.

2 BACKGROUND AND OBJECTIVES

In 2016, the CAA announced their consultation on outcome-based regulation (OBR)¹. This marked an important policy shift for the CAA, signalling a move forward from the previous output-focussed SQRB regime to an outcome-based approach that is grounded in economic principles and aligned with regulatory best practice across many other regulated sectors. In June 2022, the CAA published its Final Proposals² for OBR in H7. In this paper, we provide an independent review of the CAA's Final Proposals for OBR against:

- 1 **The CAA's policy objectives** – we have reviewed the CAA's original policy objectives and assess its Final Proposals against its own guidance and principles.
- 2 **Regulatory best practice** – we have drawn on the latest price control methodologies used in the UK water and energy sectors to assess the CAA's Final Proposals.
- 3 **General economic principles** – we have considered the CAA's Final Proposals to examine whether they represent sound economic principles and effectively incentivise outcome delivery for customers.

3 REVIEW OF THE CAA'S PRINCIPLES FOR OBR

The CAA's business plan guidance³ for H7 included five principles for OBR:

1. *"OBR should be informed by robust consumer research.*
2. *The structure of OBR should include 'outcomes', 'measures', 'targets' and 'incentives'.*
3. *The Consumer Challenge Board and airlines play a key role in the development of OBR.*
4. *OBR should build upon the SQRB.*
5. *Performance reporting should be comprehensive and targeted at consumers."*

¹ CAA, Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime, December 2016

² CAA, Economic regulation of Heathrow Airport Limited - H7 Final Proposals Section 1: Regulatory Framework, June 2022

³ CAA, Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control, April 2017

We have reviewed the H7 Final Proposals for OBR against the principles above and find that the CAA have not fully met these high-level objectives as described in their guidance:

Principle 1: OBR should be informed by robust consumer research

Heathrow has used extensive consumer research, covering areas such as its outcomes synthesis⁴, willingness to pay⁵, customer preference prioritisation⁶ and cost-benefit analysis⁷. In April 2021, the CAA acknowledged in the “Way Forward” document⁸ that Heathrow was successful in demonstrating an “improved ‘golden thread’” by linking up consumer research to its business plan proposals for outcomes and measures.

However, as we will discuss in the following sections of this report, the CAA’s decisions in its Final Proposals are not aligned with Heathrow’s consumer research with regard to the key OBR building blocks of measures, targets and incentives. Instead, in these areas the CAA has largely relied on continuity from the previous SQRB regime – a scheme which did not use consumer research to design targets and incentives – and airline views.

In its Final Proposals, the CAA sets out its concerns around the practical challenges with using consumer research to inform decisions. It states: *“we remain of the view that there would be advantages if the implementation of the OBR framework could be informed by relevant findings from consumer research. But with a large volume of research available, and a wide range of judgements to be made about which studies to use and how precisely to convert their findings into a specific set of rebates, we continue to consider that the existing set of rebates is a more sensible starting point for consultation with stakeholders than the set of rebates put forward by HAL.”*⁹ The CAA makes limited reference to consumer research elsewhere in its Final Proposals on OBR, so it is not clear how the CAA has reflected consumer research in its Decisions. Comparing the Final Proposals to the policy ambition set out by the CAA in 2017, it is difficult to see how or where the CAA has reflected consumer research. The quote above highlights that there is a large volume of research available but the CAA has found it difficult to convert this into incentive values. It appears that the same difficulty may have applied to other areas as the CAA does not mention how it has taken into account consumer research or the voice of the consumer to reach its Final Proposals. As the CCB can no longer represent the consumers’ voice, the Final Proposals only reflect consumers’ preferences to the extent that Heathrow has used its research to reflect these in its proposals. In contrast, the CAA has paid little attention to the consumer voice. This approach is not in-line with the CAA’s own principle to use consumer research to inform decisions in relation to OBR and is also not in-keeping with regulatory best practice. This is a key area where the CAA needs to improve its approach at future price reviews.

⁴ Blue Marble Research, Consumer Outcomes – Future Measures, 2020

⁵ Systra, Heathrow Airport Customer Valuation Research, 2018

⁶ Systra, Passenger Priorities Research, 2020

⁷ ICS, Developing the Cost Benefit Analysis Framework - Parts 1, 2 & 3, 2019

⁸ CAA, Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward, April 2021

⁹ CAA, Economic regulation of Heathrow Airport Limited - H7 Final Proposals Section 1: Regulatory Framework, June 2022, 3.62

Principle 2: The structure of OBR should include 'outcomes', 'measures', 'targets' and 'incentives'

The CAA has included all four mentioned building blocks in the proposed OBR framework. This achieves the second principle.

Principle 3: The Consumer Challenge Board and airlines play a key role in the development of OBR

The Consumer Challenge Board (CCB) was set up by the CAA as part of the H7 process to “*support our strategic theme of empowering consumers as part of a wider agenda to put passengers and cargo users at the heart of our approach to airport regulation*”¹⁰. In the previous Q6 price control, the CAA engaged its Consumer Panel to provide feedback on the CAA’s overall approach and decisions. The CCB’s terms of reference expanded the consumer voice by allowing it to engage directly in constructive engagement with Heathrow and airlines during the business planning process. This reflects the role of consumer bodies in other regulated sectors, such as Consumer Challenge Groups in water at PR14 and PR19 and the Customer Engagement Groups in energy sector.

As part of constructive engagement, the CCB served as an important challenge to Heathrow and the airline community, as both parties have a key part to play in delivering customer experiences at Heathrow. Direct consumer representation is important as, for example, the Australian Competition and Consumer Commission identified that “*airline interests do not necessarily coincide with the interests of the broader community*” and that “*although airlines can be expected to seek a commercial advantage in negotiations with airports they cannot be expected to seek lower prices overall for the benefit of the broader community*”¹¹.

Following the Court of Appeal's decision on Heathrow expansion and the impact of Covid-19 on the aviation sector, the CAA disbanded the CCB while stating that it will explore “*alternative approaches in continuing to ensure consumers' interests remains at the heart of its regulatory work for H7*”¹². However, it is not clear how the voice of the consumer is represented in the CAA’s Final Proposals in the absence of the CCB. The CCB’s work was only mentioned a handful of times in the “Way Forward” and H7 Final Proposal documents. The CAA has not replaced the CCB with any credible process for reflecting the consumer voice directly in the price control process. As a result, airline views were generally given more weight than consumer views, especially in key areas of OBR such as targets and incentives. The consumer voice is only represented via the research that Heathrow has conducted and used to inform its proposals. The CAA appears not to have sought any consumer views either directly or via its Consumer panel. Therefore, the CAA has not followed this principle when it comes to reflecting consumer views.

¹⁰ CAA, Decision on the Terms of Reference for the H7 Consumer Challenge Board (CCB), September 2015

¹¹ ACCC, Productivity Commission Inquiry into the Economic Regulation of Airports - ACCC submission in response to the draft inquiry report, 2019

¹² CAA, Consumer Challenge Board webpage, <https://www.caa.co.uk/Consumers/Guide-to-aviation/Consumer-Challenge-Board/>

Principle 4: OBR should build upon the SQRB

The SQRB framework has been in place since the Q4 price review covering 2003 - 2008, following the Competition Commission's recommendations to the CAA in 2002. The CAA has acknowledged that "*the overall structure of the SQRB scheme has remained largely unchanged*"¹³ over the previous three price controls but several developments made a review of SQRB relevant, including:

- Change in Heathrow's ownership: The CC's remedy around SQRB reflected BAA's ownership of Heathrow, Gatwick and Stansted airports and the need for service improvement and reporting across BAA's portfolio. Heathrow Airport Holdings Limited now only owns and operates Heathrow airport.
- The Civil Aviation Act 2012: This act set the CAA's primary duty as "*to further the interests of users of air transport services in respect of our economic regulation functions*".
- Regulatory best practice: The CAA stated that they wanted to "*build on best practice approaches to service quality regulation being developed in other sectors*". The CAA's consultation document also included a reference to Ofwat's PR14 periodic review which introduced the Outcome Delivery Incentive (ODI) regime.

As a tried and tested scheme, it makes sense to take into account aspects of SQRB that currently work for the interests of consumers. It is also important to take into account that there are key differences between other regulated sectors and aviation, so exact replication of other sectors' regulation will not be ideal. Airlines represent an important party not found in other sectors and play a key role in delivering passenger services at the airport, such as check-in and baggage experiences. Therefore, the CAA is correct to take into account aspects of the SQRB scheme that deliver airline needs, but introducing OBR presented an opportunity to more meaningfully evolve the existing regime. However, as we will explore in following sections, the H7 Final Proposals do not represent a significant move forward from SQRB. Instead, they largely maintain the SQRB approach with some additions. This adds complexity without achieving efficiency in the price setting process by focusing on the areas that consumers consider most important. Therefore, we do not believe the CAA has not shown enough ambition in achieving this principle, as SQRB mechanisms have remained unchanged in a number of key areas where they could have been improved to better foster outcome delivery. This is a key area where the approach needs to be improved at future price reviews.

Principle 5: Performance reporting should be comprehensive and targeted at consumers

Heathrow currently provides information and performance reporting on the SQRB scheme on its website, covering measures, performance levels and incentive payments across its terminals. Key metrics on SQRB performance are also displayed across the airport on information displays, allowing consumers to engage with Heathrow's performance during their journey. As

¹³ CAA, Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime, December 2016

Heathrow is already committed to this principle and no further challenge was provided by the CAA, CCB or airlines, this principle is not noted to be one of concern.

FIGURE 1 SUMMARY OF CAA'S PRINCIPLES AND EVALUATION

Principles for OBR identified by CAA	Evaluation: Has the CAA followed through?
1 OBR should be informed by robust consumer research	✗ Consumer research has not been fully considered by CAA when setting targets and incentives
2 OBR should include 'outcomes', 'measures', 'targets' and 'incentives'	✓ The structure of the new framework includes all of these building blocks
3 The CCB and airlines play a key role in the development of OBR	✗ Airline views are given much more weight than consumer views, esp. following CCB's disbanding
4 OBR should build upon the SQRB	✗ Lack of ambition from CAA means that SQRB has remained unchanged in a number of areas
5 Performance reporting should be comprehensive and targeted at consumers	↔ Heathrow is committed to this principle and CAA, CCB and airlines have not identified any issues

4 OUTCOMES

4.1 CAA'S APPROACH

The CAA has proposed to accept Heathrow's business plan outcomes, as they are effectively linked to consumer research and were supported by the CCB. Heathrow's outcomes were based on a synthesis study¹⁴ and cover six key areas of airport services that customers consider important:

FIGURE 2 HEATHROW'S OUTCOMES



Source: Heathrow, Revised Business Plan, December 2020

¹⁴ Blue Marble Research, Consumer needs synthesis, November 2020

While the proposed outcomes are aligned with the CAA's policy objectives, they are not effectively integrated with the remaining elements of OBR. Instead, the outcomes could currently be interpreted as “add-ons” to the previous SQRB regime and do not translate to a true focus on what passengers really want when it comes to the subsequent building blocks. In its initial consultation on OBR¹⁵, the CAA stated that the SQRB's output-based approach risks missing the “*bigger picture' by not adequately capturing what consumers want and value from the airport service*” and that OBR should “*focus its attention on what passengers value, giving stakeholders confidence that the regulatory regime is appropriately targeted*”. However, as we discuss in the following sections, the Final Proposals for OBR are a continuation of the SQRB approach with consumer outcomes simply overlaid on top of the previous approach.

4.2 COMPARISON TO REGULATORY PRECEDENT

The water sector has been at the forefront of designing and running an outcomes-based approach to regulation since Ofwat introduced outcomes to the sector at PR14 and therefore provides the most useful comparison. The CAA's approach contrasts with this in respect of the design of outcomes. When Ofwat introduced an outcomes-based regime at PR14, it recognised that outcomes need be linked effectively to the other building blocks of OBR and not simply be taken in isolation. This is illustrated by some of the statements that Ofwat made at the PR14 Final Determination.¹⁶

- It was clear that Ofwat saw the outcomes as more than just standalone aspects of the price control and that instead it was important how the measures and outcomes were linked together: “*alongside the outcomes, companies have proposed a set of new measures that will demonstrate how well each of the outcomes is being delivered.*” “*For each outcome proposed, we asked companies to identify one or more measures that would provide evidence that they were delivering the outcome*”.
- The development of the outcomes was an important aspect of outcome-based regulation, Ofwat identified that the outcomes were one way in which it could encourage companies to deliver benefits to customers: “*we have designed this innovative outcomes approach to deliver a number of benefits to customers and wider society...companies have developed outcomes through customer engagement, including detailed dialogue with the customer challenge groups (CCGs).*”
- “*Our focus throughout the review has been on making sure that the promise of the new outcomes approach is realised, with the creation of effective incentives that protect customers against under-delivery and where merited, reward companies for outperformance*”.

In contrast, the CAA appears to treat the outcomes as a stand-alone layer of OBR that is not effectively integrated with the price control.

¹⁵ CAA, Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime, December 2016

¹⁶ Ofwat, Final price control determination notice: policy chapter A2 - outcomes, December 2014

4.3 SUMMARY AND CONCLUSION

The CAA has not treated outcomes as important inputs towards delivering effective measures, targets and incentives. For the most part, the remaining building blocks are not influenced by the introduction of a outcomes-based approach or engagement with consumer views, so the CAA has not fully followed through with its guidance on outcomes. This is a missed opportunity as the overarching outcomes can be used to guide the development of measures, targets and incentives to ensure that OBR delivers the outcomes that matter most to consumers – and this is something the CAA should address at future price controls.

5 MEASURES

5.1 CAA APPROACH

Ultimately consumers care about the outcomes they receive rather than how these are delivered. Heathrow has identified in its consumer research that passengers are not necessarily able to differentiate between the individual impacts of Heathrow and 3rd parties when it comes to the experiences they receive at the airport¹⁷. This supports Heathrow and the CCB's view that the range of measures should try to reflect outcomes that are important to customers across the passenger journey rather than being output-focused.

In its revised business plan, Heathrow included a number of new measures that improved upon the SQRB list by better reflecting outcomes that are important to customers across the passenger journey. These included areas such as departure flight punctuality, arrival management and overall customer satisfaction. The CAA has accepted most of these new measures and also acknowledged that some of the airlines' proposals on measures were too *"narrowly focused on services provided solely by HAL as the regulated entity"* rather than on fundamental customer outcomes.

However, many of the CAA financial measures¹⁸ for H7 remain targeted at airlines rather than passenger outcomes. Of the 20 measures with financial incentives, half relate to assets provided by Heathrow to airlines. This approach is not aligned with consumer preferences as the asset-based measures are not directly relevant for consumers. There is a risk that Heathrow is incentivised to focus on measures that are of lower importance to passengers. Furthermore, continuing to focus measures on assets and outputs rather than outcomes limits Heathrow's ability to choose solutions that deliver outcomes at lowest cost and greatest value for consumers which is inefficient. This is the result of maintaining the SQRB approach and adding complexity without taking the opportunity to fully reflect consumer views.

¹⁷ Populus, Resilience Qualitative Research, October 2019

¹⁸ CAA, Economic regulation of Heathrow Airport Limited - H7 Final Proposals Section 1: Regulatory Framework, June 2022, Tables 3.1 and 3.2

TABLE 1 CAA PROPOSED MEASURES

MEASURE	TYPE	TARGET
Financial incentives		
Cleanliness	Financial	Passengers
Wayfinding	Financial	Passengers
Helpfulness/attitude of security staff	Financial	Passengers
Wi-Fi performance	Financial	Passengers
Security queue time – central search	Financial	Passengers
Security queue time – transfer search	Financial	Passengers
Security queue time – staff search	Financial	Passengers
Control post vehicle queue time	Financial	Airline assets
Availability of lifts, escalators and travelators	Financial	Passengers
Availability of check-in infrastructure	Financial	Passengers
Availability of arrivals baggage carousels	Financial	Passengers
Availability of T5 track transit system (TTS)	Financial	Airline assets
Availability of stands	Financial	Airline assets
Availability of jetties	Financial	Airline assets
Availability of fixed electrical ground power	Financial	Airline assets
Availability of stand entry guidance	Financial	Airline assets
Availability of pre-conditioned air	Financial	Airline assets
Pier-served stand usage	Financial	Airline assets
Hygiene safety testing	Financial	Airline assets
Runway operational resilience	Financial	Airline assets
Reputational incentives		
Overall satisfaction	Reputational	Passengers
Customer effort (ease)	Reputational	Passengers
Enjoy my time at the airport	Reputational	Passengers
Feel safe and secure	Reputational	Passengers
Ease of access to the airport	Reputational	Passengers
Helpfulness/attitude of airport staff	Reputational	Passengers
Passengers with reduced mobility – overall satisfaction	Reputational	Passengers
Immigration queue times	Reputational	Passengers
Timely delivery from departures baggage system	Reputational	Passengers

MEASURE	TYPE	TARGET
Departures flight punctuality	Reputational	Passengers
Airport that meets my needs	Reputational	Passengers
Ease of understanding Heathrow's Covid-19 safety information	Reputational	Passengers
Airport departures management	Reputational	Passengers
Airport arrivals management	Reputational	Passengers
Baggage misconnect rate	Reputational	Passengers
% of UK population with 3 hours (and one interchange) of Heathrow by public transport	Reputational	Passengers
Passenger injuries	Reputational	Passengers

Source: CAA Final Proposals, Table 3.1, Table 3.2

5.2 COMPARISON TO REGULATORY PRECEDENT

The UK Regulators Network (UKRN) has recognised the benefits of outcomes-based incentives. In its response to the recent BEIS consultation on reforming regulation it stated its support for ‘a focus on outcomes rather than “tick-box” compliance’ and highlighted that many regulators are already adopting a more outcomes based approach.¹⁹

In water, Ofwat has become increasingly outcomes focused in its incentives measures framework (known as performance commitments). It first adopted an outcomes-based approach at PR14 which introduced a new outcomes framework and required water companies to identify and deliver the outcomes that customers most value. Companies were then incentivised on these outcomes.

Each subsequent iteration of the price control has moved the list of performance commitments away from outputs to outcomes. Its most recent price control methodology consultation for PR24, Ofwat continues to take an outcomes-based approach that can ‘allow companies the flexibility to chose the best way of delivering outcomes’²⁰. It is proposing to streamline the number of measures to focus on ‘key outcomes that are important to customers and the environment’ and ‘do not intend to focus performance commitments [measures] on outputs’.²¹ To this end it has identified around 50 measures in PR19 related to tracking outputs and excluded them from the list of performance commitments²².

In addition, Ofwat has signalled that it will use an “inferred benefits approach” when valuing marginal benefits to calibrate outcome delivery incentives for asset-based measures. This approach would use mapping of asset performance against customer impact to derive the

¹⁹ UKRN, Response to BEIS consultation: Reforming the framework for Better Regulation, 2021

²⁰ Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021

²¹ Ofwat, Creating tomorrow, together: consulting on our methodology for PR24. Appendix 6 - Performance Commitments.

²² These have been reclassified as price control deliverables.

ultimate value that customers place on avoiding asset failures. A similar approach could be used by the CAA to assess and value the asset-based measures for Heathrow. This would mean that, for example, the CAA would consider the ultimate impact on passengers from, for example, availability of stands. Ideally this would then be captured in an outcome-based measure instead of an asset-based measure. Where other factors influence the outcome that are outside of the control of the regulated company, the asset-based measure could at least be described in a more consumer-friendly way. By including all asset-based measures, the CAA has effectively added some outcome-based measures to input-based measures. This means that the Final Proposals do not deliver outcome-based regulation but a complex mix of regulatory approaches.

A focus on outcome based incentive measures has also guided the ongoing reform of the rail sector. Whilst still in early stages, the market engagement preview for Passenger Service Contracts has signalled operators will be rewarded *'when trains are clean and comfortable and passenger satisfaction increases. Further, payments to PSC operators will depend mainly on trains being on time and minimal disruption for passengers'*.²³ This places passengers at the heart of the incentive scheme rather than asset-based measures.

Beyond utilities, the Financial Conduct Authority (FCA) is also proposing an outcomes based approach to its new Consumer Duty.²⁴ This is driven in part by a recognition of the limitations of more prescriptive measures: *'Too often regulation is seen as a compliance or box-ticking exercise. If we regulate with detailed inputs we can make it worse, as firms focus on the regulatory requirements rather than the outcomes.'*²⁵

5.3 SUMMARY AND CONCLUSION

As we have set out above the CAA has not treated outcomes the foundation for setting effective measures, targets, and incentives. Half of the financial measures relate to the provision of assets to airlines and many of the key customer outcomes have reputational incentives only. This risks creating a mismatch between consumer priorities and Heathrow's regulatory incentives and fails to place consumer views at the heart of OBR. It also limits Heathrow's flexibility in delivering these outcomes at the best value for consumers. Looking forward, CAA should look to replace output-based measures with true outcomes-based measures that reflect key customer priorities.

²³ Department for Transport, Passenger Service Contracts. Market Engagement Preview, October 2021

²⁴ FCA, A new consumer duty. Consultation paper CP21/36, December 2021

²⁵ Charles Randell, Chair of the FCA and PSR, to the Building Societies Association, Outcomes-focussed regulation: a measure of success?

6 TARGETS

6.1 CAA APPROACH

In its initial business plan guidance for Heathrow²⁶, the CAA identified that target-setting should take into account a number of factors:

- *“Customer preferences and satisfaction with respect to historical and current performance levels;*
- *The scope for improving performance (including consideration of innovative ways of working) without incurring significant extra costs on the basis of setting demonstrably challenging targets for management; and*
- *The willingness of consumers and airlines to pay for investment to further improve performance beyond that possible using existing facilities. This willingness to pay information should also be used as part of process of robust investment appraisal to identify the most cost beneficial option to deliver service improvement”.*

However, in practice the CAA's Initial Proposals for targets were heavily based on Arcadis' assessment of Heathrow's historical performance. Arcadis' assessment for the Initial Proposals failed to fully reflect consumer views and was too focused on historical performance, without considering in detail Heathrow's H7 cost allowances. Arcadis' updated assessment for the Final Proposals²⁷ includes some references to the cost allowances and evolving consumer expectations but still does not:

- take into account how other parts of the price control affect Heathrow's ability to achieve the targets;
- fully reflect consumer views; and
- adequately consider that historical performance levels are not always a good indicator of what is achievable in the future.

Arcadis report is still largely focused on analysing historical performance with no detailed analysis of the impact of costs or consumer preferences.

The approach that the CAA took did not therefore meet its own principles that it had previously set out. We provide further detail on each of these three points below.

6.1.1 FAILING TO TAKE INTO ACCOUNT OTHER ASPECTS OF THE PRICE CONTROL

While it is legitimate for regulators to set targets with a level of challenge (similar to the cost efficiency challenge), in principle, service targets should be set with consideration to other aspects of the price control, in particular how costs are set. If service targets are set in isolation of other aspects of the price control, then this leads to a number of risks including:

- there is a risk that the service levels are unachievable, as improvements can often not be delivered without some impact on costs; and

²⁶ CAA, Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control, April 2017

²⁷ Arcadis, OBR Phase 2 - Targets Assessment FINAL REPORT, June 2022

- it risks missing opportunities to link OBR up to other aspects of the price control which may lead to an unwieldy set of overlapping but unlinked incentive mechanisms that makes it hard to focus management on the consumer outcomes that really matter.

The CAA has developed its proposals for OBR in isolation of other areas of the price control. In particular, the service quality targets that it has set were largely based on an assessment of historical performance which did not give due consideration to the cost allowances it was setting. For example, the CAA has set more stretching targets for some measures (e.g. Overall Satisfaction, Punctuality, Baggage, PRS/PRM, Cleanliness, Wayfinding) but they have not reflected on how this required service improvement is likely to affect opex or capex. This risks Heathrow being unable to achieve these targets, or being unable to deliver on other commitments elsewhere in the business plan. The CAA has also set the more stretching level of service from 2023, which fails to take account of the fact that it will take time to deliver these service improvements.

Setting OBR in isolation from other aspects of the price control has also led to missed opportunities to set effective incentives across the whole price control, as illustrated in the following two examples.

In addition to the measures and targets within OBR, the CAA has also set capex delivery incentives at the project level. The capex delivery incentives are output based measures, which will require Heathrow to deliver specific outputs even if it finds an alternative, more efficient way of delivering a project and set of consumer outcomes. This lack of focus on consumer outcomes therefore risks consumers not getting the best deal. The CAA has stated that *“we do not agree with HAL that the performance against the OBR framework should be the primary means of assessing effective capex delivery”* and that *“there are likely to be many projects for which the OBR framework is less relevant, for example because there is not a measure that would capture the specific impact that a proposed project is intended to deliver”*.²⁸

In our view, the CAA has missed the point here. If it had been more ambitious with the way that it had introduced OBR, such that the measures were more linked to the overall consumer outcomes and introduced more new measures rather than relying on many of the old SQRB measures, then the overall outcomes framework for H7 could have been used more broadly. The logic of OBR is that the vast majority of a company's expenditure is covered by the outcomes measures, such that a company is held to account to deliver on the consumer outcomes and consumers have protection through this framework if a company fails to deliver. The issue is not with OBR in general therefore but rather the way that the CAA has implemented it. If the CAA had introduced a more effective form of OBR, then the outcomes measures could have been used to provide consumer protection and the capex delivery incentives would not have been required.

Separately, the CAA's assessment of commercial capex was based solely on its payback analysis, which prioritises the objective of lowering airport charges in H7 and fails to take into account those other considerations, including service quality. One of the high level outcomes included

²⁸ CAA, Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks, June 2022

in the OBR framework is 'I have an enjoyable experience at the airport', which is underpinned by various measures including:

- Overall satisfaction;
- Enjoy my time at the airport; and
- Airport that meets my needs.

For these measures, Heathrow will be subject to a target and potentially exposed to financial penalties if it cannot meet those targets. Heathrow notes that many of its commercial capex projects are aimed at enhancing the retail experience. For instance, within Heathrow's commercial capex programme, the 'Digital and Data Transformation' project is described as "*Upgrade existing legacy capability & implement new digital & data propositions through H7, to **enhance each passengers' end to end journey through Heathrow**. This investment reflects the need to modernise given changing **consumer expectations** of service & protect revenue given a significant shift to eCommerce post Covid. It will help to contribute to the following OBR measures; Enjoy my time at the airport; overall satisfaction; helpfulness/attitude of airport staff; ease of understanding Heathrow's Covid-19 safety information & an airport that meets my needs*".²⁹ However, the CAA appears to have ignored these considerations and therefore missed an opportunity to encourage commercial capex that delivers better service for consumers.

Overall, the CAA has set outcomes targets in isolation from other aspects of the price control. This risks Heathrow being unable to deliver on the service targets. It also means there are missed opportunities within other aspects of the price control to link up to consumer outcomes, which may mean that consumers do not ultimately get the best deal. Further, Heathrow has a long list of various measures and incentive mechanisms that it needs to manage within H7, which is not effective regulation.

6.1.2 FAILING TO REFLECT CONSUMER VIEWS

The CAA and its advisors have focused largely on Heathrow's historical performance when considering how to set H7 targets. The CAA has not carried out cost-benefit analysis or an in-depth review of Heathrow's consumer research to assess where the socially optimal level of service is. Focusing on a backwards looking approach also fails to consider how consumer preferences may have changed over time and would fail to pick up on any material shift in priorities. This is a particularly troubling approach to have taken shortly after the COVID-19 pandemic, which is likely to have led to shifts in consumer preferences.

Indeed Heathrow's research, alongside external sources, have indicated that consumer preferences and expectations have evolved over the course of the COVID-19 pandemic. This means that historical performance related to satisfaction measures may relate to an out-of-date consumer context. Heathrow's research found that pandemic experiences have made passengers more engaged about cleanliness and customer service than in the past, which makes comparisons against historical performance less relevant. These findings about evolving consumer expectations are also reported by independent third parties. For example, the ONS have reported that the vast majority of adults now practice aspects of cleanliness

²⁹ Arcadis, HAL RBP UPDATE 2 - CAPEX PLAN REVIEW, June 2022

and hygiene, such as face covering and increased hand washing, regardless of the level of COVID-19 in the UK. On the other hand, practiced social distancing relates more closely to national restrictions and has therefore declined significantly as restrictions have eased. PwC research shows that 85% of customers now make travel decisions depending on the communications regarding safety received from transport providers and recent McKinsey research has found that transport customers now expect higher levels of service, such as more tailored products, faster-turnaround and digital services.

In summary, the H7 targets that the CAA has set are not sufficiently linked to current consumer views or preferences. We cannot therefore have confidence that the H7 outcomes framework will deliver what consumers want in terms of the level of service or the priorities across different aspects of service.

6.1.3 HISTORICAL PERFORMANCE IS NOT ALWAYS A GOOD INDICATOR OF WHAT IS ACHIEVABLE IN THE FUTURE

The CAA and Arcadis' heavy reliance on historical performance also risks assuming that past performance is representative of future performance, even though there are key risks around the post-pandemic recovery. Future demand is clearly more uncertain, both in terms of the level and profiles of demand (e.g. distribution of demand across the airport will be less uniform for the foreseeable future compared to Q6, when passenger demand was higher and more stable).

The CAA has acknowledged the “*there remains a greater than usual level of uncertainty about passenger forecasts*”³⁰ and correspondingly proposed a traffic risk sharing (TRS) mechanism to help manage risks associated with future passenger volumes. This risk around demand is also relevant when considering service delivery at Heathrow, especially with considerations around the composition of demand, peakiness of demand and Heathrow's ability to rapidly adjust to sudden changes in demand.

Heathrow is likely to face more peaky demand and volatility in the future relative to Q6, as a result of the uncertainty around the evolution of COVID-19 and longer-term changes in passenger preferences. This could affect aspects of service in the airport, such as harder-to-manage peaks and troughs throughout the day and less predictable flow rates through security checks. There is also a risk around larger and more sudden changes in demand over H7 if significant travel restrictions were to be re-introduced either in the UK or in other significant markets. This means that, compared to Q6, Heathrow may face a more difficult service context as it may have to adapt to changes more frequently in the upcoming period, for example due to difficulty around staff rostering and flexing the workforce. Heathrow's ability to adapt service to changes in demand will be further complicated by external factors which were less apparent in Q6, such as a much tighter labour market³¹. We have seen some of these impacts in the recent months already and it is clear that managing greater demand uncertainty creates more risk around delivering service quality targets.

³⁰ CAA, Economic regulation of Heathrow Airport: H7 Final Proposals - Summary

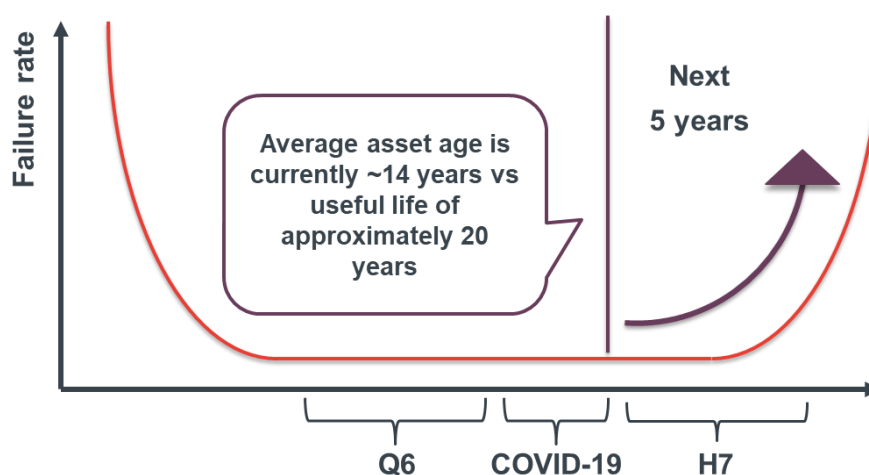
³¹ For example, the Recruitment and Employment Confederation (2021) has found that 88% of recruiters say that labour shortages are one of their biggest concerns for the remainder of 2021. Many staffing companies reporting the tightest labour market they've ever experienced.

Another important aspect around the context of historical performance is the state of Heathrow's asset portfolio in Q6, and how this will differ over H7. The CAA and Arcadis identified that Heathrow performed strongly in asset-based measures over Q6 but have not considered the state of Heathrow's assets in detail.

In 2019, we engaged with Heathrow's asset management team and discussed the relevance of the age profile of assets as an important piece of context around Q6 performance³². Heathrow demonstrated that under the "bathtub curve" model³³, it can be shown that high levels of performance in Q6 correspond to the "Useful Life" phase with low failure rates and stable performance.

However, the asset age context for performance in H7 will be more challenging than Q6, with an average asset age of c. 14 years compared to an average useful life of 20 years. As these assets approach their end of life in H7, Heathrow will face increased pressure on service and maintenance.

FIGURE 3 INDICATIVE BATHTUB CURVE BASED ON HEATHROW'S ASSET PORTFOLIO



Source: Information and data received from Heathrow's asset management team during Constructive Engagement on Heathrow's IBP in March 2020

Note: Based on LEPC, Airbridges, PCA, FEGP and SEGS assets across Heathrow Terminals 2, 3, 4 and 5

6.2 COMPARISON TO REGULATORY PRECEDENT

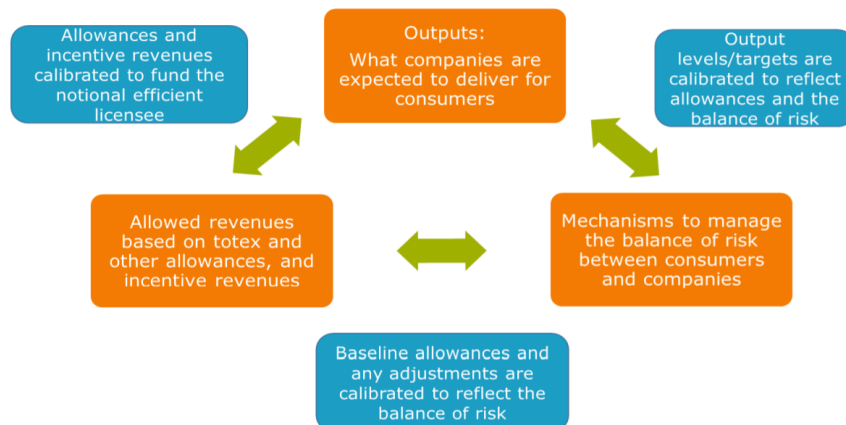
"In the round" assessments of companies in other regulated sectors, such as water and energy, also ideally involve comparisons and benchmarking between companies to determine efficient levels of performance. This is evident in cost benchmarking in these regulated sectors, but also

³² During the initial business planning stage in March 2020, we received data from Heathrow's asset management team on LEPC, Airbridges, PCA, FEGP and SEGS assets regarding the size, age and average useful life of the portfolio.

³³ The bathtub curve is a well-respected model relating to mechanical and electrical asset performance. See "EPA, The Fundamentals of Asset Management, 2012"

in outcome-based regulation and target setting. The diagram below illustrates how Ofgem has made “in the round” decisions at RIIO-2.

FIGURE 4 OFGEM’S “IN THE ROUND” APPROACH TO RIIO-2 DETERMINATIONS

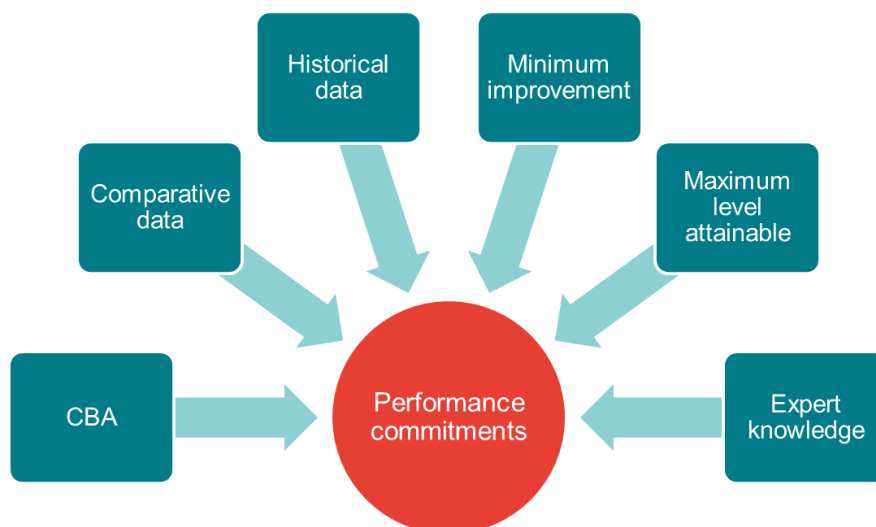


Source: Ofgem, RIIO-2 Final Determinations - Core Document, December 2020

Ofwat’s guidance³⁴ for PR19 stated that companies should use six approaches to inform the way that targets were set. This included historical information on a company’s own performance but Ofwat recognised that this information alone is not sufficient to ensure that the targets were stretching and also to reflect what customers want. Companies were required to look at their own historical performance, compare this to what other companies had achieved, and consider what the minimum improvement level would be taking this information into account. Companies were also required to carry out cost-benefit analysis and to reflect on the maximum attainable level. The use of expert judgement (e.g. engineering expertise) was also encouraged to ensure that this in the round assessment was pragmatic and reflected potentially changing circumstances from one price control to the next.

³⁴ Ofwat, Delivering Water 2020: Our methodology for the 2019 price review Appendix 2: Delivering outcomes for customers, December 2017

FIGURE 5 OFWAT'S PR19 APPROACH TO SETTING TARGETS



Ofwat has recently reflected on how it should set costs and service targets in future, following the CMA reviews at PR19. While the CMA found that “overall, with the exception of leakage...Ofwat had not imposed targets that were unachievable”, it also found that there were examples where “improvements in performance will only come at a cost”.³⁵ Following this, Ofwat has stated that it has an ambition to:

“build on our PR19 approach to setting cost allowances and performance levels by drawing a more explicit link between cost allowances and the service levels we set (ie the cost-service relationship). The output from our assessment of the cost service relationship will be an overall total expenditure allowance that will enable an efficient company to deliver suitably stretching levels of service for the benefit of customers and the environment.”³⁶

This demonstrates the importance of not setting service quality targets in isolation from other aspects of the price control, and in particular the way that cost allowances are set.

Ofwat has recently published its methodology for PR24, and it has more closely aligned how costs and service performance targets are set.

Ofwat said “for each performance commitment, we intend to forecast the performance levels efficient companies can deliver from base expenditure based on historical performance trends. This forecast may take the form of a linear trend, diminishing trend or an alternative relationship if appropriate. We will also consider supporting evidence

³⁵ Competition and Markets Authority, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final report, March 2021, p. 630 and 631

³⁶ Ofwat, Assessing base costs at PR24, December 2021

that provides context for these trends. The impacts of enhancement expenditure will also be considered to determine a final PCL.”³⁷

As Ofwat itself notes the “cost-service relationship is challenging and complex” but is has committed to finding a “pragmatic and proportional approach moving forward”.³⁸ This illustrates that there is regulatory precedent for drawing a more explicit link between service quality targets and cost allowances, despite this being challenging to do in practice. Ofwat has also explicitly recognised the link between enhancement expenditure and performance commitments. While the details of its approach are yet to be tested and there may be disagreement over the level of challenge required, this demonstrates that with well-defined outcomes measures, it is possible to link capital expenditure to consumer outcomes.

We recognise that benchmarking and comparisons within the UK are difficult for Heathrow, due to the differences in its size and volumes compared to other domestic airports. Nevertheless, Heathrow performs very well compared to international comparators with “*the best ASQ scores of any major hub airport in Europe*” and record ASQ scores on passenger satisfaction in recent quarters³⁹. Ofwat’s guidance stated that companies “*might also be able to use comparative data from other sectors or countries*” depending on circumstances. Therefore, the CAA must take into account Heathrow’s excellent comparative performance when assessing targets, rather than simply judging against historical performance in isolation. Heathrow’s strong performance against other airports would indicate that it is near the top end of the performance distribution, and therefore its Q6 targets already reflect a very strong benchmark.

6.3 SUMMARY AND CONCLUSION

Overall, the CAA and its advisor’s approach is still too backwards-looking and overly focused on Heathrow’s historical performance. What Heathrow has been able to achieve in the past is not always a good indicator of what is achievable in future. In the context of H7, the CAA’s approach fails to sufficiently reflect that there is uncertainty around future demand profiles and Heathrow will have to deal with older asset base during H7. The CAA’s approach has also failed to properly reflect consumer views, meaning that we cannot have confidence that OBR will ultimately deliver what consumers want in terms of service levels and priorities across service areas. In future the CAA should make an in the round assessment when considering where to set targets. This approach should reflect what consumers want, have closer links to how cost allowances are set, and better reflect the changing environment of the future price control.

³⁷ Ofwat, Creating tomorrow, together: consulting on our methodology for PR24 Appendix 9: Setting expenditure allowances, p.77, July 2022

³⁸ Ofwat, Assessing base costs at PR24, December 2021

³⁹ Based on reported ACI ASQ information in Heathrow’s RBP update (Heathrow, H7 Revised Business Plan - Update 1, June 2021)

7 INCENTIVES

7.1 CAA APPROACH

The CAA's Final Proposals on H7 incentives represent no significant evolution from SQRB, with an unchanged approach to incentive design, a heavily downside-skewed risk profile and arbitrary rebalancing of SQRB incentive allocations. We recognise that we have made all these points previously during the H7 process, however we repeat them here as the CAA's approach goes against economic principles and is fundamentally flawed. It is particularly important that the CAA reconsiders this aspect of OBR at H8.

On overall incentive design, the CAA has accepted the airlines' views to continue with a knife edge approach. The CAA has also decided to continue with the +7.00% / -1.44% downside to upside revenue risk range for rebates and bonuses, as in Q6.

In its November working paper⁴⁰, the CAA detailed its approach to allocating the downside and upside revenue risk ranges to the list of financial measures. On the allocation of rebates, the CAA stated that their "*starting point for considering the proposed allocation of rebates for H7 was the current set of rebates under the SQRB scheme*". This essentially involved rebalancing the Q6 allocation of the 7.00% downside risk range for new and removed measures in H7. However, in both their initial consultation⁴¹ and guidance⁴² documents, the CAA explicitly pointed towards the use of consumer priorities when allocating incentives:

*Consultation document: "Priority of outcome performance standards should reflect consumer priorities, and **this should inform the calibration of financial measures**"*

*Guidance document: "**Incentives must be justified and calibrated with respect to consumer priorities and willingness to pay**"*

For its revised business plan, Heathrow engaged Systra⁴³ to understand consumer priorities around different measures and areas of service, and correspondingly calibrated incentive levels. Heathrow's resulting allocation of incentives did not represent a wholesale change from Q6 allocations, however incentives were better allocated according to consumer priorities and Heathrow's approach was also more in line with the CAA's guidance. The CAA did not agree with Heathrow's approach, and instead somewhat arbitrarily rebalanced existing SQRB allocations for changes in the list of measures. The CAA's approach has led to some changes in incentive allocation that go against the findings of Heathrow's consumer research.

However, when allocating bonuses, the CAA's approach did reference Heathrow's customer research on priorities and valuation⁴⁴. The CAA used the research to identify that the central search and timely delivery of baggage measures warranted bonuses, and used them in place

⁴⁰ CAA, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Working paper on outcome based regulation, November 2021

⁴¹ CAA, Incentivising the right consumer outcomes – discussion paper, May 2016

⁴² CAA, Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control, April 2017

⁴³ Systra, Passenger Priorities Research, December 2020

⁴⁴ Systra, Passenger Priorities Research, December 2020

the outgoing flight information display screens and departure lounge seat availability bonus measures. While the CAA's approach for bonus allocation is more in line with their guidance than their approach to rebate allocation, we believe that if this approach was followed through fully it would also point towards more areas where customers value outperformance and therefore justify bonus incentives.

The CAA's decisions in its Final Proposals illustrate how arbitrary its judgements on incentives are. The CAA states that it has "*made other minor adjustments to round rebates up or down and to ensure the total comes to 7 per cent of airport charges revenue*".⁴⁵ This statement clearly demonstrates that the CAA has made arbitrary decisions, that its approach is not grounded in sound economic theory or principles and also that the incentive rates it has set are not based on consumer valuations. This point is further illustrated in an example from the CAA's Final Proposals. The measure called 'timely delivery from departures baggage system' became reputational only at the Final Proposals. The CAA concluded "in place of this...HAL should be able to earn bonuses in relation to security queues for transfer passengers".⁴⁶ The incentive structure for this measure was not changed due to new information on consumer valuations or to ensure the incentives had good economic principles, but rather this change was made arbitrarily to compensate for a change that was made elsewhere in the outcomes package. This approach goes against the CAA's own principles for OBR and is also not in-line with regulatory precedent as we go on to explain in the remainder of this section.

7.2 COMPARISON TO REGULATORY PRECEDENT

7.2.1 SLIDING SCALE INCENTIVES

The CAA's approach is at odds with clear regulatory precedent for sliding scale incentives, where incentives reflect the impacts of relative under/over performance and every unit counts. Sliding scale incentives are used in:

- **Water:** As part of its PR19 guidance⁴⁷, Ofwat strongly discouraged knife edge incentives as they do not provide incentives beyond the performance threshold and may "*drive inefficient behaviour by companies to the detriment of customers.*" Similarly, in its PR24 methodology consultation Ofwat has included sliding scale incentives that are intended to be symmetrical both for individual performance commitments and as a package.
- **Energy:** For RIIO-2⁴⁸, Ofgem set principles for incentive design with a focus on ensuring that "*DNOs incur penalties at a level that reflects the consumer detriment associated with the any decline in service performance*" and that incentive payments should "*reflect the value to the consumer of the service improvement (or the detriment caused by service degradation)*".

⁴⁵ CAA, Economic regulation of Heathrow Airport Limited - H7 Final Proposals Section 1: Regulatory Framework, June 2022, para 3.87

⁴⁶ As above.

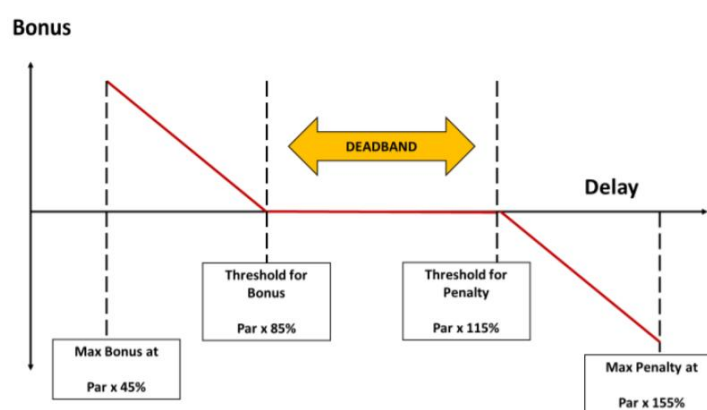
⁴⁷ Ofwat, Delivering Water 2020: Our methodology for the 2019 price review Appendix 2: Delivering outcomes for customers, December 2017

⁴⁸ Ofgem, RIIO-2 Sector Specific Methodology - Core document, May 2019

- Telecoms: Ofcom's principles for Service Level Guarantees⁴⁹ between Openreach and its customers are based on the "pay compensation on a per event basis" and that the "amount of compensation should compensate for average loss".
- Aviation: The CAA's four service quality incentives for NERL at RP3⁵⁰ are all based on a sliding scale design, with deadbands and collars for maximum bonuses and penalties.

FIGURE 6 CAA PROPOSED SLIDING SCALE INCENTIVES FOR NERL AT RP3

Figure D.2: C2 deadband and incentives



Source: CAA

Source: CAA, UK RP3 CAA Decision Document: Appendices, August 2019

The regulatory precedent, including CAA's own approach for NERL, strongly supports sliding scale incentives. Sliding scales also represent sound economic principles, as they can more adequately incentivise outcome delivery by sending strong signals around the detriment and benefit corresponding to different service levels. Airlines have argued that sliding scales introduce the concept of "acceptable failure" for Heathrow. We do not agree with this argument, as all failures under well-calibrated sliding scales would be "unacceptable" to a regulated company. Moreover, compared to knife-edge incentives, sliding scale designs correctly reflect that "large" failures should not be penalised equivalently to "small" failures, which would present poor incentives for companies.

7.2.2 OVERALL RISK AND RETURN

Based on our analysis of the latest energy determination⁵¹, Ofgem has allowed a downside risk range for outcome incentives which is just over two times larger than the corresponding upside

⁴⁹ Ofcom, Service level guarantees: incentivising performance - Statement and Directions, March 2008

⁵⁰ CAA, UK RP3 CAA Decision Document: Appendices, August 2019

⁵¹ Ofgem, RIIO-2 Final Determinations - Finance Annex (REVISED), 2021 and Ofwat, PR19 final determinations: Aligning risk and return technical appendix, 2020

ranges. In comparison, the H7 incentives point to a c. 4.9x larger downside compared to upside range for Heathrow.

In its Final Methodology for PR24⁵², Ofwat has confirmed that it plans to use a symmetrical aggregate sharing mechanism, as follows:

- “as a starting point, we propose that companies can earn or incur up to +3% or -3% RoRE without any sharing of payments beyond which payments are reduced by 50%. Beyond +5% and -5% RoRE, payments would instead be reduced by 90%”;
- “this provides protections to both customers and companies from very high outperformance or very high underperformance payments”.

Ofwat’s indicative PR24 RoRE range for the notional company also illustrates that it expects companies to face a symmetrical overall risk and return for outcomes, see below.

FIGURE 7 PR24 INDICATIVE RORE RANGE FOR NOTIONAL COMPANY



Source: Ofwat, *Creating tomorrow, together: consulting on our methodology for PR24, Appendix 10 - aligning risk and return*, July 2022

At PR24 Ofwat has also amended the way that the unit incentive rates are calculated as it believes that “outperformance and underperformance rates should generally be symmetrical”.⁵³

Compared to the water and energy sectors, where poor service and delivery by regulated monopolies can result in significant detriment and negative externalities, it is not entirely

⁵² Ofwat, *Creating tomorrow, together: consulting on our methodology for PR24, Appendix 8 - outcome delivery incentives*, July 2022

⁵³ As above

apparent why an airport should be faced with a more skewed and stretching incentive package. The downside skew in other sectors helps represent the risk to customers and corresponding incentivisation against “bad” outcomes, such as pollution, outages and other harmful events. On the other hand, Heathrow, as a business focused on positive customer service, should be incentivised to deliver “good” outcomes, such as easier and predictable journeys. Therefore, the CAA’s proposal’s for a heavily downside-skewed package do not seem reasonable when compared to risk ranges in other sectors.

7.2.3 DRAWING ON CONSUMER RESEARCH

The CAA has stated that *“with a large volume of research available, and a wide range of judgements to be made about which studies to use and how precisely to convert their findings into a specific set of rebates, we continue to consider that the existing set of rebates is a more sensible starting point for consultation with stakeholders than the set of rebates put forward by HAL.”*⁵⁴ While the CAA is right that there are multiple challenges associated with carrying out consumer research and drawing on the insights to inform how an outcomes framework is developed, other regulators have adopted a different approach to the CAA.

In water as an example, Ofwat has not shied away from these challenges and customer engagement has directly been used to set the incentive rates within the outcomes package. Ofwat has also been brave enough to experiment with different approaches to how customer engagement should be carried out and used in setting price controls. When Ofwat introduced OBR in the water sector at PR14, customers were front and centre to this innovation. Companies were required to carry out customer research to inform the way that incentives were set. Despite practical challenges with carrying this through, Ofwat concluded in the PR14 Final Determinations that *“it is appropriate to base the incentive rates in the ODIs on the value that customers place on delivery.”*⁵⁵

Ofwat has recently published the methodology for the third price control based on outcome-based regulation, PR24, and customer engagement is still central to the design of incentives, however Ofwat has adopted a different approach to carrying out the customer research. Ofwat concluded that for PR24 it would lead a collaborative research piece rather than relying only on companies’ customer research. It states that the benefits of this approach are as follows:

- *“Increasing the overall quality and consistency of customer research on customer preferences and valuations;*
- *Providing us, companies and other stakeholders with greater certainty that we are reliably identifying similarities and real differences between customers and communities across company, regional and national boundaries;*

⁵⁴ CAA, Economic regulation of Heathrow Airport Limited - H7 Final Proposals Section 1: Regulatory Framework, June 2022, 3.62

⁵⁵ Ofwat, Final price control determination notice: policy chapter A2 - outcomes, December 2014

- *Where appropriate, provide comparable results across all companies that can help the customer challenge process.*⁵⁶

In its recent PR24 methodology publication, Ofwat has confirmed that companies should use the insights from the collaborative research to inform how ODIs are set. Ofwat has stated that the “collaborative research is the basis for marginal benefit estimates for almost all common performance commitments”.⁵⁷ Ofwat has proposed a specific formula for calibrating incentives that sets reward and penalty rates at 70% of marginal benefits. This provides a clear link between consumer research and incentive rates and the overall risk and return balance. This shift from individual companies undertaking research to collaborative research is another approach to dealing with practical challenges of drawing on customer insights to set price controls. While some may not agree with the details of the design of each of Ofwat’s approaches, the positive side of Ofwat’s approach is that it has faced the challenges head on and has not shied away from directly using customer views to inform how price controls are set.

7.3 SUMMARY AND CONCLUSION

The CAA’s goal for future reviews should be to incentivise Heathrow to further stretch in delivering high levels of service, and continue delivering consumer outcomes with innovation and ambition. A more balanced package, with greater scope for rewarding outperformance, would help incentivise such behaviour from Heathrow at H8.

8 CONCLUSION

In setting its Final Proposals for H7, the CAA has missed an opportunity to deliver meaningful change with a move forward from the output-focussed SQRB regime to a more outcomes-based approach to regulation. It has not given a voice to the consumer, has not followed its own principles in designing OBR, and has not reflected best practice from regulatory precedent from other sectors that have applied outcomes-based frameworks, such as Ofwat and Ofgem’s recent periodic reviews. Instead, the CAA’s version of OBR is a continuation of the SQRB approach, which has been largely unchanged since its inception in 2003.

- The CAA has not achieved the majority of the principles it set out in its initial guidance for Heathrow. This includes the CAA’s objectives of adequately reflecting consumer research in its proposals, ensuring consumer views are weighted commensurately with airline views, and meaningfully evolving the current output-focused SQRB regime to better deliver outcomes for consumers.
- Regardless of the high-level policy objectives the CAA initially identified, the fundamental principle underpinning OBR in H7 should be centred around translating robust consumer outcomes into effective measures, targets and incentives that reflect consumer views and deliver their expectations. Yet, the Final Proposals for outcomes

⁵⁶ Ofwat, PR24 and beyond: Creating tomorrow, together, May 2021

⁵⁷ Ofwat, Creating tomorrow, together: consulting on our methodology for PR24, Appendix 8 - Outcome delivery incentives, July 2022

are not effective, as they simply act as “add-ons” to the existing SQRB regime without acting as important inputs towards the remaining building blocks of OBR.

- The CAA’s approach to targets is not aligned with its guidance, by focusing primarily on Heathrow’s historical performance and thereby discounting a wide range of evidence that Heathrow considered in its research.
- Lastly, the CAA’s decisions on incentives represent no significant change from SQRB, with a heavily downside-skewed package of incentives coupled with inefficient rebate design. This approach on incentives does not reflect regulatory precedent, and likely push Heathrow towards becoming more risk averse when considering economic principles. For effective OBR at future reviews, the CAA should push Heathrow to drive further service improvements for its customers and deliver innovation and ambition, through the use of sliding scale incentives, a more balanced under- and outperformance risk range, and incentives that reflect consumer valuations.

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