

Working Paper on Future Models for Economic Regulation: HSPG Response

Introduction

Heathrow Strategic Planning Group (HSPG) is a non-statutory partnership of Local Authorities working together to ensure a strong local authority voice in respect to matters relating to the current operations and future growth at Heathrow Airport. The member authorities are Spelthorne Borough Council, Elmbridge Borough Council, Runnymede Borough Council, Surrey County Council, Royal Borough of Windsor & Maidenhead, Slough Borough Council, London Borough of Ealing and London Borough of Hounslow.

Preliminary Observations

HSPG has considered the very interesting discussion in the working paper about potential changes in economic regulation and has the following observations on the analysis presented and on future work by the CAA. We would be very happy to discuss these further. We are also copying these comments to DfT and to CISHA (council on independent scrutiny of Heathrow airport).

The expansion project is highly complex and working to an exacting timetable. In relation to the interface between changes in economic regulation and the planning processes associated with a development consent order the following points are critical:

- Any changes in economic regulation need to be reviewed against the timetable for securing development consent and its implementation. A shift to a new regulatory model could be very disruptive.
- Statutory obligations (planning, environment and others) must not be undermined by changes in economic regulation.
- Sufficient mitigation and compensation are essential components in considering growth and a significant strand of being a 'good neighbour' to the communities, businesses and environments within which Heathrow sits.

Approach to Evaluation

Turning to the specific issues in the working paper, in respect of the CAA's primary duty, the evaluation framework must not have a narrow focus on current consumers. As a minimum it should address quality as well as cost and future consumers as well as current ones.

Moreover, the evaluation criteria as proposed:

- do not give sufficient weight to the delivery of infrastructure that is necessary to meet user needs and expectations.
- over emphasise competition without countervailing considerations about the impacts of reduced integration in the asset base and in operations (clearly competition on procurement and operation within an integrated environment is very different).

In respect of the latter point, HSPG recognises the arguments in principle for both a project-by-project and a major programme approach. Competition between asset operators or owners would require a project-by-project approach. So, there must be a very clear appreciation of why competition would lead to genuine cost and quality benefits and not detract from the integration of operations that HAL have suggested, with some force, should be one of the criteria for evaluating specific regulatory models. From the perspective of HSPG, the case for the benefits of competition arising from third party ownership and operation of assets is unproven from experience elsewhere and would need to be substantiated to a much greater extent before it became a fundamental element of a revised regulatory regime or moving to a project-by-project approach.

In terms of secondary duties, HSPG is clear that any future regulatory model must allow reasonable measures to mitigate the environmental effects of the airport and hence whether the model can support the capital expenditure required for expansion, including environmental mitigation measures.

This, however, is necessary but not sufficient. In applying the duty to secure the ability of the licensee to finance 'its activities', these activities must include **all** the activities that are required to address fully the externalities imposed by the expanded airport and to ensure that the infrastructure is of sufficient quality.

So, the central question is who defines the nature of these activities. That becomes even more significant if there is not any public funding for expansion. The new regulatory model cannot leave some vital infrastructure unfunded. Nor should it be used to shift costs to other users of services, particularly on transport.

One potentially significant example which may be instructive to address is how additional infrastructure provision relating to energy supply for the expanded airport would be addressed within the regulatory regime. On the one hand there are existing delivery mechanisms in place, but expansion will add further to the case for enhancement and bespoke arrangements to ensure resilience and have imperatives in terms of the timetable for work to be completed. How would the infrastructure necessary to secure robust and sufficient energy supply to the expanded airport be addressed through a reformed regime for economic regulation?

Accordingly, it is critical for the CAA to be clear about how it will reflect in its assessment the Government's objectives on climate change, noise and air quality alongside the central CAA focus on the efficient and timely delivery of new capacity.

As regards efficient and timely delivery, the approach should be to define the envelope of costs reflecting the full range of relevant activities and then focus on efficient and timely delivery.

To underline the point, it would be unacceptable from the perspective of the stakeholders represented by HSPG to see activities necessary to ensure that the benefits of expansion are realised and the externalities of expansion are properly addressed as somehow detracting from efficient and timely delivery.

Possible Models

In terms of the broad options for change considered in the paper:

- for the options associated with the development and enhancement of the current regulatory approach, HSPG is particularly aware that there is, currently, a gap in knowledge about the effects of more recent innovations. It is clearly crucial to see the results of the *ex post* analysis of capital costs for T5, the operation of the more recent *ex ante* regime for capital costs, plus the impact of stronger involvement of stakeholders and outcome-based regulation for quality. Unless the evidence militates strongly against any of these, HSPG would regard all of them as part of the baseline approach to be included in any new regulatory framework and against which any further changes should be considered.
- From the perspective of people living around the airport, there will be an expectation that a new regime for economic regulation does indeed have incentives and where necessary penalties for delivery, particularly for the mitigation measures to address the impact on local communities. How would a reformed system of economic regulation add to the pressure on the developer and operator to ensure that these are indeed delivered?
- In principle, there could be significant benefits in moving to a long-term regulatory framework for expansion and this should be a significant focus for the next stage of work by the CAA.
- In respect of model 1b, the potential benefits of formal separation between the system planning function and the operational functions including asset delivery should be examined further. Separating design and co-ordination of systems from operational aspects could help in scoping changes that would secure wider development benefits identified through spatial planning. We are, however, very conscious of the substantial organisational change processes involved in such a split, particularly if the system planning function were to be hived off into a NESO type of structure.

- HSPG views changes to facilitate competition in the delivery of infrastructure – broadly models 4 – 6 - including competitive tendering, contracts for delivery and operation, as relevant options that should be considered further. As discussed above, we are far more sceptical about models 7 and 8 which would allow third party involvement in ownership and operation. If such a model is to be adopted, the asset or operation must be clearly separable from the wider operation of the airport, and the practical consequences must be subject to fundamental review.
- In that context, any regulatory model must give full weight to the risks to safe and effective operations both during and after construction. This includes removing any incentives to cutting corners for speed or cost reduction.
- In relation to model 9, the discussion in the working paper illustrates the significant problems with price benchmarking with international comparators. If such benchmarking were to be used mechanistically it would need to be very precise and the evidence suggests that test is not currently met.
- Using long run incremental costs to cap charge increases requires a robust basis for determining forward costs associated with an ‘increment’ in operational outputs. The ability to develop a sufficiently robust basis is unproven.
- Light touch regulation and more emphasis on commercial pressures and negotiation along the lines of Gatwick would be a huge change. To move in this direction would require a fundamental review of market power. HSPG would also be very concerned if forward investment plans were not binding and could be reopened through commercial negotiation.

HSPG
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