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9th August 2022

British Airways Response to CAP2365
Economic regulation of Heathrow Airport Ltd
H7 Final Proposals

Thank you for the opportunity to respond to your latest consultation on the Economic Regulation of Heathrow; we set out below our views on the Civil Aviation Authority's ("CAA") proposals and implications for the wider policy environment.

This consultation response is structured as follows:

- Chapter One: Executive Summary
- Chapter Two: Overview of Regulatory Framework
- Chapter Three: Consultation Response
- Annex One: Supporting Detail to Consultation Response
- Annex Two: AlixPartner's report titled "Analysis of the CAA's Final Proposals", dated 9 August 2022
- Annex Three: CEPA's report on the Cost of Capital, dated 9 August 2022

CHAPTER ONE: EXECUTIVE SUMMARY

Heathrow is an essential component of the UK's infrastructure, hosting highly competitive network airlines that connect Britain to the world. Airline networks build connectivity that drives the economy forward by connecting people and goods with key business and leisure markets, however, these benefits are under threat where a monopoly business is motivated to secure financial advantages for its investors through regulatory protections that would be unattainable in a competitive market.

Monopolies derive their market power from powerful barriers to entry, and where unchecked, this power causes substantial damage to the economy through their ability to levy excessive prices, place constraints on supply to maximise profit, and hold back economic productivity through their own inefficiency, depriving the economy of dynamism and leaving households poorer as a result.

As a result, regulation must seek to protect consumers, and should not tend toward positions held by the regulated company, neither as a result of the information asymmetry, nor due to excessive regulatory caution that is incompatible with dynamic and competitive markets. Otherwise, the consequences would be severe, and the consumer left unprotected from the power of the monopoly.

As a whole, the Final Proposals are a marked improvement on the Initial Proposals and there are aspects of it that we support. Whilst we welcome the CAA's position in Final Proposals that passenger charges should be no more than £24.50[1] in 2020 prices we maintain that this number remains too high for reasons that follow. We also support the Final Proposals in so far as they:

- **Reject charges at a level advocated by Heathrow** which elevate charges in some instances up to three times greater than those in Q6

- Introduce **capital efficiency incentives** to ensure that Heathrow's capital expenditure becomes more efficient over time based upon robust delivery obligations

- **Reject further adjustments to the regulated asset base**, ensuring incentives are not undermined further by additional ex post adjustments

Nevertheless, we consider that fundamental aspects of the CAA's Final Proposals are flawed and have clearly been driven by a combination of errors and irrational judgements at the heart of the price control. With respect to the price cap specifically, the CAA's position has achieved the bottom of the £24.50 to £34.50 range presented in Initial Proposals[2], which rightly recognises the fact that Initial Proposals were inherently inflated, as noted in our response[3] to those Initial Proposals. However, the errors we have identified elsewhere in the regulatory framework support a position that the price cap should be lowered still.

This is particularly the case within passenger forecasting, measurement of risk within the cost of capital, and calibration of the traffic risk sharing mechanism, which individually have been set in ways that elevate the charge, and in combination are inconsistent with each other under a volume-based regulatory framework

More specifically, the aspects of the CAA's Final Proposals that do not go far enough, and our key remaining areas of concern are as follows:

- **Passenger forecasts** remain too low for the H7 period, as evidenced by independent forecasts for UK aviation. We consider the CAA remains too reliant on Heathrow's model;

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[1] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", table 3: price cap profile

[2] CAA CAP2265A, "Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary", table 3: summary of our initial proposals for airport charges

[3] British Airways response to CAA CAP2265

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- **Traffic risk sharing,** as currently provided for within the regulatory framework, is an unacknowledged risk transfer, with the outer band undermining key incentives, and an inner band too narrow due to the annual approach;

- Whilst the Final Proposals have done well to exclude measures outside of Heathrow's control, the **outcome based regulation** as proposed results in lower targets than those in place in Q6, an easier ability to earn bonuses, and omits key aspects of critical infrastructure;

- **Operating expenditure** remains greater than necessary, with all people costs inflated by a shared service margin and unnecessary pension deficit repair costs included;

- **Commercial revenues** are lower than desirable with a weak management stretch target applied, and terminal drop-off charges reduced for an anomaly in Heathrow's calculation of revenues that has not been accepted by the CAA without airline verification;

- **Capital expenditure** is inflated by c.£1.2bn in the later years of H7 to a level that significantly exceeds delivery capability and any likely capital requirements;

- The Final Proposals contain weaker **capital incentives** compared to other regulated sectors, resulting in insufficiently strong incentives to ensure expenditure does not run over-budget;

- The **cost of capital** is inflated by an asset beta that fails to recognise the significant transfer of risk identified above and over-estimates its starting point in the market;

- The **regulated asset base** is inflated by a RAB adjustment that has been awarded in error, and was granted on the basis of spending commitments that have not been kept; and

- The **asymmetric risk allowance** has been applied on the basis of calculations that are not sufficiently robust, and duplicate the measurement of risk in the cost of capital.

We also have significant concerns in respect of:

- **Heathrow's capping of passenger numbers in 2022**, which will result in consumers paying for Heathrow's inability to provide capacity, and which is unaccounted for in the CAA's model

- **Information asymmetries**, with information and model confidentiality resulting in airlines not being in a position to review and where necessary challenge evidence provided by Heathrow

- The weight the CAA has placed on **Heathrow's financeability** at the expense of the consumer, particularly where equity has not been raised as a result of the pandemic

- **The process of this periodic review**, which has been protracted even before the pandemic, with a failure of constructive engagement and lengthy process delays.

We remain concerned that the CAA has been overly generous by continuing to accept many of Heathrow's arguments in its Final Proposals, particularly where our ability to challenge Heathrow's position has been limited by a vast information asymmetry between airlines and Heathrow. This has been exacerbated by Heathrow's submission of an RBP Update 2 in its response to Initial Proposals along with additional submissions during the CAA's development of Final Proposals that have not been the subject of scrutiny or in some areas not even been released to airlines due to Heathrow's "confidentiality" concerns.

As part of our response, we, together with Virgin Atlantic Airways Limited and Delta Air Lines, Inc. engaged independent expert economists, AlixPartners, to examine and provide their independent views on the CAA's economic analysis underpinning the Final Proposals. A copy of Alix Partner's report dated 9 August 2022 is appended to this response ("**AlixPartners Report**"). We (alone) also engaged CEPA to prepare a report regarding the cost of capital. A copy of this report ("**CEPA Report**") is also appended to this response. We make reference to both reports throughout this response. In addition, we incorporate by reference our previous responses to this H7 periodic review, including our response to the CAA's Initial Proposals and those of the AOC/LACC that represent the airline community at Heathrow. Should there be any inconsistency between our previous responses and this response then this response should be taken as our up to date position.

At this stage, our analysis suggests an airport charge of ✂ on average across H7 (2020p)[4]; we are not yet able to fully utilise the CAA's PCM and CTA's model for opex and commercial revenues, therefore will seek to provide greater accuracy to this estimate as our familiarity with the CAA's PCM improves.

CHAPTER TWO: OVERVIEW OF REGULATORY FRAMEWORK

The CAA duties are set out in section 1 of the Civil Aviation Act 2012 ("CAA12" or the "Act"). It provides that the CAA must "carry out its functions under this chapter [Chapter One: Regulation of Regulation of Operators of Dominant Airports] in a manner which it considers will further the interests of users of airport transport services regarding the range, availability, continuity, cost and quality of airport operation services" and must do so "in a manner which it considers will promote competition in the provision of airport operation services". Sub-section 3 provides that in performing its duties, the CAA must have regard to, amongst other things:

a) the need to secure that a licence holder can finance its provision of airport operation services (although the CAA is not required to ensure the financing of regulated airports in all circumstances);

b) the need to secure that all reasonable demands for airport operation services are met;

[4] As compared to £24.50 (2020p).

c) the need to promote economy and efficiency on the part of the licence holder in its provision of airport operation service; and

d) the principles set out in sub-section 4, namely that regulatory activities should be carried out in a way that is transparent, accountable, proportionate and consistent, and only targeted at cases in which action is needed.

In relation to paragraphs (b) and (c) above, the explanatory notes to the Act states that one would expect these needs to be met in a competitive market where airport operators provide the services demanded by passengers at minimum cost. The requirement to have regard to these needs reflects the fact that the aim of the economic regulation of airports is, as far as is possible, to replicate the outcomes of a competitive market

Sections 14 to 21 concern the granting of licences by the CAA to dominant airports. Pursuant to Section 18, a licence may include:

a) such conditions as the CAA considers necessary or expedient having regard to the risk that the holder of the licence may engage in conduct that amounts to an abuse of substantial market power in a market for airport operation services (or for services that include airport operation services), and

b) such other conditions as the CAA considers necessary or expedient having regard to the CAA's duties under Section 1.

More specifically, Section 19(2) states that "A licence must include such price control conditions as the CAA considers necessary or expedient having regard to the risk referred to in Section 18(1)(a)"

It is against this regulatory framework that any decisions on the H7 regulatory period must be made

CHAPTER THREE: CONSULTATION RESPONSE

This Chapter Three contains our key submission points with respect to Final Proposals. It identifies both those aspects of Final Proposals that we support but, more importantly, those aspects of Final Proposals that we disagree with or where we consider material errors have occurred.

We have adopted the structure of the Final Proposals for ease of reference.

This Chapter Three should be read together with Annex One: Supporting Detail to Consultation Response which follows broadly the same structure at Chapter Three and in which we set out additional details supporting our submissions.

1. Passenger Forecasts[5]

1.1. Heathrow is regulated on a per passenger maximum allowable yield, which incentivises Heathrow to deliver capacity in response to demand changes; as noted by AlixPartners, "the impact of passenger forecasts is even more crucial than in most regulatory control periods"[6]

1.2. Despite operating at or near capacity for many years, the pandemic has demonstrated the impact that government intervention can have on passenger volumes by artificially supressing demand; it is clear that Heathrow does not now face any material remaining Government pandemic-related travel restrictions, and that the drivers of passenger volumes must be based upon underlying economics

1.3. As set out in the AlixPartners report, "were the CAA to materially underestimate (or overestimate) the rate of recovery in passenger traffic this could lead to airlines paying materially too much (or, too little) in airport charges compared to the costs incurred by HAL"[7]; passenger volume forecasts not only act as the divisor of Heathrow's forecast cost base, but drive forecasts of commercial revenues in the single till, and as a result are extremely important across other building blocks of the price control

1.4. In this context, it is imperative that the CAA develops defensible and independent forecasts of passenger volumes within a process that allows airlines to engage in the assumptions used; unfortunately, this has not been the case, since the CAA has neither developed its own model independent of Heathrow's model nor made the model available to airlines, leading to significant errors as a result

1.5. Furthermore, the recovery in 2022 has demonstrated the shortcomings of Heathrow's modelling, with strong passenger demand compelling it to materially increase its investor disclosures related to passenger forecasts twice this year alone[8]; this suggests the Heathrow model is unreliable at best as an indicator of H7 passenger volumes, and at worst contains substantial inaccuracies and errors

Heathrow's modelling errors not fully removed by the CAA adjustments

1.6. Whilst we welcome the CAA's adjustments to Heathrow's model where they remove clear duplication and bias, we remain concerned that Heathrow's model contains a number of other adjustments to input economic and passenger forecast data such that the CAA may not have removed the many biases and influences introduced by Heathrow over time

[5] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", chapter 1
[6] AlixPartners, Comments on the CAA's Final Proposals, section 3
[7] AlixPartners, Comments on the CAA's Final Proposals, section 3
[8] Heathrow (SP) Ltd, Results for the 3 months ended 31 March 2022, and previous reports as set out at Heathrow's Investor Centre

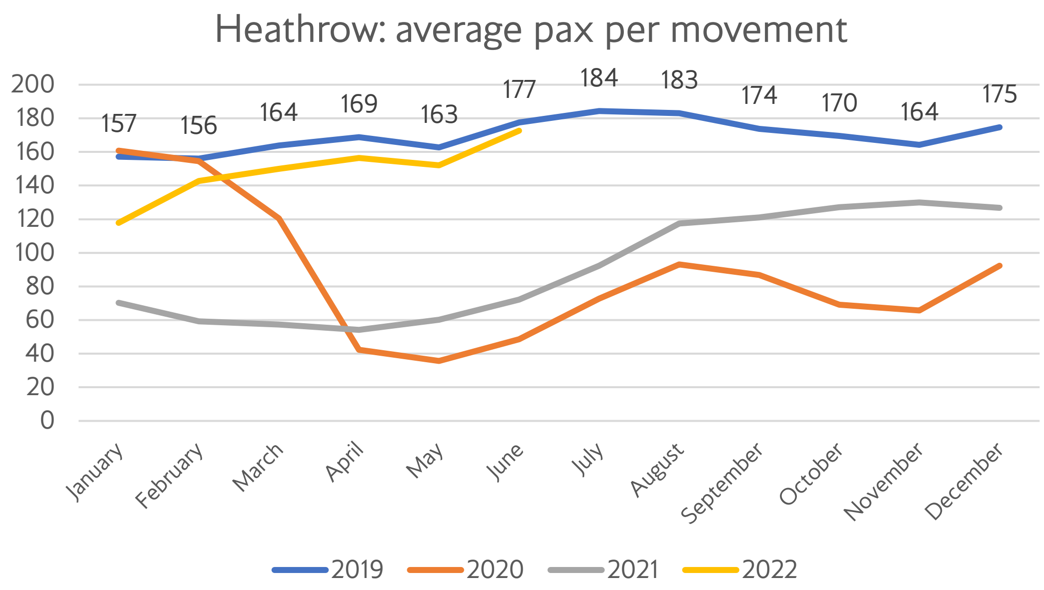
1.7. In particular, we are not convinced that there should be any adjustments to the input of Oxford Economics forecasts by Heathrow, since the economic data itself would capture those key elements in the first place; we note that Oxford Economics incorporates data on air fares, business sentiment, inflation, trade intensity, population, exchange rates and wealth amongst others, therefore any adjustments in these areas must be fully reversed by the CAA for accuracy

1.8. In addition, we are not clear that the CAA's adjustments actually removed the stated effects or clear as to the mechanism by which the bias has been removed; without re-running the model in full absent the bias, the model is unlikely to produce a result that is useful or uses the techniques built by the original modeller, with adjustments to model outputs instead further clouding the modelling approach

1.9. We therefore believe that in its continued use of the Heathrow model and despite its adjustments with which we partially agree, that the CAA is in error as a result of the many and varied adjustments that Heathrow may originally have introduced to adjust the Oxford Economics data to its own purposes; we continue to have severe doubts about the Heathrow model due to the fact we have not been able to independently verify any of Heathrow's modelling

1.10. For example, we are unable to see what information has been used for load factors when considering the supply model applied to Heathrow; nevertheless Heathrow's performance to date demonstrates that passengers per movement by June 2022 had almost recovered to pre-pandemic levels as new aircraft deliveries have both replaced aircraft retired during the pandemic and delivered new growth, whilst airlines direct larger-capacity aircraft towards Heathrow

Chart 1.1: Heathrow passengers and air transport movements[9]



1.11. Business travel is another key concern, since the Oxford Economics data use IATA passenger intelligence service ("PaxIS")[10] as an input to its economic data; this captures the world's airline sales information that settles through IATA's Billing and Settlement Plan ("BSP"), and further considers direct, low cost and charter sales along with those in non-BSP markets

1.12. Therefore, there should be no need to make any adjustments for business travel, whose demand is already captured within the forecasts of passenger volumes generated by Oxford Economics; the interactions of market demand and air fares is fully considered within these forecasts, and we believe it would be an error to make any downward adjustment for business travel as a result, and therefore that the CAA must fully remove this effect from the Heathrow model rather than allowing an impact of "10% in the most likely scenario for these Final Proposals"[11]

1.13. Carbon pricing has been fully factored into the underlying Oxford Economics data using the latest information on the impact of such costs on demand; whilst we agree with the CAA that "the increase in airline operating costs is unlikely to be as high as that suggested by HAL"[12], due to the fact that this information and airfares are already incorporated into the underlying data for passenger demand from Oxford Economics, it is clearly in error for the CAA to maintain "the same increases

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[9] Heathrow monthly traffic statistics to June 2022
[10] IATA Passenger Intelligence Services (PaxIS) overview
[11] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.46
[12] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.48

to fares as a result of increased costs to airlines that we previously used for Initial Proposals"[13]

1.14. We continue to believe that "HAL's use of "covid demand overlays"[14] in its demand model" are fundamentally flawed due to duplication with the underlying Oxford Economics passenger forecast data; in particular the opacity in modelling, the anomalies highlighted by the CAA and the duplication with the supply model give particular cause for concern since none of these modelling approaches have been seen and audited by airlines or their advisors

1.15. The CAA is therefore in error to even "use the covid demand overlays which had been in the HAL model for Initial Proposals"[15] given its own observation that "the covid demand overlays were simply refitted to the mathematical equation assumed to model the demand recovery from the pandemic. This resulted in an overall decrease in traffic forecast for H7 in the central scenarios even though the amendments to the TRM generally gave rise to an improvement in demand"[16]

1.16. As a result, it is clear to us that Heathrow's forecasting model contains potentially incorrect economic adjustments that are completely opaque to airlines, using non-robust mathematics and poor logic that result in lower passenger volume forecasts for H7; it is imperative that the CAA reconsider the weight placed upon Heathrow's model and place greater weight on external forecasts, because, as identified by AlixPartners, even using an adjusted version of Heathrow's model will result in error

The synthesised forecast

1.17. The CAA state that "we have continued to take account of HAL's model, using both HAL's assumptions and those we have decided to amend, as well as the AOC/LACC's forecast" and that "we have also taken into account other air traffic forecasts, modifying them where we consider it necessary to make them more applicable to Heathrow over H7"[17]; unfortunately, this does not disclose how exactly this synthesis has been performed

1.18. AlixPartners observes that "the CAA final traffic estimates give very little weight to the external forecasts"[18], "only mentions the external forecasts when forecasting the 2022 volumes"[19], and "simply states that the amended RBPu2 model

[13] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.49
[14] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.52
[15] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.52
[16] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.51
[17] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.34
[18] AlixPartners, Comments on the CAA's Final Proposals, section 3
[19] AlixPartners, Comments on the CAA's Final Proposals, section 3

projections are within the range of the external forecasts"[20] even where "this does not appear to be the case as regards the most relevant forecasts"[21]

1.19. It appears that the CAA central forecast is still based upon the CAA adjustments to Heathrow's model, with indeterminate weighting placed upon "a range of traffic forecasts, alongside other relevant information and evidence"[22] informed by various non-Heathrow forecasts, that have themselves been adapted to infer a Heathrow forecast as a % of 2019 volumes by converting "all forecasts to a comparable, common basis"[23]

1.20. These forecasts are not however the latest available given that Eurocontrol have published an interim forecast update covering 2022-2024[24]; as the CAA will be aware, Eurocontrol plan to issue their next, comprehensive 7-year forecast for air traffic in autumn 2022, at which point we would be keen to ensure that the latest information is taken into account

1.21. The CAA must therefore be cautious that it is using the latest available information, noting also that the ICAO economic impact analysis was updated in June 2022, and the ACI Europe forecast was updated in May 2022, since by not using the latest information available the CAA approach is in error; in addition, the CAA should be careful to consider the input economic data of many of these forecasts

1.22. It is important to note that the economic data provided by Oxford Economics that drives its Tourism Economics forecasts of air passengers is a common input for many of these forecasts; it should be concerning that these separate forecasts result in such different inferred answers for Heathrow's forecast passenger volume when they have been developed on the basis of this common input

1.23. We further reiterate our view that the CAA's base forecasts remains based upon CAA adjustments to the Heathrow model alone; the weight placed upon external forecasts appears to be low, and where the CAA notes that its modelling output "was broadly in the overall range of datapoints considered"[25] the way in which it has adapted these forecasts to Heathrow passenger numbers appears to have simply confirmed the output of its adaptations to Heathrow's model

1.24. The CAA forecasting approach does not therefore appear to change fundamentally from that of Initial Proposals, being an adjustment to Heathrow's model that itself remains unscrutinised; the synthesised forecast appear to have

[20] AlixPartners, Comments on the CAA's Final Proposals, section 3
[21] AlixPartners, Comments on the CAA's Final Proposals, section 3
[22] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.17
[23] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.54
[24] EUROCONTROL Forecast Update 2022-2024
[25] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.61

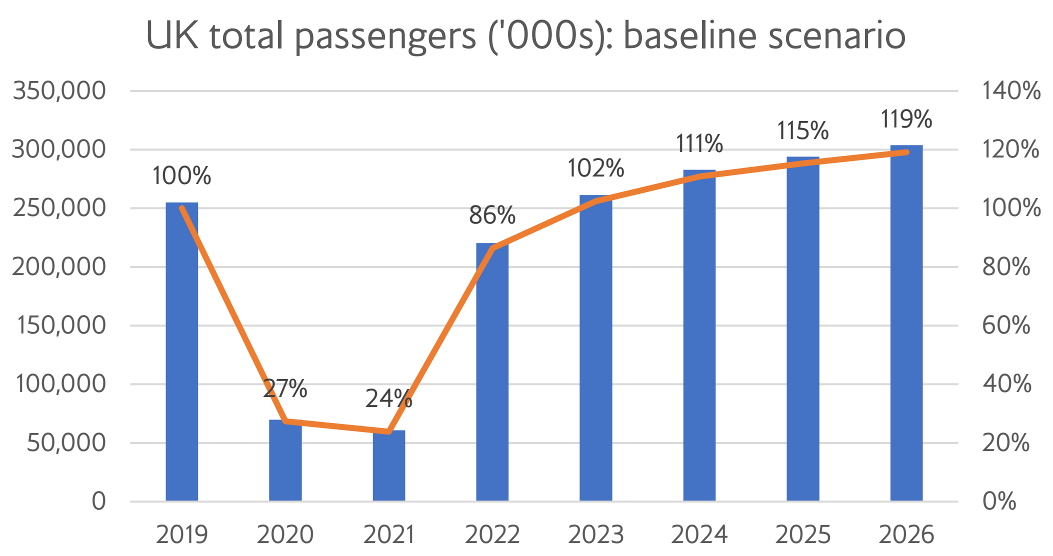
little or no effect on the CAA's forecast numbers other than to confirm the output of its original approach

1.25. It is imperative that the CAA properly takes into account external forecasts to correct these errors, which provide useful information that can be used to infer the recovery of passenger volumes at Heathrow; as noted by AlixPartners, "given the abundance of available public sources, we consider the CAA has moved in the right direction by accounting to some degree for external forecasts in its results"[26], though it is our view that these have neither been given sufficient weight, nor have been the latest available information to infer a Heathrow forecast

Updates to independent forecasts

1.26. The latest information on passenger forecasts available from Oxford Economics shows UK passenger numbers exceeding 2019 numbers in 2023, far ahead of the information shown in the CAA's Final Proposals for this data source, leading to our concerns that the CAA may have used dated information in its analysis

Chart 1.2: Oxford Economics UK air passenger forecast[27]



1.27. Were passenger numbers at Heathrow to remain in line with those across the UK, we have provided an indicative forecast for passenger numbers at Heathrow as below, though we have capped this forecast at 85m passengers in 2024 to 2026 to reflect the current capacity of the terminal infrastructure

1.28. It is not credible that a capacity constrained airfield that is home to major network airlines might not recover to 2019 levels of passenger demand until the end of the

[26] AlixPartners, Comments on the CAA's Final Proposals, section 3
[27] Oxford Economics UK Total Passenger Baseline data, extracted 29th July 2022

H7 price control period where the Oxford Economics data that feeds the same model reaches 119% of 2019 volumes in 2026 for the UK as a whole

Table 1.3: Indicative Heathrow passenger numbers based upon UK forecast

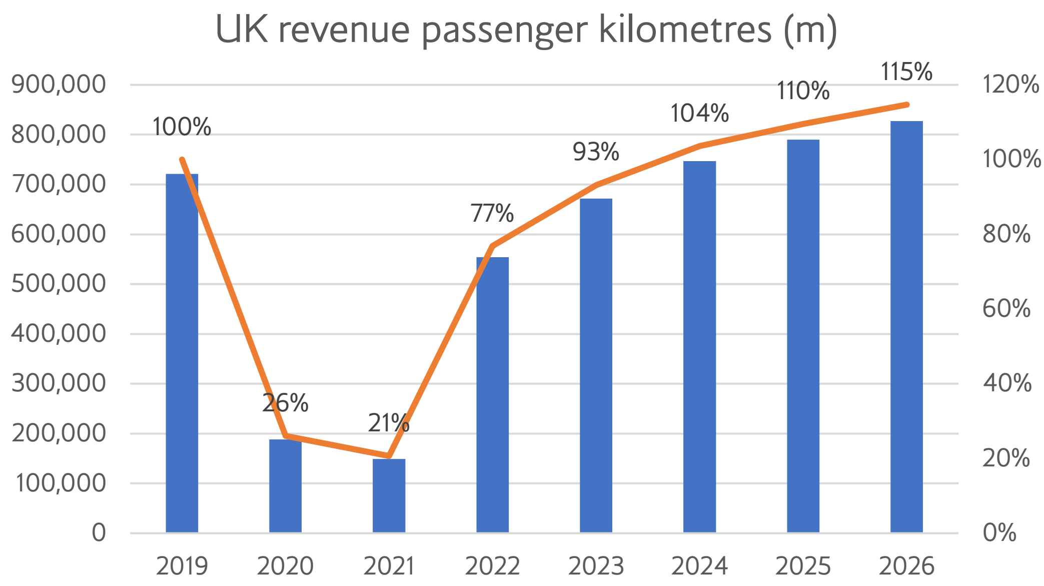
	2019	2020	2021	2022	2023	2024	2025	2026	
UK Passengers (k)	255,086.8	69,834.4	60,835.8	220,486.9	261,273.7	282,845.0	294,107.4	303,877.3	
% of 2019 passengers	100.0%	27.4%	23.8%	86.4%	102.4%	110.9%	115.3%	119.1%	
Heathrow passengers (m)	**80.9**	22.1	19.3	69.9	82.9	89.7	93.3	96.4	
Heathrow passengers with 85m cap	**80.9**	**22.0**	**19.4**	**69.9**	**82.9**	**85.0**	**85.0**	**85.0**	**407.8**

1.29. This exercise suggests Heathrow passenger numbers of 407.8m over the course of H7 based upon the fundamental economics of UK passenger demand; whilst this only uses Oxford Economics' base case scenario information (rather than its high case), it highlights the strength of demand that exists in the UK at present; given present local capacity restrictions at Heathrow, this might be viewed as indicative of unconstrained passenger numbers were Heathrow able to operate to capacity

1.30. We note that these indicative numbers almost exactly match the passenger numbers seen in 2020 and 2021 within 100k, and unlike other approaches has not over-forecast in those years; in particular, this reflects the strong demand that continues to be seen now that travel restrictions have been removed, reflecting the reality of the situation rather than artificial limitations of the Heathrow model

1.31. When considering other forecasts, the CAA must also be cautious that it is not looking at forecasts of Revenue Passenger Kilometres ("RPKs") rather than passenger numbers, since flying has become more concentrated on shorter haul sectors as a result of changes in its mix during the pandemic

Chart 1.4: Oxford Economics UK RPK forecast[28]



1.32. Since much airline reporting is based upon capacity measured in ASKs and RPKs, the CAA should be aware of this potential for confusion when using RPK-based forecasts, including those of Bain, Airbus, Boeing and ICAO, which would under-estimate the effect of the recovery and strength of passenger demand

1.33. For example, the latest Airbus forecast, which itself has been updated to 2041[29] and is therefore a later version than the one referred to by the CAA, considers global RPK demand to recover to 2019 levels between 2023 and 2025, but this is not only a global forecast but one produced in RPK alone; it also notes that Western European flows both internally and within the US will see some of the strongest growth, supporting the position of Heathrow on key routes, suggesting that actual passenger volumes in Heathrow's core markets will lead the recovery

1.34. Bain's forecasts also suffer from the same limitation based on both global estimates of recovery[30] and baselined upon revenue; with the inclusion of markets unrelated to Heathrow that do remain subject to restrictions that are not relevant to Heathrow, this forecast cannot be held as an accurate representation of Heathrow's recovery in passenger volumes, and the CAA would be in error to infer that Heathrow's traffic would be delayed until 2025 as a result

1.35. Finally, we note that ACI Europe updated its forecasts in May 2022[31], suggesting a significant improvement over its October 2021 forecast used by the CAA; this shows significant demand in summer 2022 leading to forecasts of 2023 traffic just 10% below that of 2019 and a full recovery in 2024

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28 Oxford Economics UK Revenue Passenger Kilometre data, extracted 29th July 2022
29 Airbus, Global Market Forecast 2022
30 Bain, Air Travel Forecast: When Will Airlines Recover from Covid-19? 17th May 2022
31 ACI Europe, Airport traffic forecast 2022 Scenarios & 2022-2026 Outlook

1.36. Nevertheless, we note this is also based upon Europe-wide forecasts, and given the historic strength of Heathrow's demand, expect that this would significantly under-estimate the likely recovery at Heathrow; in addition, we believe that the same underlying economic data from Oxford Economics may be used in its development, suggesting further duplication of the same date shown above

1.37. The CAA state that it has "sense-checked the forecasts against the latest data by creating and applying monthly profiles to each of them. The out-turn for the first few months of 2022 was much lower than in 2019 and called into question some of the higher forecasts for 2022"[32]; however this is in error, since as we have noted, these forecasts have been subsequently updated for the Omicron wave, and as a result such a process would only be relevant to an updated forecast

1.38. We note the CAA comments that "over the last 6-12 months, the economic outlook has deteriorated, with significant macroeconomic headwinds appearing, not least the rise in energy prices which is having a significant impact on the overall cost of living"[33]; we reiterate again that this all appears to be contained within the Oxford Economics passenger forecast data, which includes all economic risks within the base case forecast, and we have yet to see such factors "increasingly likely to weigh on consumer sentiment"[34]

1.39. Likewise, there has been minimal impact of the Ukrainian conflict or further waves of the pandemic on our business, since our exposure to those markets was already limited, flying continues around Russian airspace, and Governments have continued to remove testing requirements as society has adapted to live alongside the virus in subsequent mutations; whilst we have seen challenges with recruitment across the industry, our schedule is a realistic reflection of what we expect to operate

1.40. Considering both our schedule and the current performance of Heathrow[35], we are therefore extremely concerned that the CAA's figure at "68% of 2019 levels, the middle of the range discussed above"[36] is too low and is based upon dated information; as a result, we believe a passenger forecast at this level is in error, and we therefore welcome the CAA's proposal to incorporate new information as discussed below

[32] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.56
[33] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.58
[34] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.68
[35] Heathrow monthly traffic statistics to June 2022
[36] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.69

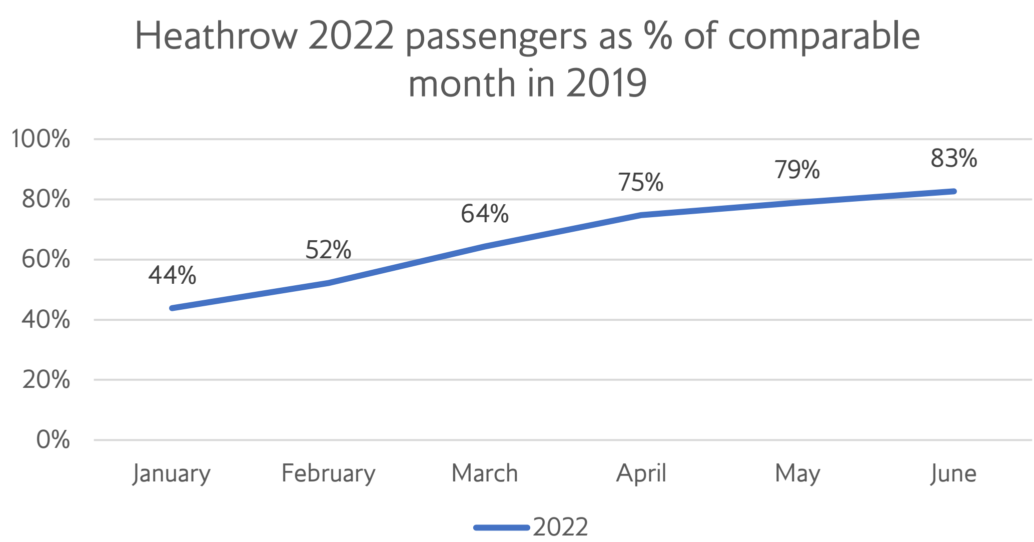
2022 passenger volumes

1.41. The CAA's comparison of forecasts for 2022 does not appear to be correct, since updated forecasts are now also available; these show demand reaching 86% of 2019 levels (Oxford Economics), 78% (ACI Europe) and 65% (Heathrow Investor Relations; in addition, our Q2 financial results show that customer demand continues to recover strongly; despite this, the CAA remains at a figure of 64% of 2019 passenger volumes, below even Heathrow's latest estimate for 2022

1.42. This is demonstrated by Heathrow's passenger forecasts, which themselves show a 2022 post-Omicron performance that is heading significantly higher than the CAA's forecast; even considering any artificial limitations on capacity, which Heathrow has set to 100,000 departing passenger per day, and which demand exceeds, these further add evidence that the CAA's 2022 forecast is far too low

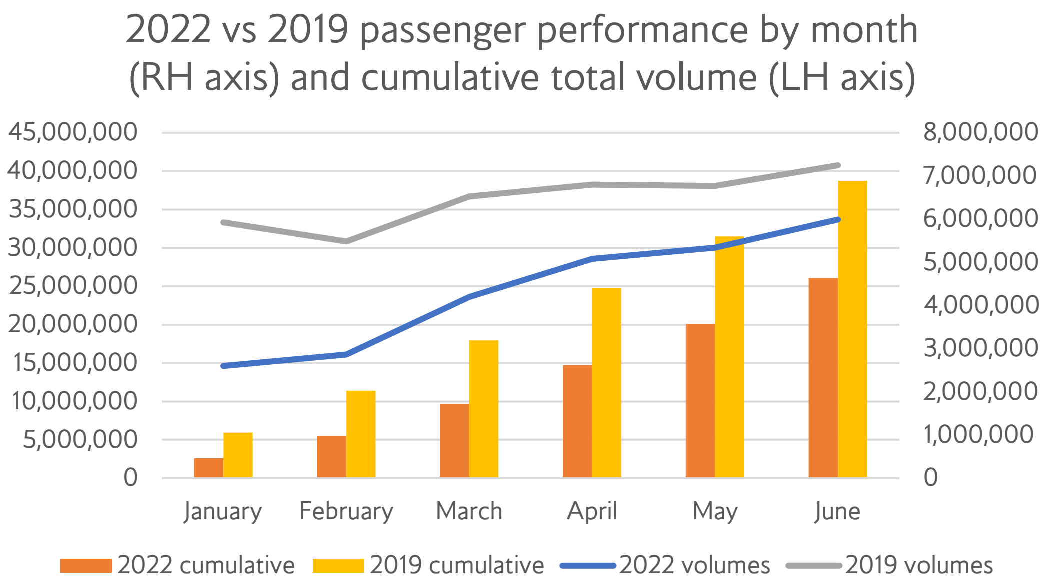
1.43. This is reinforced by AlixPartners who note that "when forecasting the passenger traffic for the rest of 2022, it is more sensible to consider that passenger traffic will be near the June recovery rate, i.e., 83%, rather than the one observed since January 2022"[37]; this continues with the observation that "the CAA's forecasting model likely underestimates passenger traffic"[38]

Chart 1.5: Heathrow 2022 passenger volumes as % of 2029[39]



[37] AlixPartners, Comments on the CAA's Final Proposals, section 3
[38] AlixPartners, Comments on the CAA's Final Proposals, section 3
[39] Heathrow monthly traffic statistics to June 2022

Chart 1.6: Heathrow 2022 passenger volumes compared to 2019[40]



1.44. Our recent Group results set out that "passenger capacity in quarter 2 was 78% of 2019 (Q1 guidance: c80%), up from 65% in quarter 1, driven primarily by IAG's key regions of European shorthaul (capacity 89% of 2019), North America (84%) and Latin America & Caribbean (81%)" with "load factor of 81.8% (3.2 points lower than in 2019, but higher than 72.2% in quarter 1)"[41]; recall that **we report capacity in terms of Available Seat Kilometres ("ASKs")** and as a result, the effect of more short-haul flying means passenger volumes are higher even than suggested above

1.45. Whilst we agree with the CAA that early booking data at "62% of 2019 levels was a likely lower bound for the forecast for the whole of 2022"[42], we note that these figures have since been substantially up-rated across the industry, and since the CAA's forecasts of 52m are not materially above this lower bound at just 64% of 2019 levels, a forecast this low does not appear particularly credible

1.46. We also disagree with the CAA's rationale for stating that "since our baseline (CAA-amended (unshocked) HAL Mid case) forecast for 2023 was 84% of 2019 levels, we considered that it would be unlikely that the remainder of 2022 be higher than 80% of 2019 levels"[43]; this is a self-reinforcing logic based upon a self-imposed limit of the CAA forecast itself rather than any rational analysis of where demand might actually reach in the later stages of 2022, particularly since Heathrow has already achieved volumes in June at 83% of 2019 levels, and is in error as a result

40 Heathrow monthly traffic statistics to June 2022
41 IAG results for six months to 30th June 2022
42 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.66
43 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.67

Passenger forecast for 2023-2026

1.47. It is our view that the CAA is in error to "place more reliance on our CAA-amended HAL forecast"[44] for the remaining years of the price control, both since Heathrow's model should not be used as a starting point, and because the recovery from the pandemic of the unshocked passenger numbers is incompatible both with the demand recovery already seen and supported by our fleet and network plans

1.48. As a result, we agree that passenger numbers will be driven by "standard economic and supply drivers of passenger demand and less by covid-19"[45], though our view that it will in fact be solely driven by passenger demand as the proven strength of the recovery has already largely removed the pandemic as a factor; it is our view that Heathrow passenger numbers will recover to 2019 levels in 2023, in line with Oxford Economics forecasts

1.49. Oxford Economics forecasts that form the input to the Heathrow model shows UK passenger numbers exceeding 2019 numbers in 2023, far ahead of the information shown in the CAA's Final Proposals for this data source; we again caution the CAA that it is not looking at forecasts of RPKs rather than passenger numbers, since flying has been more concentrated on shorter sectors during the recovery from the pandemic

1.50. ACI Europe's latest forecast also forecasts that a "full recovery to pre-pandemic volumes is now expected for 2024 rather than 2025"[46] in its base case and in addition that Eurocontrol's latest forecast for the UK's en-route service units ("TSU") forecasts suggests 2023 levels will exceed 2019[47]; whilst we recognise that this includes overflight information, where other markets recover at least at the same rate, this supports the UK forecasts seen in the Oxford Economics data

1.51. TSU forecasts are also more comparable to passenger numbers, being the basis of charging by Air Navigation Service Providers ("ANSPs"), which are allocated on the basis of aircraft weight; considering the difference between TSUs and movements of aircraft under Instrument Flight Rules ("IFR"), the difference results from the significant reduction in private jet flying related to sanctions on Russian businesses

1.52. Assuming therefore that the major carriers who cross UK airspace continue to rebuild their networks at similar rates to those who land or depart from UK airports and Heathrow in particular, the TSU forecasts for the UK are a relevant indicator of Heathrow's likely performance; it is inconceivable that Heathrow's underlying demand and passenger performance will deviate materially from those of other

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[44] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.70

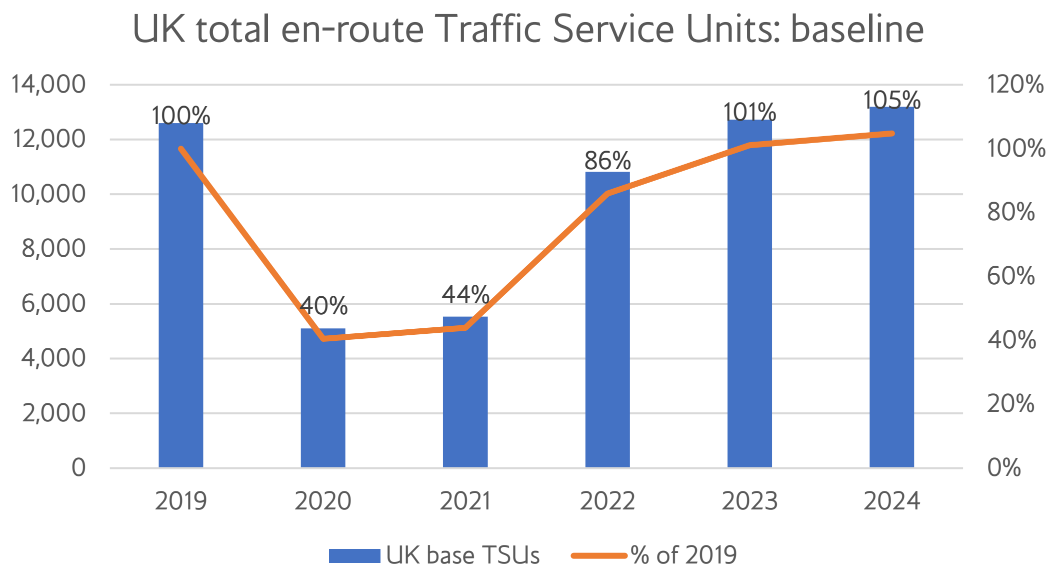
[45] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.70

[46] ACI Europe, Upward revision of European airport passenger traffic forecast, 20th May 2022

[47] EUROCONTROL Forecast Update 2022-2024

European airports, and as a result, a demand recovery rate at Heathrow could be inferred from this forecast

Chart 1.7: Eurocontrol UK en-route TSU forecast[48]



1.53. We understand that Eurocontrol will be updating its forecast again in autumn 2022, capturing the latest available information on recent summer performance and updated economic information; this remains applicable being the basis of the NATS NR23 price control forecasts, where it now forms the basis of an established, independent forecast for the price control

1.54. Economic factors will continue to drive passenger demand from 2023 to 2026, all of which are incorporated into the baseline Oxford Economics data that forms the basis of the Heathrow model; whilst we therefore agree with the CAA that many things might happen, we reiterate that this is already accounted for the in the forecasts of UK air passengers provided by the Tourism Economics product

1.55. Therefore, whilst the CAA is not incorrect to expect "buoyant consumer expenditure seen in 2022 to gradually unwind as negative real wage growth and a squeeze on disposable incomes will likely weigh on consumption decisions"[49], the CAA is in error to make separate adjustments to Heathrow's model on the basis of these factors rather than running it again in full using the latest input economic data that fully incorporates all these various economic factors

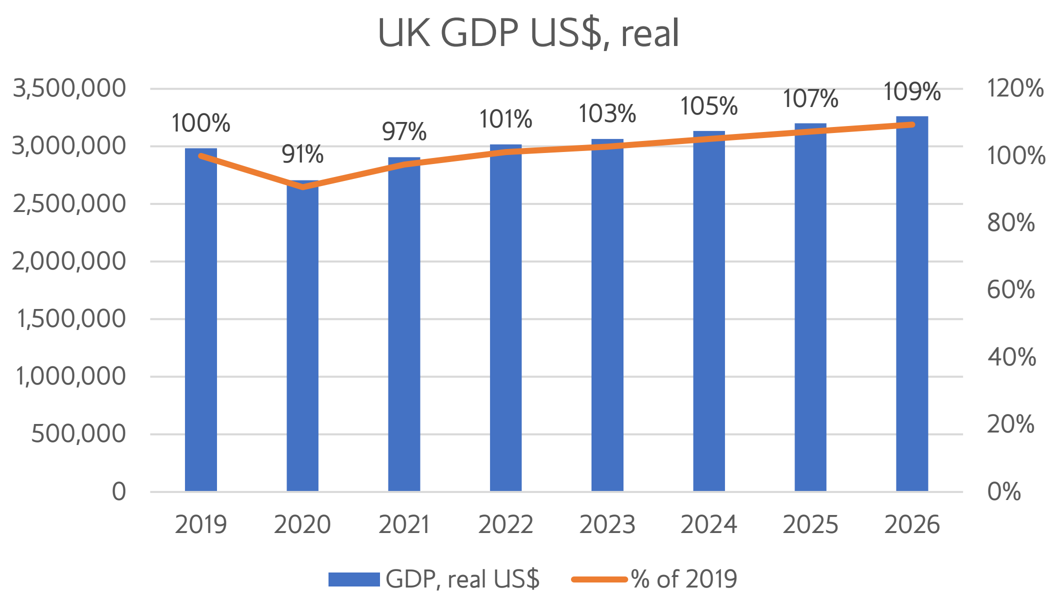
1.56. Similarly, the effect of changing costs that – in a highly competitive marginal cost based pricing environment – might lead to changes in fares that have an impact on demand, is also accounted for in this economic data; given that "demand at

[48] EUROCONTROL Forecast Update 2022-2024
[49] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.72

Heathrow has historically been more robust in the face of economic headwinds than that at the rest of the UK airports"[50], we fully expect Heathrow to outperform many of the independent forecasts we have noted above

1.57. The CAA states that in 2025 and 2026, "the size of the economy is predicted to be larger than before the covid-19 pandemic, supports our view that Heathrow could reach and surpass 2019 passenger volumes by 2025"[51], however GDP forecasts for the UK suggest that the economy is already larger than prior to the pandemic, and will continue to exceed its pre-pandemic size in 2023

Chart 1.8: Oxford Economics UK GDP forecast in USD, real terms[52]



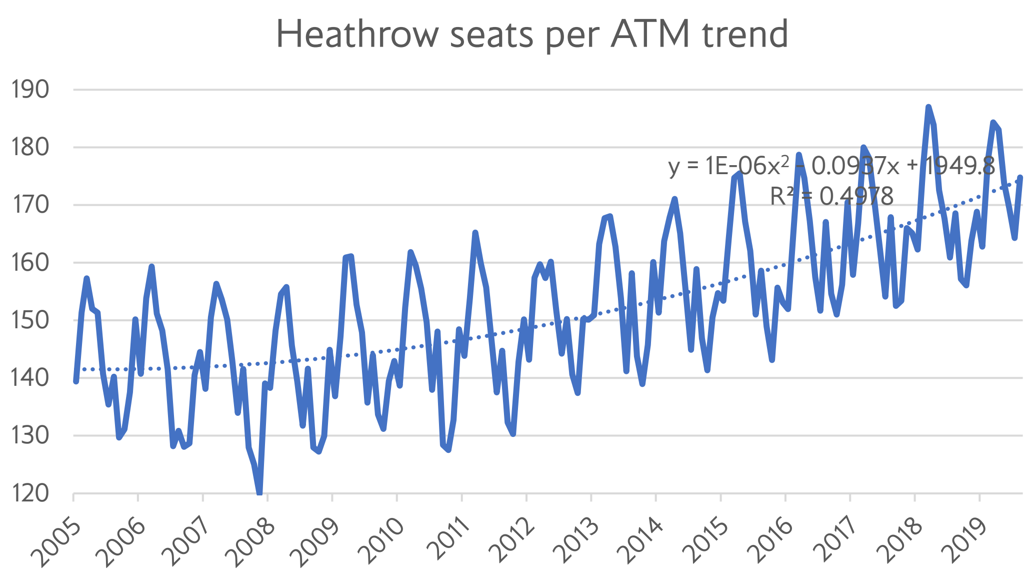
1.58. Whilst we recognise that Heathrow will remain constrained by the planning limits placed upon it in terms of Air Traffic Movements ("ATMs")[53], this only reinforces the robust nature of the return to 2019 passenger levels at Heathrow, and the CAA must take into account the actual terminal throughput that is achievable and has been previously declared by Heathrow[54]

1.59. In order to cater for these limitations, airlines have been generally increasing the size of aircraft flown at Heathrow, including for example our recent order for A320 and A321 neo aircraft[55], which have been replacing smaller and older A319 and

[50] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.74
[51] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.75
[52] Oxford Economics, accessed 29th July 2022
[53] Heathrow Airport: Local Rule 3: Administration of the Heathrow Air Transport Movement cap
[54] Heathrow Airport: Appendices to Winter 2019 capacity declaration
[55] International Airlines Group, IAG orders 27 A320neo family aircraft, 28th July 2022

A320 aircraft over time; this can be demonstrated by the long-term trend of seats per ATM at Heathrow, which continues to rise as the ATM limit has been reached

Chart 1.9: Heathrow seats per ATM trend[56]



1.60. We are therefore confused by the CAA's logic in considering it "appropriate to allow for a modest reduction in passenger numbers 2023 to 2024 (largely reflecting economic pressures) and a modest increase 2025 to 2026 (reflecting the longer-term resilience of passenger traffic at Heathrow airport)"[57]; given the underlying economic data provided by Oxford Economics contains relevant economic information, and where the resilience of Heathrow would bring forward such a recovery in advance of other markets, we believe the CAA's forecast is in error

1.61. The CAA further states that such "changes smooth the path of the forecast over the remainder of H7 without significantly altering the overall passenger volumes for H7"[58]; it does not appear logical to smooth the path without changing the overall volumes for H7, and this is an approach that otherwise further detracts from the independent evidence, and which it is imperative for the CAA to correct to avoid error

1.62. Finally, we are unclear as to the purpose of the high and low forecasts that have also been produced, since they do not appear to directly represent any particular economic scenarios; nevertheless, Oxford Economics do themselves produce up and down scenarios, and we believe those should be applied to the model to give an independent view of alternative scenarios

[56] Heathrow monthly traffic statistics to June 2022
[57] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.76
[58] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.74

Purpose of shock factor unclear

1.63. We also note that the CAA reiterates that it considers "that use of a shock factor continues to be appropriate as the possibility for unforeseen external demand shocks remains"[59]; whilst we consider the effect of this further in our later section on asymmetric risk allowance and the TRS mechanism, we disagree with the CAA's application of the adjustment as it is duplicative of risk captured in the cost of capital

1.64. AlixPartners note that "it is important to know whether the impact of the individual historical shocks were added back into the historical data (in the individual months or years in which they occurred) before calibration or estimation of the model"[60], and "if this has not been done asymmetric shock factors will have been applied to forecasts that already implicitly include the impact of these shocks, and therefore would be invalid"[61]

1.65. In particular, we believe the CAA are incorrect by justifying "the application of a shock factor to cover temporary and difficult-to-predict non-economic shocks (such as major volcanic eruptions, terrorism events, wars)"[62]; the calculation of the 0.87% used in these Final Proposals, and the previous shock factors included in previous price controls incorporate all downturns including those that are economic in nature

1.66. As a result, we believe the CAA has miscalculated the shock factor should it wish now to limit such downside protection only to non-economic factors, which are clearly over-represented by this erroneous calculation; we consider this further in our commentary on the asymmetric risk allowance and TRS mechanism

1.67. We remain of the view that the cost of capital will anyway incorporate all and every risk to which the company is exposed, be it economic, political, geographic or other in nature; we therefore believe the CAA remains in error to apply a downside shock factor to forecasts, and further to link this calculation through the TRS mechanism and the asymmetric risk allowance

1.68. This is a view endorsed previously by the Competition Commission, who noted that "communicable diseases can be considered a normal business risk and that Heathrow Airport's shareholders are compensated for bearing such risks through

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59 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.19

60 AlixPartners, Comments on the CAA's Final Proposals, section 3

61 AlixPartners, Comments on the CAA's Final Proposals, section 3

62 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.77

the allowed cost of capital"[63]; as a result, it is imperative that the CAA corrects for this error by removing the shock factor in its entirety

CAA reliance on Heathrow model

1.69. Due to a lack of transparency, we have been unable to properly assess Heathrow's forecasts or the changes the CAA suggests it has made to the Heathrow model; unlike during the Q6 periodic review – "despite repeated requests for it to do so, HAL has refused to make its passenger forecast models openly and transparently available to stakeholders"[64]. We can see no legitimate basis on which Heathrow can rely for not making its passenger forecast models available on a confidential basis.

1.70. This is highlighted by AlixPartners, who note that "given the central position that HAL's traffic forecasting model plays within the process for determining traffic forecasts (and by extension the whole of the H7 charge control), it is very concerning that these models have not been made available for interested parties to consider in detail"[65]

1.71. Despite stating that a lack of transparency "has undermined our confidence in the credibility and robustness of HAL's passenger forecasts and caused us to place less weight on this evidence"[66], the CAA have stated that "to produce our passenger forecast for Initial Proposals, we used HAL's traffic model and made adjustments based on our judgement around the input assumptions used"[67]

1.72. As a result, whilst the CAA characterise its approach to Final Proposals as now using "both HAL's model and a wider range of independent forecasts…drawing on a wider and deeper evidence base to enhance our method, taking into account a wide range of industry views on recovery"[68], the central forecast remains based upon CAA adjustments to the Heathrow model, with no development of its own independent forecast away from the Heathrow model

1.73. We consider this approach flawed and, given the statements made by the CAA that they have placed less weight on the Heathrow model, which is incompatible with their apparent actual and ongoing use of an adjusted Heathrow model; we see little evidence that the stated regulatory policy of placing less weight on the model has actually been taken in practice

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[63] As noted in CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.26
[64] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.15
[65] AlixPartners, Comments on the CAA's Final Proposals, section 3
[66] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.15
[67] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 47
[68] Ibid., para 47

1.74. Given the significant, ongoing issues with Heathrow's modelling for which the CAA applies correction factors, and without being able to check the veracity of Heathrow's modelling for ourselves, we continue to express deep concern that the CAA remains wholly reliant upon Heathrow's proposed modelling approach rather than independently developing its own forecasts, leading to a significant error where "HAL's model remains the starting point for developing our own forecasts"[69]

1.75. In addition, Oxford Economics has continued to release GDP and passenger forecast information continuously throughout the period; yet where the CAA consider Heathrow's RBP Update 2 model to contain the "latest Oxford Economics forecast (October 2021)"[70], this is now not the case and to avoid error, the CAA must ensure that modelling is updated for the latest economic information

1.76. This is compounded by Heathrow's failure to update its forecast model in H1 2022 in the face of rapidly rising demand that has come to exceed its monthly forecasts; instead, it has used its previous high forecast of 52.8m applied to 2022 in isolation, reverting to its December mid case for subsequent years rather than re-running its H7 forecasting model, limiting the CAA's ability to base its forecasts on more recent economic information and in effect avoiding further scrutiny of its forecasts in subsequent years of H7

Quality assurance

1.77. As we have noted above, we disagree with many aspects of the CAA's approach to passenger forecasting for these Final Proposals, with numerous errors creeping into the process; we are also sceptical of Skylark's conclusions on the CAA's approach, since it does not appear to recognise some of the major inaccuracies that we have identified above

1.78. In particular, whilst we agree that the CAA's "forecast may prove pessimistic for 2022 given more recent actual data"[71], our view is that Skylark are fundamentally incorrect to assess that "mid case forecast for 2026, at 101% of 2019 levels, could be erring on the optimistic side"[72] since their rationale is flawed; aircraft that have been retired have since been replaced by those of comparable capacity or greater, and the constraint that applies to ATMs does not prevent passenger numbers continuing to rise, at least up to the c.85m limits of the terminal infrastructure

1.79. We therefore welcome the CAA's recognition that "passenger throughput at Heathrow greater than 2019 levels can be achieved despite the limits on runway

[69] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.20
[70] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.27
[71] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.83
[72] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.83

capacity, up to the terminal capacity of 85m passengers"[73]; the recognition of the capacity of the existing infrastructure is important, since it recognises what has been invested already through the RAB

Airline forecasts

1.80. We welcome the CAA's consideration of airline forecasts provided in our response to Initial Proposals, which we agree though "relatively simple" is "evidence-based and logical"[74]; we have been open with the CAA that our model is not perfect, largely as airlines plan for networks, measure capacity in terms of available seat kilometres ("ASKs") and sell that capacity using revenue management techniques, and do not model passenger numbers separately based upon econometric forecasting models

1.81. However, the CAA is not correct to suggest that the airline forecast "for 2022 is based on airline schedules and forward booking trends"[75]; whilst we have pointed to evidence from airline schedules and forward booking trends to support the near term figures of the airline forecast, our forecast was an inference of Heathrow demand built on the basis of the Eurocontrol figures, a fact we were transparent about in our submission

1.82. The CAA should also be clear that we only used the baseline scenario to generate our forecast; this Eurocontrol baseline is described as their most likely scenario, whereas the Eurocontrol high scenario that we did **not** incorporate considered a case where "travel restrictions are relaxed, with most inter-regional flows restarting by the middle of 2022"[76], a situation that increasing describes current market demand

1.83. It is therefore incorrect to suggest that it is based upon "airline intentions to fly and does not account for possible lower load factors than in 2019"[77]; this is particularly relevant as load factors are now stronger than at any point in the recent past, not only as a result of Heathrow's artificial capacity restrictions but as a result of extremely strong demand in the recovery

1.84. Furthermore, we believe that being based upon the baseline scenarios of an independent forecast of flight volumes, the CAA is not correct to suggest that our forecast "does not appear to properly account for downside risks, makes it appear

[73] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.84
[74] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.30
[75] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.30
[76] EUROCONTROL Forecast Update 2021-2027
[77] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.31

more likely to represent a high, rather than a mid-case, forecast"[78]; this is only true insofar as Eurocontrol traffic forecasts overestimate passenger volumes that might arise through Heathrow (albeit there is no evidence that this is the case)

1.85. The CAA is not incorrect to note that "throughout 2020 and 2021, airlines' schedules were generally at or near 2019 levels up until three or four weeks before the relevant departure date and it was only at this point that airlines reduced them"[79]; this should be seen as a product of the difficult environment in which we were operating

1.86. This resulted in a situation where we could see demand that would arise were restrictions to be removed, but restrictions continued in place longer than we envisaged; furthermore, it is unlikely that such a situation is likely to arise again in future now that the UK slot regime has adapted to the circumstances of the recovery

1.87. In addition, it is an error to suggest that forward bookings that "are at or near 2019 levels cannot be confidently extrapolated to the whole year"[80]; whilst forward bookings may represent only a proportion of the total bookings for the year, they are an important indicator of demand for flights, and as the booking window has returned to normal pre-pandemic levels, represent a reliable indicator of demand and an important input to revenue management decision-making

1.88. The airline community has updated its Heathrow passenger forecasts from those submitted in response to Initial Proposals in an exercise led by Virgin Atlantic Airways Limited; these have been based upon public information on seats available for sale at Heathrow, accounting for the recent capacity constraints

1.89. The output of which correlates closer to actual and industry forecasted data; full details are provided in the response from Virgin Atlantic but have been summarised below:

Chart 1.9: Updated airline community forecast[81]

	2022	2023	2024	2025	2026	Total
Passengers (m/pa)	65.0	80.4	82.0	83.6	85.0	**396.0**
% of 2019	85%	99%	101%	103%	105%	

Incorporating new information

78 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.31
79 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.30
80 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 1.30
81 Refer to Virgin Atlantic response to CAP2365

1.90. In the context of new information on passenger forecasts, the CAA seeks "representations on how we should interpret "differs significantly" in the context of the H7 price control review"[82]; we support a further consultation that considers new information on passenger volumes given the likely significant effect on the price control and incentives package, particularly where a relatively small change in the passenger volume assumption has an outsized effect on charges as a result of the single till

1.91. It is therefore worth considering the recent development of International Financial Reporting Standards ("IFRS"), where a recent publication[83] provided companies with guidance on how to make materiality judgements and amended certain accounting standards[84] to provide clarity over the definition of significance, where companies are now required to disclose *material* accounting policy information instead of *significant* accounting policies

1.92. Materiality may as a result provide a better yardstick for the definition of significant change, where they might be "considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users"[85]; in particular, this means that certain information may be material because of its nature, even if the related amounts are themselves immaterial

1.93. Nevertheless, a two week consultation is extremely short and would place significant resource burdens on parties, which given a likely material effect on the regulated entity and interested parties might be inappropriate; in particular, internal governance arrangements would likely preclude an effective response to such a consultation, unless the significant change proposed was simple in nature

1.94. We therefore advocate a slightly longer consultation period that would allow parties to effectively engage in the consultation process, and deliver meaningful responses that allow the CAA to set a robust passenger forecast for the H7 price control; the importance of this is highlighted by AlixPartners who state "while HAL is protected against over-forecast projections, the airlines have little protection against under-forecast passenger traffic"[86]

Heathrow capacity provision in 2022

1.95. The CAA must be aware that its approach to forecasting is jeopardised by Heathrow's inability to meet demand; this is a result of its rejection of airlines' views that summer 2022 would bring a strong rebound in passenger volumes once restrictions had been removed, and subsequent failure to provide capacity through terminal infrastructure and security processing in a timely manner

82 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 111
83 IFRS Practice Statement 2: Making Materiality Judgements, September 2017
84 Definition of Material (Amendments to IAS 1 and IAS 8)
85 International Standard on Auditing 320, Materiality in planning and performing an audit, para 2
86 AlixPartners, Comments on the CAA's Final Proposals, section 4

1.96. As noted by AlixPartners, "we do not consider that it would be appropriate for passenger forecasts to be reduced to account for any decisions by HAL to limit capacity due to staffing or other resourcing difficulties within its control"[87]; in failing to deliver sufficient capacity, the CAA must not penalise consumers for Heathrow's failure to prepare for the recovery in passenger volumes

1.97. In particular, this failure to provide capacity contravenes Heathrow's obligations in its licence to meet reasonable capacity demands, and has compromised airlines' ability to deliver; we must stress that Heathrow is not alone in this regard, as additional recruitment issues result from the Government's lethargy in addressing referencing issues that have inhibited the ability to issue airside passes both at Heathrow and at airports and airlines across the UK

1.98. Nevertheless, Heathrow has contributed to these problems in a number of areas, and it is imperative that the CAA clearly sets out how it will address this within the price control model to avoid consumers paying for Heathrow's shortcomings through an artificially supressed passenger forecast in 2022 for H7

1.99. Given the significant limitations of the Heathrow forecasting model that has twice required uprated numbers for its investors in 2022 alone and the existing provision of infrastructure capacity, we suggest a more simplistic and intuitive approach could provide a better basis for regulation, particularly where the addition of a TRS mechanism would allow the CAA to account for out-turn volumes below total capacity

1.100. The CAA regulates a monopoly whose operations have approached capacity for a number of years; given that Heathrow operates at or near capacity, invested capacity provides a logical volume input for the CAA's price control model, which reflects the capacity that should be available and has been invested in the RAB; in combination with an appropriately designed TRS, calibrating the price control model at capacity would ensure that Heathrow is always held responsible for capacity provision whilst operating efficiently at any out-turn passenger volume

1.101. This approach, which was set out in our response to Initial Proposals would avoid unnecessary modelling complexity within the passenger forecasting model, whilst creating a simple logic that the airport has an invested capacity, and ensure that passenger numbers are no longer contentious at any future periodic review; given Heathrow's failure to heed warnings from airlines that a strong recovery would emerge in 2022, it would also incentivise Heathrow to ensure it is prepared for any capacity scenario

[87] AlixPartners, Comments on the CAA's Final Proposals, section 3

Conclusion

1.102. It is our view that the CAA's passenger forecasts are fundamentally flawed and materially understate passenger demand at Heathrow for many reasons which we summarise below.

1.103. The CAA failed to produce its own, independent model for demand at Heathrow, and rather the CAA's baseline forecast remains based upon Heathrow's model subject to certain adjustments.

a) It was wrong for the CAA to place heavy reliance upon Heathrow's model, which likely reinforces Heathrow's own regulatory position

b) Heathrow's model has never been released for scrutiny, this is a significant flaw in the process and very concerning. This position is echoed by AlixPartners who describe this as very concerning and for which there is no rational justification

c) It is irrational for forecasting to be primarily led by the regulated company and not the regulator

d) The CAA's adjustments to Heathrow's model are not transparent and we cannot therefore ascertain if decisions are supported by appropriate evidence

e) The CAA's synthesised passenger forecast provides confirmation bias to the CAA's numbers derived from Heathrow's model rather than being a true alternative forecast

f) The result undermines the basis of the TRS, by reducing the incentive for Heathrow to perform efficiently

g) The CAA provide no solution to prevent consumers paying through the price control model for passenger capping as a result of Heathrow's inability to provide capacity

1.104. Heathrow's model upon which the CAA relies does not incorporate the latest available economic information

a) Heathrow has failed to update its models and deliver those updates to the CAA

b) Independent Oxford Economics forecasts show baseline UK demand reaching 86% of 2019 levels in 2022, rising to 102% in 2023

c) Recent Heathrow performance demonstrates demand was already at 83% of 2019 levels in June and has since strengthened further. This demonstrates that the CAA's forecast at 68% of 2019 demand in 2022 is flawed

1.105. The CAA has not fully removed all biases from the Heathrow model upon which it relies for its forecasts

a) Oxford Economics forecasts of UK passenger volumes take into account economic fundamentals, inflation, business travel, air fares, load factors, fuel, carbon and other information

b) It is an error that Heathrow therefore made any corrections for these in the first place, and by not fully removing all Heathrow's biases, the CAA itself is in error

c) The continued use of the Covid demand overlays are therefore a further error, since this effect is also duplicated in the base economic information

d) It is not credible that the same Oxford Economics data that feeds the Heathrow model forecasts 119% of 2019 demand in 2026, whilst Heathrow's model at a capacity-constrained airfield fails to reach 2019 demand in 2026

e) Evidence shows that seats per movement at Heathrow have demonstrated a continual upward trend to mitigate the effect of the 480,000 limit on air traffic movements, demonstrating that constraining volume forecasts as a result of supply is an error

1.106. Independent forecasts demonstrate stronger recovery of passenger demand than forecasts by the CAA's adjusted Heathrow model, and have since been further updated

a) the CAA has erred by discounting the airline forecasts as a result of incorrect assertions of its basis

b) the CAA has failed to incorporate additional information from those independent forecasts into its model thereby failing to take into account all relevant information

c) ACI Europe, Airbus and Eurocontrol have all produced more recent forecasts than those used by the CAA

d) Eurocontrol in particular demonstrate TSU activity at 86% of that in 2019, recovering to 101% in 2023

e) Where the CAA has used RPK information to infer passenger numbers, this is wrong because stage length has decreased since 2019 with greater focus on short haul flying from the UK and Heathrow

f) Since RPK is the basis of the Airbus Boeing and ICAO forecasts, whilst Bain is based upon revenue, these forecasts therefore understate passenger volumes

g) the CAA was wrong to discount the strength of airlines' forward bookings as an indicator of booking strength

1.107. The shock factor is not justified and duplicates other mechanisms

a) It was wrong of the CAA to provide for a shock factor in addition to the TRS and asymmetric risk allowances when all economic information is incorporated in the cost of capital

b) The calculation is based at present on economic factors that are incorporated into the baseline economic information forecast by Oxford Economics

c) The suppression of passenger forecasts is unnecessary anyway with the advent of a TRS

1.108. New information must be incorporated where it is material

a) Final Proposals should be based on best available information. The CAA must therefore incorporate new information before its Final Decision is published in order to avoid incorporating these errors into its forecasting approach

b) Any correction that results in a material change in the price control will be significant and require further consultation

c) The CAA should not rely upon the TRS to make up for its forecasting errors, where these could be corrected in advance of its Final Decision

d) We continue to suggest for an alternative approach to passenger forecasting, which would entirely remove any incentive for Heathrow to supress passenger forecasts and support a better TRS structure

2. Regulatory Framework[88]

2.1. The TRS mechanism represents a significant transfer of risk from Heathrow to consumers, without proper justification, with the CAA suggesting variously that it is required for forecasting uncertainty, or to reduce upward pressure on the cost of capital, or to "clarify" Heathrow's risk exposure, or to support Heathrow's financeability. This is contrary to the CAA's duties under the Civil Aviation Act 2012.

2.2. None of these justifications start from a position of the fundamental incentives of the price control or the effect on consumers, which is reflected in a structure that insures nearly all Heathrow's risk exposure in major downturns by transferring it to

[88] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", chapter 2

consumers within the outer band, and an approach that is incompatible with the present cap of passenger numbers during the peak summer months in 2022.

2.3. Rather, the CAA's Final Proposals continue to deal with building blocks largely in isolation, and as a result are flawed because incentives are weakened or undermined by failing to fully consider risk, incentive and implementation issues

2.4. The most significant of these remain the wholesale transfer of risk to consumers as a result of the introduction of the TRS mechanism, a situation that has resulted in the average revenue based price control becoming more of a hybrid through the protection of revenue to Heathrow; it is unacceptable that such a large scale transfer of risk should take place without significant consultation and analysis. This risk transfer has also been fundamentally under-priced in the cost of capital

2.5. As observed by AlixPartners, "the TRS will limit HAL's traffic risk to only 2.8 million (2022) to 4.1 million (2026). This is in stark contrast to Q6 where HAL's traffic exposure was unlimited"[89]. It is imperative that the CAA both properly reflect this risk transfer in the cost of capital.

2.6. Further, the TRS mechanism presents serious incentive issues that require correcting. The incentive issues are created where the sharing rate changes between the inner and outer bands, which create incentives on Heathrow to close infrastructure or limit capacity, as evidenced by our experience in the recovery from the Covid pandemic; as set out in the AlixPartner's Report, the solution for this would be the removal of the outer band in its entirety, which the CAA must do in order to avoid significant error.

Asymmetry of mechanism

2.7. We agree with the CAA that, should it be minded to introduce a TRS mechanism, sharing based upon traffic volumes remains superior to revenue risk sharing; this is particularly important since the structure of the single till would otherwise distort "incentives to optimise commercial revenue"[90] under revenue risk sharing that under Heathrow's proposal is only in the outer band

2.8. However, the implementation is highly asymmetric as a result of limited upside opportunities for consumers and significant new protections for Heathrow, as highlighted by AlixPartners; it is imperative that the CAA address this "asymmetric impact between the under-forecast scenario and the over-forecast one"[91] in order to correct for this significant error in its Final Proposals

2.9. The CAA must consider the actual capacity of the existing infrastructure that is unlikely to permit passenger numbers to reach the outer band on the upside in the

[89] AlixPartners, Comments on the CAA's Final Proposals, section 4
[90] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.20
[91] AlixPartners, Comments on the CAA's Final Proposals, section 4

latter years of the price control. As noted by AlixPartners, "in the short term any upside in passenger numbers is restricted by capacity issues related to staff shortages"[92]; furthermore, "in the longer term, it is unlikely to observe passenger traffic significantly above the CAA's forecast because passenger volumes would ultimately reach Heathrow's maximum capacity"[93]

2.10. In particular, the CAA's proposals for a 105% sharing rate of the outer band beyond 10% traffic volume deviations, based upon Heathrow's proposal "to reflect the commercial revenues associated with higher or lower passenger numbers"[94] in effect results in a near fixed revenue allowance within the outer band, and traffic risk sharing only within the inner band. As noted by AlixPartners, "HAL's incentives to promote incremental growth is all but removed. For example, HAL would have no incentive to work with existing or prospective airlines to re-energise growth, and make use of the spare capacity created by the downturn in passengers"[95]. It is imperative that the CAA correct this error which require significant changes to the incentive structure of the price control.

Unintended consequences of outer band

2.11. The CAA's asserts that they "do not agree that HAL would face incentives to avoid entering the outer band"[96], yet it does not appear to properly understand our concern; as proposed, Heathrow would be incentivised to avoid entering the outer band on the upside, using capacity restricting tools such as those in use this summer[97], which has limited capacity to 100,000 departing passengers per day

2.12. As explained in our response to Initial Proposals, Heathrow would also be incentivised to enter the outer band in the event of a downturn that approached the 10% limit of the outer band, where we cited evidence of firm behaviour in the United States; the CAA is therefore in error not to study the likely behaviour of Heathrow and the nature of incentives in depth to result in an appropriate design

2.13. We have faced significant difficulties in trying to convince Heathrow to re-open Terminal 4 and recruit to meet the passenger numbers we expected this summer, and such a structure will only impede further our efforts to restore capacity in such circumstances; it is an error therefore for the CAA to introduce such a high sharing rate in its outer band due to the impact on reducing Heathrow's incentives to meet demand for capacity if it enters the lower outer band, contrary to the CAA's duties as set out in the Act

92 AlixPartners, Comments on the CAA's Final Proposals, section 4
93 AlixPartners, Comments on the CAA's Final Proposals, section 4
94 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.25
95 AlixPartners, Comments on the CAA's Final Proposals, section 4
96 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.23
97 ACL Framework for use of Local Rule A

2.14. AlixPartners note that in the event of a downturn "miscalibration will have severe consequences on HAL's incentives to promote recovery"[98], where "given the difficulties in estimating the opex and commercial revenue elasticities on which this calculation depends, the CAA has left insufficient margin for error and risks either leaving HAL with no incentive to promote traffic growth, or even a negative incentive to constraint traffic"[99]

2.15. In particular, we note that "this level of risk sharing in the outer band has no regulatory precedent from similar automatic mechanism in other airports"[100], and are concerned that the CAA has made an error; it is imperative therefore that the CAA address the unaddressed concerns of its own advisors, who state that "possible that the outcomes (e.g. in respect of HAL's revenue, EBITDA and airport charges) could be materially different to those currently forecast by the CAA (and potentially not as desired). This could result in HAL being over-compensated or under-compensated through the TRS, potentially significantly"[101]

2.16. Considering also the CAA's rationale for high sharing factors, where 100% "would effectively guarantee HAL's revenue from airport charges"[102], such high sharing rates would demonstrably mean that regulation has become revenue-based for the outer band; at such levels, the incentive to ensure that expenditure is efficient is undermined where it faces only an "expected net loss of around £0.12 for every £1 reduction in airport charges"[103]

2.17. Taking this further to 105% "will more than compensate HAL for the loss of airport charges revenues, after taking account of the expected impacts on commercial revenues and opex"[104], therefore whilst Heathrow may still have some incentive to raise passenger numbers, it remains extremely limited, and more importantly any incentive to make operations more efficient becomes severely undermined, as evidenced by a structure that "will protect HAL from between 91 and 94 per cent of the expected impact on its EBITDA of traffic changes in the outer band"[105]

2.18. The single till is calculated only on a forecast basis at the periodic review, therefore it is important that Heathrow is incentivised to meet or beat commercial revenue forecasts in all cases; there is no reason that Heathrow should not be exposed to risk in the outer band, particularly when mis-forecasting may make outcomes in

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98 AlixPartners, Comments on the CAA's Final Proposals, section 4

99 AlixPartners, Comments on the CAA's Final Proposals, section 4

100 AlixPartners, Comments on the CAA's Final Proposals, section 4

101 CAA CAP2366E Review of the CAA's proposed traffic risk sharing mechanism, Deloitte, June 2022, p 8

102 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.43

103 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.43

104 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.43

105 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.44

that band more likely, and we observe that the CAA's proposed structure would result in Heathrow being able to recover more than it requested for the RAB adjustment should this structure have been in place during the current pandemic[106]

2.19. It is also important to appreciate that changes in commercial revenue in response to passenger volumes occur within the central band of the TRS as well; the CAA's rationale therefore for applying a higher sharing rate to the outer band as a result of the existence of the single till is therefore illogical since the effect described exists also within the central band, in which the CAA uses a different treatment

2.20. The CAA is in error to propose risk sharing of "105 per cent of any difference"[107] within the outer band, since this wholesale transfer of risk and change in the incentive structure of the price control is neither considered in appropriate depth given recent experience, nor fully reflected in the cost of capital calculations

2.21. The CAA must correct its errors by removing the outer band from its proposals, which risks introducing significant incentive issues to the price control; it is imperative that the CAA address the concerns of its own advisors and act in the interests of consumers to ensure that Heathrow's incentive to provide capacity, as required in the Act, remains present at all deviations from forecast volumes

Consumer impact of TRS mechanism

2.22. Considering the highly asymmetric impact of the TRS on consumers, AlixPartners highlights a potential solution to address the current limitations of the CAA's proposed mechanism; where the application of risk sharing based upon an amount of "50 per cent of any difference"[108] may result in asymmetry, AlixPartners suggests instead that "the CAA should implement an asymmetric sharing, with a 60/40 rather than 50/50 sharing"[109]

2.23. Given outcomes that would have resulted in consumers paying more than even Heathrow requested in its original RAB adjustment are clearly disproportionate and at odds with the intent of the Act to protect consumers from monopoly power; the CAA must correct its errors therefore by reassessing what the TRS needs to achieve, and ensuring that it is designed with consumers in mind by removing the outer band in its entirety

2.24. The analogy of the TRS within the NATS En-route plc ("NERL") price control is not as relevant to Heathrow, since the lead time to train new controllers and ensure interoperability with other ANSP infrastructure means a greater degree of protection is necessary for NERL; in the case of Heathrow, it neither has the same

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[106] Refer to Virgin Atlantic and AOC/LACC response to these Final Proposals
[107] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.36
[108] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.36
[109] AlixPartners, Comments on the CAA's Final Proposals, section 4

technology base nor lengthy and complex employee training requirements that warrant a greater degree of protection from forces that would otherwise exist in a competitive environment

2.25. AlixPartners also notes the lack of relevance of NERL, noting that the CAA "may refer to the NATS precedent which does have a 100% sharing factor in the upper band, but since NATS is not an airport it does not have the same ability and influence and develop overall air traffic growth as do airlines and airports"[110]

Implementation

2.26. We continue to agree with the CAA that "the adjustment to airport charges should be smoothed over a number of years, rather than a one-off adjustment, typically two years later, as is seen in some other risk sharing mechanisms"[111]; it is important to note that early collection of sums owed before the recovery from such events could compromise the recovery and conflict with the CAA's duties as a result

2.27. However, we are concerned that the CAA has now placed its secondary duty to financeability ahead of that to the consumer through its proposal that "starts to adjust charges two years after the original divergence between forecast and out-turn traffic levels"[112]; whilst any event will likely be unique in its nature, we note that this might result in recoveries just 13 months after an event, should such an event begin as late as December of a preceding year

2.28. The CAA's proposals appear to base this profile entirely on ensuring Heathrow is compensated at the earliest possible opportunity, rather than with consumer interest in mind, as evidenced by the comment that the "reason for not starting the adjustment to allowed charges until year t+2 is purely a practical one, reflecting the timing of when traffic out-turns are known and when HAL sets its charges for the forthcoming year"[113]

2.29. Whilst this pandemic has effectively been a two-year event, with demand now recovering strongly, a two year application of the TRS might be appropriate only in this specific case, since the pandemic became global in early 2020 rather than later in the year; it would be perverse to automatically begin recovering amounts in a manner that would compromise the early stages of any recovery, a situation that the CAA and NERL specifically adjusted for during the pandemic

Cumulative vs annual approach

[110] AlixPartners, Comments on the CAA's Final Proposals, section 4

[111] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.28
[112] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.28
[113] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.38

2.30. We have previously preferred a cumulative approach to the TRS, since we would therefore avoid a situation where in a decade, we have ten separate balances relating to deviations from forecast; therefore we are concerned that the CAA's new proposals are in fact more complex than previously described, particularly where consumers are no further disadvantaged in favour of Heathrow's financeability concerns

2.31. Consider a situation in which passenger volumes fell 12% below forecast in year one, then were 3% above forecast for each of the four remaining years of the price control, based for simplicity on a flat forecast; in such a situation, passengers would be the same as forecast at the periodic review, yet the regulated company would have collected more than assessed at the periodic review, all else being equal

2.32. This is an illogical outcome, and given that other adjustment terms such as the k-factor and cumulative capital expenditure adjustment also consider cumulative changes, we consider the CAA's argument to consider this too difficult in relation to the TRS to be particularly unfounded and not a legitimate reason for not doing so

2.33. As noted by the CAA, abandoning the cumulative approach results in situations where "certain patterns of traffic out-turn might now pass the 10 per cent threshold and trigger stronger risk sharing whereas this would not have happened under our previous cumulative approach"[114]; since the CAA themselves recognise that the solution to this would be to "expand the central band in order to adjust for this"[115], and it is imperative the CAA do so to avoid this particular error

2.34. Considering the above, in the event that the CAA does not remove the anomalous outer band in response to our comments above, we cannot support the CAA's proposals to apply risk sharing only up to "any difference up to 10 per cent of forecast allowed revenues"[116] where it has itself identified that this band should be wider where no longer using cumulative differences

2.35. The CAA's proposes that adjustments should be uplifted by "the real WACC and general price inflation (as measured by the Retail Prices Index, for consistency with the real WACC)"[117], yet where RPI is no longer an office measure of inflation, and CPI-based metrics will be required from 2030 at the latest, this appears to be an error since the tail end of any adjustment will now fall after 2030

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[114] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.30

[115] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.30

[116] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.36

[117] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.36

2.36. This approach is not consistent with changes that have been made elsewhere in the price control, in particular "the use of the CPI (rather than the RPI) for inflation indexation"[118] within the financial framework section of the Final Proposals; if the CAA does not change its approach, the tail end of any TRS adjustment will be in error by being based upon inconsistent inflation indices as RPI becomes unavailable

2.37. In line with our previous comments on the use of the RAB, we continue to believe that such amounts should be held separately, ensuring the RAB remains solely a log of efficiently-incurred capital expenditure that has yet to be recovered from consumers through charges; nevertheless, we agree with the CAA's proposal to apply the adjustment "spread out over a period of ten years"[119]

2.38. The use of the RAB to apply differences based upon the TRS mechanism remains problematic as we have previously set out in our response to Initial Proposals; it remains preferable for such adjustments to remain outside of the RAB for the entirety of their life to avoid situations where outperformance against the CAA's excessively low forecasts might cause RAB deductions and hence issues with credit metrics and financeability, penalising consumers at future periodic reviews

2.39. Finally, given that the CAA has not maintained a detailed register of assets incorporated into the RAB, we cannot see how the CAA can implement its proposed depreciation profile separately from the efficiently-incurred assets already within the RAB;, it is unclear how the CAA could implement this separately from the overall price profile to "apply a slightly backloaded depreciation profile, so that the overall impact on HAL's allowed revenues (which reflects both depreciation and the allowed rate of return) will be roughly the same in each of the seven to ten years"[120]

<u>Other aspects of the regulatory framework</u>

2.40. We agree with the CAA on its continued rejection of Heathrow's "proposal for a formal reopener condition in its licence"[121]; in particular, we agree that "the circumstances that might justify reopening a price control in future could be complex in nature and difficult to enshrine in a formal licence condition"[122]

2.41. However, we disagree with the CAA that there was previously any justification to adjust Heathrow's price control – indeed the CAA did not actually re-open the Q6 price control in response to Heathrow's request for a RAB adjustment; the basis of

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118 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.49
119 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.28
120 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.36
121 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.31
122 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.31

the price control has however radically changed as a result of the CAA's "proposed TRS mechanism includes strong risk sharing for large differences between out-turn and forecast traffic levels"[123]

2.42. We are further confused by the CAA's insinuation that its role in the case of re-opener mechanisms might be to "protect HAL from all possible future events"[124] beyond the impact of the TRS; this is clearly contrary to the CAA's duties under the Act, where the aim of regulation is not to protect Heathrow from events but to protect the consumer from Heathrow's monopoly power, and the CAA has erred as a result

Conclusion

2.43. It is our view that the CAA's regulatory framework contains certain errors, and its proposed structure materially changes and undermines incentives

a) Regulation is no longer based upon a cap on average revenue per passenger at all volume outcomes

b) The price control has therefore become a hybrid with weaker incentives

c) This is in error where it undermines the incentives that are central to the CAA's duties in the Act

d) By curtailing Heathrow's exposure beyond 10% volume deviations, incentives are undermined and nearly entirely removed in the outer band

e) This would almost entirely remove Heathrow's incentives to deliver capacity to the benefit of consumers

f) The existence of an outer band with a differential sharing rate will also result in behavioural issues

2.44. Heathrow's risk exposure is significantly reduced, creating significant asymmetry

a) The TRS structure significantly reduces Heathrow's risk exposure compared to Q6 price control

b) These risks are transferred to consumers, who are now significantly sharing in Heathrow's risk exposure

c) This is in error since this fact is not recognised within the cost of capital, which is materially overstated as a result

[123] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.32
[124] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.32

2.45. The implementation of the TRS mechanism is excessively complex. We support the recovery of TRS balances over several years. However, it is an error to begin recovery at n+2 before the end of future downturns. It is further an error to take an annual rather than cumulative approach, particularly without widening the inner band beyond 10% and proposals for the use of the RAB and sculpting of depreciation are unduly complex as a result.

2.46. Risk sharing is incompatible with the current capacity cap in summer 2022. Where these are the result of Heathrow's shortcomings, it is inappropriate that consumers pay for this effect. Current capacity caps are evidence of undesirable behavioural issues the CAA is likely to see with an outer band.

2.47. The CAA is correct to rule out the possibility of a re-opening mechanism.

3. Outcome Based Regulation (OBR)[125]

3.1. We are disappointed that the CAA's proposed Outcomes Based Regulation ("OBR") appears to be an inferior version of the previous Service Quality Rebates and Bonuses ("SQRB") regime. Ensuring there are appropriate incentives over Heathrow's expenditure in areas that support service quality outcomes is of critical importance, and the CAA's Final Proposals have continued to roll back on service quality achieved during Q6, tend towards Heathrow's proposed positions rather than those of the CAA's independent experts, and omit measures over key aspects of Heathrow's customers-critical infrastructure. Furthermore, it is nonsensical that OBR targets in H7 will fail to represent an improvement to consumers despite £3.6 billion of capital investment.

3.2. In broad terms, the CAA has erred by: only applying reputational incentives to areas that require significant expenditure for delivery of high service standards; applying financial incentives to areas that require little expenditure for their delivery and are easily achievable as a result; failing to ensure certain incentives are appropriately calibrated based upon independent evidence; and failing to apply bonuses to areas that have been identified as having particular delivery issues whilst simultaneously applying them to areas that are both easy to achieve and or at levels that have been achieved in the past

3.3. We echo the concerns of AlixPartners who note that the "CAA mostly relied on HAL's proposals to set targets, even though it commissioned Arcadis, an independent expert, to provide evidence relating to the setting of appropriate targets"[126]; it is imperative that the CAA uses the expertise of its independent consultants where "such expertise can be highly valuable due to the technical

[125] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", chapter 3

[126] AlixPartners, Comments on the CAA's Final Proposals, section 12

nature of the assessments required, and regulators are not in the day-to-day business of doing this work"[127]

3.4. Furthermore, by applying incentives to "services provided by HAL **and other parties** that consumers value"[128], the CAA extends the scope of regulation to parties who are not subject to economic regulation under the CAA's market power determination and in doing so has acted ultra vires, exceeding the scope of its duties under CAA12; this is an inappropriate application of OBR incentives where "setting the appropriate incentives requires that HAL has influence over these measures"[129]

3.5. In Annex One, we set out our detailed comments of various aspects that make up the OBR framework. These can be broadly summarised as follows.

3.6. **Outcomes**: the CAA's role is to ensure that "the services HAL provides meet their needs in terms of their range, availability, continuity and quality". It must ensure that its regulatory regime is applied only to "aspects of airport operation services that are directly within HAL's control".[130] The outcomes should be significantly updated to reflect the functioning of an airport and Heathrow's role in delivery of these services, either directly or indirectly.

3.7. **Measures:** The CAA has allowed the Q6 regime of SQRB to be weakened by allowing the focus of OBR to drift, becoming less focussed and less directly aimed at ensuring Heathrow's actions are appropriately incentivised. It is imperative that the CAA ensure that its measures are focussed on Heathrow's activity as funded by its operating expenditure allowance. Our detailed comments on the various OBR measures are set out in Annex One.

3.8. Most concerning, however, is that we have identified measures which essentially grant a nearly-free pass to Heathrow which in effect blunt the effect of its rebates over measures that are easier to achieve than those that required significant management effort and/or are particularly problematic at present; in particular, PRM service standards, security and baggage performance fail to deliver reasonable performance at present, yet the CAA's proposals are not sufficiently focussed on those particular areas to ensure appropriate consumer outcomes

3.9. The CAA must tailor its OBR measures and the value attributable through targets specifically to areas that are problematic, require material operating expenditure, and where the potential for detriment in consumer outcomes is significant

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[127] AlixPartners, Comments on the CAA's Final Proposals, section 2
[128] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 89
[129] AlixPartners, Comments on the CAA's Final Proposals, section 12
[130] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.2

3.10. **Measurement issues**: We are disappointed that the CAA has not given further consideration to daily measurement of OBRs at these Final Proposals. AlixPartners note that "limiting the number of extremely poor customer experiences is a desirable objective in itself, as well as improving the average customer experience" [131]

3.11. AlixPartners go on to state that the current approach "fails to capture how poor the service quality is for a minority of passengers. Indeed, if the passenger experience of a few passengers within one day, or one flight, was extremely bad, Heathrow can easily balance this over the following weeks and meet its monthly target"[132]

3.12. **Targets:** We are disappointed with the targets that the CAA has set, which in many cases are weaker than should be the case, and fail to hold Heathrow accountable to the same service standards that were in place during Q6; this is reinforced by AlixPartners who note that "CAA proposed a set of targets that does not address the concerns expressed by the airlines during the Consultation phase"[133] resulting in a situation where "HAL would have no incentive to perform better, or in some instances, maintain its performance"[134]

3.13. As further noted by AlixPartners, "the CAA does not rely enough on the evidence submitted by Arcadis, the independent experts it commissioned, when setting HAL's targets"[135]; it is imperative that the CAA correct for this error by relying on the advice of its independent expert to set targets, rather than relying mostly upon Heathrow's proposals to set targets.

3.14. Where the CAA has limited data at present for certain measures and has set cautious targets over some measures in these Final Proposals, we are concerned that the CAA has proposed targets that are weaker than suggested by its advisors; this is reiterated by AlixPartners who note that "where HAL did not submit evidence, the CAA deviated from Arcadis' recommendations"[136]

3.15. Further, "setting targets at the bottom end of the possible range of stretch targets suggested by our consultants"[137], as the CAA has done, is flawed because it will fail to deliver the very aim of outcome based regulation (i.e., ensuring quality service and incentive performance improvements). As set out in the Alix Partner's report, the CAA should at least adopt the midpoint of Arcadis' recommended range or otherwise justify why a more cautious approach is justified.

[131] AlixPartners, Comments on the CAA's Final Proposals, section 12
[132] AlixPartners, Comments on the CAA's Final Proposals, section 12
[133] AlixPartners, Comments on the CAA's Final Proposals, section 12
[134] AlixPartners, Comments on the CAA's Final Proposals, section 12
[135] AlixPartners, Comments on the CAA's Final Proposals, section 12
[136] AlixPartners, Comments on the CAA's Final Proposals, section 12
[137] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.81

3.16. It is concerning that the only area where the CAA has pushed back on Heathrow's proposed target has instead resulted in that measure being downgraded to a reputational rather than a financial incentive, where the CAA "proposed a target of 98 per cent of bags being delivered not less than 30 minutes before the scheduled departure" [138], a target that we have shown should be at a 99% level. AlixPartners observes that these decisions demonstrate "that the CAA placed a lot more weight on the airport suggestions than the independent analysis it commissioned. The CAA needs to justify why Arcadis' suggested lower bound is a more appropriate target than its mid-point" [139]

3.17. **Incentives:** We support the CAA's approach 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"[140] which fail to recognise the fundamental rationale for bonuses (i.e. incentivising the improvement of particularly problematic areas)

3.18. We also agree with the CAA that the "current knife edge system of rebates is more suitable for H7 than HAL's proposed sliding scale incentives"[141]; this is particularly the case where in implementation, Heathrow's proposals would undermine the strong incentive effect of achieving a certain level of performance, and allow moderate underperformance to be weakly penalised

3.19. Bonuses must be focussed upon particularly problematic areas and designed in a way that solves the problem identified. This is recognised by Alix Partners who state in their report that "the CAA should aim to design its targets and bonuses to incentive performance improvement from HAL". Otherwise, the incentive risks paying Heathrow windfall bonuses to deliver proven levels of performance, undermining the incentive as a result

3.20. The CAA must correct for these significant errors which risk reducing consumer service quality during H7

3.21. **Continuous Improvement:** We disagree with the CAA's suggestion that they should be able to make binding decision on disputes about exclusions to the OBR regime during major operational disruption events. We set out our detailed reasoning for this in Annex One. However, we welcome the CAA's ex-ante commitment to a mid-term review, ensuring targets can be set for measures that are not currently finalised, though are concerned by the CAA's position that it would not generally adjust for cases where targets have been set too low. This asymmetric approach to the review penalises consumers by leaving the entire OBR regime potentially mis-calibrated for the entirety of the H7 price control.

[138] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.83
[139] AlixPartners, Comments on the CAA's Final Proposals, section 12
[140] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.62
[141] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.66

Conclusion

3.22. The OBR regime in the Final Proposals is flawed for the following reasons.

3.23. The CAA's proposed measures do not cover some key aspects of Heathrow's operations. Specifically:

a) Check-in measures exclude the baggage input belt in error, which is the most problematic aspect of the infrastructure

b) Departure gate infrastructure upon which airlines are dependent is excluded in error

c) PRM service is not covered under Heathrow's economic incentives in error

3.24. Measures are not sufficiently incentivised to support service quality because:

a) Baggage measures covering in-system performance have been removed from financial incentives in error

b) Asset availability covers significant periods when equipment is not in use, undermining incentives in error

c) Control posts remain grouped and key measures averaged over excessively long periods of time

3.25. Targets are below achieved performance in Q6 and will result in reductions in service quality. Of particular concern:

a) The CAA's approach is in error by being incompatible with its decision to award a £300m RAB adjustment

b) Targets have been set at the bottom end of the ranges proposed by its consultants in error

3.26. Incentives have been applied in a manner that makes them too easily achievable

a) Bonuses have been applied in error to some areas that do not have demonstrable problems and are too easily earned

b) Bonuses applied in error to other areas would reward Heathrow for achieving previously achieved performance rather than outperformance

3.27. Finally, we support a mid-term review of OBR, though caution that by proposing not to update certain weaker targets, the CAA is in error

4. Operating Expenditure[142]

4.1. The CAA's approach to operating expenditure, described as combining "detailed bottom-up expert scrutiny of each opex category, based on the range of evidence available, with top-down review of the estimates derived from our bottom-up analysis"[143] is not an explanation that is consistent with the assessment of AlixPartners, who notes that "the starting point of CTA's original assessment of HAL's opex was based on a very high-level assessment of HAL's top-down financial model, without detailed bottom-up analysis of the actual costs that would be incurred"[144]

4.2. In addition, airlines have not been offered any opportunity to scrutinise new evidence that has been presented by Heathrow in its RBP Update 2, and remain concerned that it has continued to overstate its potential cost base

4.3. Any increase in opex must be fully justified based upon both passenger volumes and service quality requirement. As Alix Partners state in their report "There is no robust evidence that the CAA has set allowance at the efficient level of HAL's opex". If opex allowances are not set at the efficient level, then HAL will earn windfall profits and/or have reduced incentives to its minimise costs.

4.4. We are particularly concerned that since Initial Proposals, the CAA has increased its estimates of opex to allow for higher staff numbers[145]. The CAA has not addressed our concerns of the 7.5% mark-up applied to all employee contracts through the shared service agreement with LHR Airports Limited, and further, pension deficit repair costs must be removed to recognise that it is no longer required in light of a £343m surplus which itself is subject to unconditional refund and must be deducted from the RAB as a result.

4.5. Our more detailed comments on the CAA's approach to determining opex including use of the CTA's analysis are set out in Annex One. Annex One also includes our specific comments on the various costs that have informed the opex allowance such as people costs, utility costs, other operating costs etc.

4.6. Ultimately, however, we wish to stress that the current approach is deeply concerning. As AlixPartners describes it, "HAL's incentives will be to disregard lines of costs or cost items where cost allowances were particularly generous and focus instead on providing focused justifications on a bottom-up basis for various increases"[146]. Given the information provided by Heathrow has not been subject

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142 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", chapter 4
143 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.5
144 AlixPartners, Comments on the CAA's Final Proposals, section 5
145 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 56
146 AlixPartners, Comments on the CAA's Final Proposals, section 5

to any scrutiny by airlines, the basis of CTA and the CAA's Final Proposals have not been thoroughly tested. As such, it was fundamentally wrong for the CAA to not start its analysis based upon concrete information about Heathrow's cost base.

4.7. As AlixPartners put it, "HAL is being rewarded for providing poor quality information at the outset, and in an environment where it reaps 100% of the benefits from any cost reductions below forecast"[147]

4.8. It is incumbent on the CAA to correct its errors by performing detailed, bottom-up analysis of Heathrow's cost base, a view shared by AlixPartners who suggest that "there would appear to be strong merit in the CAA revisiting all of HAL's opex forecasts, as well as disclosing to the airlines the precise basis of these estimates so that they can be challenged"[148]

Conclusion

4.9. Whilst CTA's approach provides some useful information, the CAA remains heavily reliant upon confidential information provided by Heathrow, and the starting point of the CAA's analysis remains based upon obscure top-down information from Heathrow. This is concerning because:

a) Airlines have not been offered appropriate opportunity to scrutinise information provided by Heathrow

b) In particular, we have no visibility of Heathrow's assertions that support CTA's bespoke queuing model

4.10. Further errors we have identified in the CAA's analysis of opex are:

a) The CAA's judgment tends towards Heathrow's positions rather than those of its independent advisors which we consider a manifest error

b) The CAA has not removed the mark-up applied to all employee contracts through the shared service agreement with LHR Airports Ltd

c) Utility, insurance and additional pandemic-related costs appear to be additionally inflated in error

d) The CAA's approach to business rates removes Heathrow's existing incentive in error prior to the conclusion of the current valuation

e) The inclusion of pension deficit repair costs is in error, and further the £343m surplus subject to unconditional refund must be deducted from the RAB

[147] AlixPartners, Comments on the CAA's Final Proposals, section 5
[148] AlixPartners, Comments on the CAA's Final Proposals, section 5

f) We are concerned that the CAA has in error pre-judged the result of its own consultation on its fees

5. Commercial revenues[149]

5.1. As for operating expenditure, we are concerned that for commercial revenues, the CAA has "reduced our estimates in the light of new evidence presented by HAL in relation to the scope for increasing retail and surface access revenues"[150]; in particular, to ensure charges are on an efficient basis, the CAA's price control must "incentivise HAL to optimise the level of commercial revenues which, in turn, reduces the overall level of airport charges"[151].

5.2. However, the CAA remains heavily reliant upon confidential information provided by Heathrow for forecasting commercial revenues where airlines have not been offered appropriate opportunity to scrutinise information provided by Heathrow, and we have no visibility of Heathrow's passenger mode share model for surface access, or adjustments that have been made to it since expansion.

5.3. In addition, the CAA has not included revenues that would otherwise reduce the airport charge and benefit consumers. Other include:

a) an insufficiently strong management stretch target;

b) the removal of risk sharing over terminal drop-off revenues in 2024;

c) inclusion of Heathrow's assertions related to margins as a result of tax changes; and

d) overlays related to surface access that are inconsistent or favour Heathrow's position.

5.4. As a result, revenues are being depressed overall. The CAA's Final Proposals result in an "estimate of commercial revenues per passenger in 2025 [that] is 5% lower than out-turn commercial revenues in 2019 (in real terms)"[152]; this does not appear to be in line with Heathrow's previous achieved performance, and fails to stretch Heathrow to perform at its most efficient during the H7 period as a result.

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[149] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", chapter 5
[150] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 56
[151] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.2
[152] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.54

5.5. Further detail to support our submissions is set out in Annex One, as well as our specific comments on those matters that make up commercial revenues including surface access, cargo, property and terminal drop-off charges.

Conclusion

5.6. As for operating expenditure, the CAA remains heavily reliant upon confidential information provided by Heathrow for forecasting commercial revenues, and the starting point of the CAA's analysis remains based upon obscure top-down information from Heathrow, and as a result:

a) Airlines have not been offered appropriate opportunity to scrutinise information provided by Heathrow

b) In particular, we have no visibility of Heathrow's passenger mode share model for surface access, or adjustments that have been made to it since expansion

5.7. In addition, the CAA has not included revenues that would otherwise reduce the airport charge and benefit consumers. We are particularly concerned that:

a) Revenues are not in line with Heathrow's previously demonstrated past performance

b) Management stretch neither reflects the current wedge between CPI and RPI, nor the levels the CAA's advisors recommend

c) The CAA has accepted Heathrow's assertions on the impact of changes to tax without challenge

d) Modelling of geographic markets is potentially inconsistent with its approach to passenger forecasting

e) Assertions on mode share that are neither evidenced nor transparent to airlines through the modelling approach

f) Adopting a flat fares overlay for Heathrow Express that is inconsistent with Heathrow's proposed yield management strategy

g) Blending out additional parking revenues over time creates inconsistency with its mode share approach referenced above

h) Accepting Heathrow's assertions on rents is contrary to the established Guide Price approach

i) Removal of TDOC revenues based upon Heathrow modelling has not been verified by airlines, and results in an inappropriate early termination of the associated risk sharing

j) Finally, continuing to treat cargo revenues as a commercial revenue rather than directly through the price cap results in outcomes that are likely to be to the detriment of consumers

6. Capital expenditure[153]

6.1. We welcome and support the CAA's view that "… both the quality and depth of evidence supplied by Heathrow in its updated RBP on capex estimates to be generally poor for that stage in the price control process" and that capital expenditure allowances incorporated into the price control must only represent efficient investment in projects that are required by consumers and airlines.

6.2. We are disappointed therefore to see that the CAA has concluded that an increase of the capital envelope from £2.4B in its Initial Proposals to £3.6B in its Final Proposals is justified. We are not satisfied that an increase in the capital envelope is warranted given the CAA's own conclusions regarding the evidence provided by Heathrow to support such an increase and Heathrow's ability to deliver a program of this size given its past delivery record. We believe that the CAA's Final Proposals are fundamentally flawed by permitting an allowance for capital that is poorly scoped, and not in line with the CAA's duties under CAA12.

6.3. It is critically important that the CAA requires Heathrow to meaningfully engage and consult with airlines on the prioritisation, development and execution of consumer funded capital investments at Heathrow. Heathrow has not adequately engaged with the airline community to define its proposed capital program and, as such, we cannot make a reasonable conclusion as to the efficacy of its proposed capital program to efficiently deliver projects that are in the best interests of consumers.

6.4. A bigger capital envelope cannot be the default answer for capital decisions, and we strongly encourage the CAA to require Heathrow to work with the airline community to reassess and reprioritise the projects within its capital plan rather than simply proposing new investment.

6.5. We expand on our submissions regarding the proposed size of the capital envelope in the Final Proposals and the importance of Heathrow working with the airline community to (re)prioritise investments in Annex One.

Conclusion

6.6. We remain concerned about the capital programme, where the CAA had originally provided "extensive feedback to HAL setting out how the information it provided

[153] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", chapter 6

was poor and insufficiently detailed"[154]; where "HAL has provided additional material to the CAA since RBP Update 2 which has partially addressed some of the gaps"[155], this information has not been scrutinised by airlines; in response, the CAA appear to have justified Heathrow's poor information and lack of coordinated capital masterplan in error, stating "lack of detail and maturity of these programmes is not necessarily unexpected, particularly where the programmes focus on expenditure required later in H7"[156], resulting in material errors to capital allowances that are not justified by the evidence provided

7. Capital incentives[157]

7.1. We agree with the CAA that stronger incentives are needed to protect the interests of consumers from increased costs because of Heathrow making inefficient capital investments. It is clear from the difficulty in conducting ex-post reviews of capital efficiency, the large number of over-budget capital projects, the over-scoping and gold plating of capital projects, and the ever-increasing size of the RAB, that the current incentives are not fit for purpose and therefore we welcome the modifications to the incentives as proposed by the CAA in its Final Proposals.

7.2. Subject to our comment below, we believe that the introduction of these modified incentives will ensure the delivery of capital projects based on measures and outcomes agreed between Heathrow and the airline community during the early development of such capital projects.

7.3. That said, we question why the CAA has decided to apply an inappropriately low incentive rate of 25% - a rate far below comparable incentive rates in other regulated sectors. We are concerned that setting the incentive rate at such a level will not have the intended effect in practice.

7.4. In addition, we also make the following specific comments with respect to capital incentives; further supporting detail for which is set out in Annex One.

7.5. **Capex categories and delivery obligations:** We are satisfied that the set of capital expenditure categories proposed cover the full range of expenditure proposed during H7. However, we disagree with Heathrow's "view that ex ante incentives should only apply to the proportion of its portfolio where risk was relatively low or

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154 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 6.34

155 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 6.39

156 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 6.47

157 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", chapter 7

where projects were generally 'repeatable' and benchmarkable"[158], and welcome the CAA's proposals to cover all categories with incentives as a result (with some limited exceptions)[159]. As noted by Arcadis, "the capex programme HAL has proposed for H7 is, overall, one that does not carry significant risks that HAL cannot be reasonably expected to manage and has a relatively high degree of controllability"[160]

7.6. Should capital only have been partially covered by incentives – then this "would likely lead to significant additional complexity and a potential risk of gaming through the allocation of expenditure to different categories"[161]; we therefore agree with the CAA that there is "no compelling evidence to suggest that a more limited application of incentives is required or would be appropriate"[162], and efficiency incentives should be implemented therefore across all capital expenditure categories

7.7. **Incentive rate and symmetry:** As above, we disagree with the CAA's proposed incentive rate of 25%. This figure of 25% is incredibly weak by reference to other industries (as evidenced in our response to Initial Proposals, and described as such by the CAA's own advisors); even the CAA's own analysis suggests that "in the scenario of an extreme level of overspending (30% above the capex baseline), the application of a 25% incentive rate would result in a reduction in HAL's average pre-tax Return on Regulatory Equity ("RORE") during the H7 period of around 0.6%. In our view, this is a relatively modest exposure to downside risk in the context of the other uncertainties that HAL faces during the H7 period"[163], further noting the lack of complexity in the H7 capital programme combined with Heathrow's past record of delivery within G3 budgets

7.8. AlixPartners notes that "HAL should face downside risk under incentive-based regulation; this provides incentives to be efficient. Moreover, if the rate were to be 50%, this downside risk would still only be c1.2% reduction in HAL's RORE (i.e. 2 x 0.6%). Accordingly, in our view, the incentive sharing rate for overspend should be 50%"[164]; we agree. This would ensure Heathrow's efficiency incentives are at least as good as those in operation in other, more complex regulatory regimes

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[158] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.24

[159] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.32

[160] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.29

[161] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.92

[162] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.92

[163] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.95

[164] AlixPartners, Comments on the CAA's Final Proposals, section 7

7.9. We further note errors in the CAA's approach to the symmetry of the incentive, which it does not believe is appropriate where "asymmetric rates are typically applied in sectors where the incentive rate has a dual function and generally reflects submitted costs that the regulator considers are higher or lower than its own assessment of efficient costs"[165]; we disagree with this assertion, which we believe is an incorrect assessment of the function of an asymmetric sharing rate

7.10. As noted by AlixPartners, "the CMA viewed that symmetric rates should be used as a reward only to those companies that submitted acceptable business plan costs… accordingly, at G3 it would be wholly appropriate to incentivise HAL to submit high quality information on capex costs as it would otherwise face a less favourable sharing rate as regards the proportion of cost savings that it is allowed to retain"[166]

7.11. It is imperative that the CAA correct this error, and apply an asymmetric rate to Heathrow's capital incentive; we support the proposal by AlixPartners that "HAL retaining 40% of cost savings (i.e. 10 percentage points lower than the sharing of overspends) if the capex plan quality is not high would seem entirely reasonable, and retain a sensible balance as to overall incentives"[167]

7.12. **Delivery obligations:** We agree with the CAA that "delivery obligations are essential to ensure that the underlying capex baseline reflects the scope, quality and timing of the infrastructure that is to be delivered"[168]; further, where these are not achieved, we support that Heathrow "should be compensated for by a proportionate reduction to the capex baseline of a broadly equivalent value to the obligation not delivered"[169]

7.13. **Timing incentives and triggers:** We are disappointed that the CAA has "decided not to apply separate timing incentives associated with the delivery of projects against agreed deadlines"[170]. As noted by AlixPartners, "we are concerned that the loss of explicit timing triggers as existing in Q6 could have the unintentional consequence of providing HAL with an incentive to delay some capex programmes"[171]. Given the CAA's extensive commentary on reasons why ex post assessments of capital efficiency are difficult to apply in practice, we find unconvincing its explanation that "our enforcement powers could be used where

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[165] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.43
[166] AlixPartners, Comments on the CAA's Final Proposals, section 7
[167] AlixPartners, Comments on the CAA's Final Proposals, section 7
[168] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.100
[169] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.100
[170] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.117
[171] AlixPartners, Comments on the CAA's Final Proposals, section 7

we find evidence that HAL has not been acting in an economic and efficient manner"[172]

7.14. It is important that the CAA correct this error by ensuring that its previously proposed timing incentives remain in place for capex categories and exceptional projects

7.15. **Uncertainty mechanism:** We remain firmly of the view that "HAL should be required to demonstrate to the CAA that it can explain the requirement for the additional expenditure and that it has sought the agreement of the airline community with its proposals"[173]; whilst we believe it is incorrect that the CAA has incorporated unnecessary and unsubstantiated sums within its allowanced for capital expenditure, we believe that a cap on expenditure is required to ensure out-turn expenditure is not excessive, even considering new capital efficiency incentives

7.16. However, given the additional capital expenditure incorporated above, the CAA has undermined its own mechanism in error by already providing for a significant, additional margin above Heathrow's substantiated capital expenditure plan; it is therefore our view that the 5% margin over the capital expenditure envelope for H7 is unnecessary and in error, which the CAA must correct by removing it

7.17. **Governance**: We will support the CAA in its work to update the governance arrangements, which "will mean that ex ante incentives will apply to projects that progress through G3 to Core during or after Q4 2022"[174]

Conclusion

7.18. Broadly speaking, we agree with the CAA's implementation of capital efficiency incentives given the difficulties of ex post reviews. We agree with the implementation of incentives across all capital expenditure categories, preventing additional complexity and reducing the risk of gaming

7.19. However, we are disappointed that there is no finalised delivery objective for each category of capital, but support the CAA's alternative approach to adjust baselines by reference to performance assessed against G3 delivery obligations

7.20. We consider that the CAA's incentives are not sufficiently well calibrated and are therefore in error for the following reasons:

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172 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.122
173 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.73
174 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.147

a) The incentive rate has been set too low to be effective and should be 50% for over-spend instead of 25%. This is particularly relevant given the information asymmetry between Heathrow and the CAA/airlines

b) Incentives to improve information quality and solve for this asymmetry can be further addressed with an asymmetric sharing rate of 40% for under-spend

7.21. The loss of separate timing incentives undermines the CAA's approach. Specifically:

a) This results in an incentive for Heathrow to delay capital expenditure until later in the price control

b) Reliance upon the CAA's enforcement powers to initiate projects on time introduces the same issues as seen with ex post efficiency reviews

c) Such incentives are not the same as timing incentives within the delivery obligation, as established at G3

7.22. We welcome the introduction of the uncertainty mechanism to protect consumers from extreme over-expenditure. However, the CAA has undermined its own mechanism through the additional of £1.2bn in unsubstantiated additional capital expenditure allowances. As a result, the additional 5% margin is unnecessary and makes the mechanism less likely to be effective in practice

7.23. We support the CAA's work to update governance arrangements by Q4 2022, which will ensure ex ante incentives can apply in full. As a result, the additional 5% margin is unnecessary and makes the mechanism less likely to be effective in practice

7.24. We also support the CAA's work to update governance arrangements by Q4 2022, which will ensure ex ante incentives can apply in full

8. Other regulated charges[175]

8.1. Other regulated charges are those services provided by Heathrow that are neither consumed on a per passenger basis, nor can be feasibly delivered by other providers.

8.2. In general, we support the CAA's move to a marginal cost approach, removing the distortive effect of annuities derived from the RAB alongside allocated costs that would otherwise reduce or remove incentives for efficiency. We also support the CAA's view that flexibility in the definition of ORCs may be valuable in the future. However, we caution that this flexibility should not be used as a means to recover

[175] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", chapter 8

operating expenditure separate from the airport charge. We are also concerned that the disapplication of the incentive mechanism for business rates does not allow the incentive at the current revaluation round to fully play out its conclusion.

8.3. We support reforms to ORC Governance that strengthen consumer protections, in particular anchoring ORC arrangements in Heathrow's licence, assuring airlines and users that procurement is scoped and delivered appropriately. We also support the development of guidance for protocols and dispute resolution along with the one-off review of cost allocation. However, we are concerned that the CAA's forecasts of ORCs that have been adjusted as a fixed percentage of overall operating expenditure are in error as the CAA's new passenger volume assumptions mean that this percentage is unlikely to remain the same at greater volumes. We expand on these issues in Annex One.

<u>Conclusion</u>

8.4. We support the CAA's move to a marginal cost approach for ORCs, along with changes to its scope. This approach ensures a more collaborative approach to service delivery outcomes can be achieved. We also support:

a) Changing the scope of ORCs to focus on services that better meet the definition of an ORC

b) Not including business rates within ORCs, though we disagree with the disapplication of the incentive mechanism during the course of the current revaluation round

8.5. We further support reforms to ORC Governance that strengthen consumer protections, in particular:

a) We consider that anchoring ORC arrangements in Heathrow's licence is appropriate and proportionate

b) Assuring airlines and users that procurement is scoped and delivered appropriately

c) The one-off review of cost allocation and the implementation of its results in licence

d) The development of guidance for protocols and dispute resolution

8.6. However, we are concerned that the CAA has introduced errors through forecasts of ORCs that are have been adjusted as a fixed percentage of overall operating expenditure

9. Weighted average cost of capital[176]

9.1. We welcome the CAA's assessment in the Final Proposals that "suggests that a lower WACC than our Initial Proposals range is appropriate"[177]; in particular, we welcome the changes resulting from "the application of a higher downward adjustment to the asset beta to take account of TRS arrangements"[178] along with the beneficial impact of higher forecast inflation

9.2. Nevertheless, we remain disappointed that the CAA has not acted upon a number of areas set out in our response to Initial Proposals, noting in particular that the "real post-tax cost of equity of 7.5% (which means **we are allowing equity returns 20% higher than the market average**)"[179]; this is an unacceptable outcome for a regulated business that is subject to numerous regulatory protections unavailable to participants in competitive markets, and entirely irrational

9.3. We note AlixPartners' observation that the "CAA failed to take account of the fact that aiming down within the range of WACC estimates will compensate for information asymmetries that exist between HAL and the CAA in terms of passenger forecasts, opex, and commercial revenues (should the forecasts remain as in FP)"[180]

Conclusion

9.4. We welcome the CAA's assessment of WACC at Final Proposals that reduces its estimates from Initial Proposals based upon the evidence, in particular:

a) A lower cost of embedded debt as a result of the significant rise in inflation

b) A reflection of Heathrow's debt structure within the estimation of embedded debt costs

c) The inclusion of an adjustment for TRS across the asset beta

9.5. However, we remain concerned with the CAA's approach in a number of specific areas, including:

a) The inclusion of an uplift for relative risk changes, which is not supported by evidence and is inconsistent with other assumptions

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176 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", chapter 9
177 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 63
178 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 63
179 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 64
180 AlixPartners, Comments on the CAA's Final Proposals, section 1

b) The use of an enduring pandemic effect that is contrary to the evidence and upwardly biased as a result of the estimation methodology, which differs from regulatory precedent

c) An adjustment for the TRS mechanism that could reasonably be greater given the comparison to the risk profile at other utilities

d) The use of a 31st March cut-off that excludes significant new information on inflation

e) The application of a halo effect that is not supported by the evidence and undermines other incentive properties

10. Regulated Asset Base[181]

10.1. The RAB is ultimately the value of efficient capital expenditure incurred by Heathrow that it has yet to recover from consumers through airport charges. It is extremely important that the CAA consider the incentives it sets by reference to the RAB, where consumers might be harmed by the financial engineering that is conducted in other Group entities, using the RAB as a tool to raise significant levels of debt within the WBS structure.

10.2. Our main comments on the RAB focus on two key issues: (i) HAL's requests for further RAB adjustments; and (ii) the CAA's £300M RAB adjustment. We address these below. However, we also set out in Annex One our more detailed comments on other aspects of the RAB including for example price control re-opening, H7 traffic risk sharing, remuneration of historical expenditure and asset utilisation.

10.3. **Further RAB adjustments:** We are disappointed that Heathrow has continued to request a RAB adjustment in response to the pandemic, and incorporate by reference our previous submissions on this topic, where we remain firmly opposed to any ex post adjustment, particularly given Heathrow's significant outperformance prior to the pandemic and failure to inject any new equity at its ultimate parent company, FGP TopCo Ltd

10.4. We support the CAA's decision not to award any further RAB adjustment to Heathrow, supporting its reasoning and rationale for not doing so. We also agree with the CAA's statement "that HAL's investors should have understood, that downside risks, including pandemic-related risks, were expected to be borne by HAL in accordance with the risk allocation set out in the CAA's Q6 final proposals document"[182].

181 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", chapter 10

182 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.29

10.5. This position is supported by AlixPartners who state that "any further RAB increase, without investment commitment, or to increase the airport capacity or improve the service quality, would likely result in airport charges increases to the detriment of consumers and moreover would raise serious questions about the incentive properties of the regulatory framework"[183]

10.6. **CAA's £300M RAB adjustment:** We also remain firmly opposed to the £300m RAB adjustment, which the CAA state was made "particularly to support HAL's financeability, the timely re-opening of airport capacity and the quality of service it provides during 2021, ahead of the new H7 price control period starting in 2022"[184]. This is inaccurate. The CAA previously stated that the RAB adjustment was made where Heathrow had "set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 **and beyond**"[185]

10.7. It is imperative therefore that the CAA correct for this error by reference to the investment promises that Heathrow made to the CAA in advocating for the RAB adjustment, which have not been delivered; as we have previously set out in our response to Initial Proposals, that investment has not in fact been delivered, and consumers are now suffering from Heathrow's delays in re-opening capacity and delivery service quality outcomes

10.8. These concerns are also reflected in the AlixPartners report, which suggest that "the RAB adjustment needs to be associated with precise and binding conditions regarding future deliverables to provide HAL with appropriate incentives"[186], however "this 'strong incentive' will be undermined if HAL is allowed to retain this adjustment if the necessary service quality and terminal capacity is not delivered throughout 2022"[187]

10.9. In addition, they note that "We support the CAA's conclusions that a further RAB adjustment should not be made. We agree that any further RAB increase, without investment commitment, or to increase the airport capacity or improve the service quality, would likely result in airport charges increases to the detriment of consumers and moreover would raise serious questions about the incentive properties of the regulatory framework"[188]

[183] AlixPartners, Comments on the CAA's Final Proposals, section 11
[184] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 74
[185] CAA CAP2140, "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", para 4.15
[186] AlixPartners, Comments on the CAA's Final Proposals, section 11
[187] AlixPartners, Comments on the CAA's Final Proposals, section 11
[188] AlixPartners, Comments on the CAA's Final Proposals, section 11

Conclusion

10.10. We support the CAA's decision not to award any further RAB adjustment because:

a) A further request by Heathrow for an upward RAB adjustment is not justified

b) The CAA has not set any legitimate expectations at the Q6 periodic review that it would act in such a manner

c) The CAA's powers under CAA12 section 22 do not compel it to submit to any request to re-open the licence

d) The Q6 licence was appropriately calibrated ex ante at the Q6 periodic review, at which point Heathrow did not appeal

e) Ex post adjustments are incompatible with incentive regulation

f) The introduction of TRS at H7 does not require an ex post adjustment to the Q6 licence for credibility

g) Financeability is assessed on an ex ante basis at the periodic review and there is no UK regulatory principle that guarantees recovery of regulatory depreciation

h) Asset utilisation does not comprise a robust approach to regulatory depreciation, and cannot be applied ex post to an ex ante price control

i) The existence of a price cap does not warrant an ex post re-opening of a price control, nor has any other European airport been permitted ex post revenue recovery on such a scale

10.11. However, Heathrow has not delivered the incremental investments to support service quality as promised for its £300m RAB adjustment

a) The CAA must revisit its £300m RAB adjustment to enforce consumer protections

b) This applies where Heathrow has not spent additional capital sums in 2021 and failed to support service quality during the recovery in 2021 and beyond

11. Asymmetric risk allowance[189]

11.1. We remain concerned with the CAA's approach to asymmetric risk, which in conjunction with the TRS mechanism, shock factor and cost of capital results in

[189] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", chapter 11

significant over-compensation to Heathrow of the risks that it is actually bearing in the CAA's H7 Final Proposals. Our detailed reasons for this are set out in Annex One.

11.2. Most notably, however, the Competition Commission has already opined at Q5[190] that communicable diseases can be considered a normal business risk, that Heathrow's shareholders are compensated for bearing such risks through the allowed cost of capital, and also placed natural disasters, geopolitical upheaval and technological failure of either aircraft or airport systems under the same heading[191]

11.3. AlixPartners also note that "it is important to know whether the impact of the individual historical shocks were added back into the historical data (in the individual months or years in which they occurred) before calibration or estimation of the model"[192], and "if this has not been done asymmetric shock factors will have been applied to forecasts that already implicitly include the impact of these shocks, and therefore would be invalid"[193]

11.4. The CAA has developed a calculation, separately from that of the cost of capital that itself already incorporates all known risks "for dealing with future "pandemic risks" through a stand-alone revenue allowance for these low probability but significant events". Further, the CAA has provided no evidence that any asymmetric risk allowance is required. However, in applying the asymmetric risk allowance, the incentives at the heart of the regulation have been fundamentally altered. And yet, this is precisely the risk incorporated in the cost of capital, and just as for the TRS mechanism

11.5. It is for this reason the asymmetric risk allowance is unnecessary and duplicative; as a result, we maintain that the CAA is in error through its failure to recognise the degree of wholesale risk transfer in the cost of capital

11.6. **Shock factor**: We also oppose the suggestion by the CAA that "all parties also accepted that the inclusion of a shock factor within a traffic forecast was likely to produce a more accurate traffic forecast than the use of 'unshocked' forecasting models"[194]. We have repeatedly and consistently refuted such an approach on the basis that "as the demand risk was included in the asset beta, to include it in the passenger forecast without offsetting the risk accounted for elsewhere would be double-counting"[195], dealing with such shocks through a shock factor to passenger forecasts would be incorrect

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190 Competition Commission (2007), BAA Ltd: a report on the economic regulation of the London airport companies (Heathrow Airport Ltd and Gatwick Airport Ltd), appendix F, para 137 to 145
191 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.27
192 AlixPartners, Comments on the CAA's Final Proposals, section 3
193 AlixPartners, Comments on the CAA's Final Proposals, section 3
194 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.25
195 CAA CAP1103, "Q6 Final Proposals", para 3.12

11.7. **TRS mechanism:** We are also concerned about the CAA's assertions about the TRS mechanism, which it states "does not fully protect HAL from traffic risk or remove the inherent skew in the distribution of risks"[196]; the CAA has presented no evidence that this is indeed the case

11.8. As a result, it is imperative that the CAA correct its error in this regard by either presenting new evidence that asymmetric risks are now problematic, or removing the asymmetric risk allowance in its entirely; we are gravely concerned that the CAA has introduced such an allowance in direct contradiction to its decision at previous periodic review in order to provide justification for its approach to the TRS mechanism, which itself has not been properly justified

11.9. **Calculation**: We also identified errors in the way in which the CAA has calculated the asymmetric risk allowance. Specifically, we are concerned that the CAA has simply used Heathrow's updated, proposed numbers for non-pandemic shocks without appropriate challenge; whereas, the CAA's calculations of pandemic related shocks lack any evidence. The relevance of Heathrow's apparent annual losses to calibration of the calculation is unclear and we disagree with the frequency of events figure the CAA has applied which is not based on evidence. Together, these errors undermine the asymmetry risk allowance presented in the Final Proposals. We expand on these issues in Annex One.

Conclusion

11.10. The CAA has made an error through the introduction of a new asymmetric risk allowance, which covers a perceived asymmetry that the Competition Commission has already opined does not exist. Further, the requirement for an asymmetric risk allowance is not properly evidenced and in error because:

a) The CAA is making an adjustment for risks that are already included within the cost of capital

b) The CAA has presented no new evidence to support its assertion that there is asymmetry. Similarly, the CAA's own advisors have previously found no conclusive evidence of asymmetric risk

c) Those same advisors judged it inappropriate to make a specific additional allowance for skewed equity returns

11.11. Furthermore, the calculation of the shock factor is in error because:

a) Airlines have never accepted the inclusion of a shock factor at any previous periodic review, contrary to the CAA's assertion

196 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.28

b) We disagree that downside risks are not matched by upside risks when considering expansion opportunities

c) It is not clear that the calculation has been based upon data that has added back the impact of shocks before calibration

d) It has been calculated on the basis of Heathrow's proposed figures without additional challenge

11.12. In addition, the justification for the TRS mechanism is in error because the CAA has not presented evidence to support its assertions that its mechanism does not fully remove any perceived skewness

11.13. Finally, the CAA's calculation of pandemic shocks is in error because:

a) The CAA asserts without evidence that the most recent pandemic experience will be typical of any future pandemic despite evidence that past pandemics did not result in such shocks to Heathrow's traffic volumes

b) Heathrow's profitability is not a relevant consideration when calibrating the TRS and the asymmetric risk allowance

c) The frequency of pandemics is not based upon any evidenced data of the frequency of past events

12. Financial framework[197]

12.1. It is important that the CAA sets appropriate incentives through the financial framework, ensuring that consumers are not exposed to the risks of Heathrow's financial engineering, but can benefit from the lowest available cost of capital to finance necessary and efficient investment in facilities; we therefore support the continued application of the notional company, where "assessing the price control on the basis of a notional company means that consumers fund an estimate of efficient financing arrangements"[198]

12.2. However, the CAA's proposals are not sufficiently robust for regulatory depreciation, which remains wholly based upon Heathrow's proposals, which being based upon accounting depreciation, leaves the RAB more elevated than by using annual 1/20th increments that are more appropriate in a regulatory context

12.3. In addition, inflation indexation has not been fully moved to appropriate CPI-based metrics, and whilst we support a CPI-X approach to the price path and a change in

[197] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", chapter 12
[198] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.14

reference date for technical reasons, the CAA has not appropriately evidenced its decision not to use CPI for RAB indexation, understating the likely compound effect on RPI inflation on the RAB, particularly in the present market environment

12.4. Furthermore, whilst we support the CAA's approach to corporate tax based upon a pre-tax approach, we are disappointed that the CAA has not carried forward its proposal for a tax clawback mechanism, allowing significant value leakage to Heathrow's investors as a result of its financial structure.

12.5. Further detail in respect of these matters is set out in Annex One to this response.

Conclusion

12.6. Regulatory depreciation and inflation indexation are material components of the price control, yet the CAA's proposals are not sufficiently robust; in particular, the CAA is in error through its calculation of regulatory depreciation which is wholly based upon Heathrow's proposals for regulatory depreciation and, where accounting depreciation, leaves the RAB higher than when compared to a 1/20th annual increments

12.7. Nevertheless, the CAA is correct not to follow Heathrow's proposal to defer depreciation, which could compromise financeability metrics

12.8. Inflation indexation has not been fully moved to appropriate CPI-based metrics. While we support the use of a CPI-X model (as well as certain changes made e.g. to the reference date), the CAA has not appropriately evidenced its decision not to use CPI for RAB indexation, understating the compound effect on RAB inflation

12.9. The continued use of RPI is in error and poor regulatory practice following the de-designation of the measure and the 2020 HM Treasury consultation. The CAA cannot justify the continued and significant transfer of value to Heathrow as a result of the present 3.6% wedge between measures. The assertion that it is not in consumers interest to move to CPI indexation and strip CPI from the cost of capital is not evidenced in any calculation

12.10. The CAA's treatment of corporation tax appears appropriate where the pre-tax approach provides a transparent approach to calculating tax allowances. However, we are disappointed with the CAA's proposals to drop the tax clawback mechanism, which continues to allow significant value leakage to Heathrow's investors as a result of its financial structure

13. Price cap and financeability[199]

13.1. We agree with the CAA's view that their Final Proposals "reasonably support debt financeability"[200], and indeed, based upon both actual performance and our views on the additional, unnecessary value provided to Heathrow in these Final Proposals, are of the view that a substantially lower price control is also comfortably financeable; we have demonstrated this in our response to Initial Proposals, alongside a report commissioned with Virgin Atlantic Airways Limited by Houlihan Lokey at that time

13.2. However, we cannot agree with the CAA's broad-brush assertion that at a BBB- rating, "UK debt markets are more expensive and have significantly reduced liquidity"[201]. The CAA has targeted credit metrics that are unnecessarily high. Whilst debt generally becomes more expensive as the credit rating decreases, simply to assert this is the case without measuring the cost of issuing a lower-rated bond against the cost to the consumer of supporting a higher level of financeability is an error. Key debt metrics comfortably support debt financeability, and stress testing further demonstrates sufficient funds available to support Heathrow in downturn scenarios, including equity injections.

13.3. In addition, equity financeability is strong, and we support the recognition that equity injections are useful in supporting liquidity and lowering gearing; furthermore, IRR analysis shows the price control meets investor requirements, which is particularly relevant where Heathrow's forecast returns significantly exceed recent returns of FTSE100 companies

13.4. It is therefore incorrect as evidenced by the capital structure of the wider Heathrow group below FGP Topco Ltd to suggest that such a BBB+ credit rating is necessary, and an error to assert so without explicitly calculating the trade-off between a higher and lower credit rating; Heathrow has repeatedly demonstrated its robust financeability, and the CAA must comply withs its primary duty to further the interests of consumers and not be misled by Heathrow into taking value away from consumers.

13.5. We expand on these matters in Annex One of this response.

Conclusion

13.6. The CAA's profile of charges appears appropriate given its existing decision to implement an elevated 2022 price cap

[199] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", chapter 13
[200] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 70
[201] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 72

a) A smoothed profile of charges declining from the level in 2022 supports airline planning and investment decisions

b) Regular, real price decreases based upon a CPI-5.74% price path are appropriate given inflation at present

c) We recognise that such a profile enhances credit metrics in the early years of H7

13.7. However, the CAA has targeted credit metrics that are unnecessarily high:

a) A target of BBB+ for the end of H7 along with thresholds at BBB+ is in error by setting an excessive bar for assessing financeability

b) Evidence shows that ratings at all notches within BBB offer significant market depth and liquidity

c) The CAA does not evidence the cost to consumers of targeting BBB+ over BBB or BBB-

13.8. Nevertheless, we agree that debt financeability is strong:

a) Metrics that assess key debt ratios are comfortably above minimum requirements at BBB+ (and by definition far above BBB levels)

b) We are concerned that early recovery of TRS balances to support financeability is unnecessary

c) The addition of unnecessary capital expenditure that enhances the PMICR ratio appears to be financeability rather than consumer driven

d) We agree that S&P's forecasts are unduly pessimistic, particularly in the case of Heathrow

e) We support the CAA's stress testing approach, which demonstrates sufficient funds available to support Heathrow in downturn scenarios, including equity injections

13.9. We also agree that equity financeability is strong:

a) We agree that equity injections are useful in supporting liquidity and lowering gearing

b) We agree that the RORE approach had limitations in its calculation, and that IRR analysis shows the price control meets investor requirements

c) This is particularly relevant where Heathrow's forecast returns significantly exceed recent returns of FTSE100 companies

14. General comments of the H7 price control[202]

14.1. In addition to the specific comments that we have on the Final Proposals as set out above and further detailed in Annex One, we wish to make the following general comments about the H7 price control review.

14.2. Regulation of monopoly infrastructure is of vital importance in supporting a dynamic economy, since the absence of competitive forces means there is otherwise no check on the ability of the monopolist to raise prices, constrain demand and operate inefficiently; this is to the detriment of consumers and ultimately the wider economy, constraining or even reversing productivity growth and leading to reduced consumer wealth and national competitiveness

14.3. As we have explained at length in our response to Initial Proposals, the monopolist will seek to avoid and remove regulation, claiming that it is not really a monopoly despite all evidence to the contrary; this follows the maxim of Professor John Hicks, a Nobel Laurate who noted that "the best of all monopoly profits is a quiet life"[203], explaining much of Heathrow's behaviour throughout this periodic review

14.4. The CAA would therefore be in error to convince itself that it can avoid making difficult regulatory choices in order to control a monopoly's behaviour, where monopolies are defined by a lack of effective economic competition, a lack of viable substitutes, and a price far above marginal cost leading to excess monopoly profits; in particular, "a pure monopoly is an industry in which there is only one supplier of a product for which there are no close substitutes and in which is very difficult or impossible for another firm to coexist"[204]

14.5. Heathrow is clearly a monopoly and has been assessed as such by the CAA, therefore the CAA has an obligation to ensure that its economic incentives remain appropriate to substitute for the lack of competitive forces that would otherwise constrain Heathrow's behaviour; this is reflected in the CAA12, where the CAA's primary duty to further the interests of users regarding "the range, availability, continuity, cost and quality of airport operation services"[205] alongside a duty to "promote competition in the provision"[206] of such services sits squarely above any secondary considerations

Price cap incentive regulation

[202] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary"
[203] Hicks, J.R., "Annual survey of economic theory: The theory of monopoly," Econometrica, Volume 3, Number 1, Jan., 1935, p. 8
[204] Blinder, Alan S; Baumol, William J; Gale, Colton L (June 2001). "11: Monopoly". Microeconomics: Principles and Policy (paperback). Thomson South-Western. p. 212
[205] Civil Aviation Act 2012, Section 1
[206] Ibid., Section 1

14.6. Price cap regulation is intended to achieve high-powered incentives to expose the regulated firm to a high proportion of its realised costs, allowing it to benefit for a time from cost efficiencies that it can introduce; this would in theory allow both the regulated company to seek new efficiencies and simultaneously extract value from previous efficiency gains for consumers at the periodic review

14.7. Despite a significant shift in the basis of Heathrow's regulatory regime in these Final Proposals from one based upon an average revenue price cap per passenger to a hybrid as a result of the introduction of TRS, there is no analysis or discussion in the CAA's Final Proposals of this significant change in the regulatory framework; the CAA describes its approach as simply "clarifying the risks that HAL is expected to bear during H7…by reducing HAL's exposure to the current uncertain environment"[207], yet this is in reality a significant shift to a lower-risk regulatory regime for Heathrow

14.8. As a result, it is our view that the CAA have made errors in the application of its TRS mechanism, particularly in the application of the outer band with stronger sharing rates, which has a fundamental effect on the incentive nature of the entire price control; undesirable incentives might result from scenarios near the ceiling and floor of the central sharing band and detailed analysis of the proposed incentive structure is required to demonstrate that this new incentive structure results in regulatory consistency

Airlines and information asymmetry

14.9. The CAA state correctly that "HAL and airline stakeholders have put forward diametrically opposed positions on the key issues discussed in our Initial Proposals, such as passenger forecasts and the cost of capital"[208]; however, the CAA contend that "these positions are consistent with their commercial interests, with HAL suggesting airport charges should increase significantly and airlines saying they should be significantly lower"[209]

14.10. The CAA must be clear that Heathrow is the only monopolist whose position will harm consumers through excessive pricing and lowering quality, since airlines operate in a highly competitive environment where passengers actively seek alternative routings if tickets are not priced competitively; airlines are therefore the best advocates of consumers at this periodic review, with appropriate knowledge of the airport operating environment and the effect of service quality deficiencies

14.11. It is not appropriate for the CAA to rely upon private and confidential information provided by Heathrow without challenge from airlines, and the effect of this information asymmetry will be to the detriment of consumers; we have requested

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[207] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 2.35

[208] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 6

[209] Ibid., para 6

such information on a number of occasions, but our requests have been rejected as a result of Heathrow's position on confidentiality. This lack of transparency and information sharing means that the airlines have not been able to properly participate in the review and various consultations. The airlines have therefore been put at a considerable and unfair disadvantage in this process.

14.12. It is unreasonable and irrational not to share with airlines a range of information that has been used in these Final Proposals, where Heathrow has sought to prevent airlines from challenging its assertions in a number of key areas; this is particularly the case in passenger forecasting, where despite placing a lower weight on Heathrow's model, it is apparent to us that a set of adjustments to Heathrow's model remains the main basis for the CAA's forecasts.

14.13. By failing to foster a review process that provides for an open and transparent flow of information, the CAA has risked a decision that is based on material errors of fact leading to inappropriate exercises of its discretion. For the reasons set out within this response, that appears to be the case

Periodic review process

14.14. As we have previously noted, this periodic review has been difficult not only as a result of the pandemic, but also as a result of the ongoing issues surrounding the runway expansion project; in particular, the question surrounding expansion has not been settled, with Heathrow having stopped all activity on expansion, yet with a legal Airports National Policy Statement ("ANPS") again in place

14.15. Therefore, whilst the CAA have rightly elected not to include expansion capital expenditure within this price control, and "focused on setting a price control for the H7 period consistent with the operation of a two-runway airport"[210], this has resulted in an approach to the price control that is inconsistent in the application of regulatory incentives to capital already spent on expansion activities, and in conflict with its assurances to the Department for Transport[211]

14.16. The process has then been further complicated by a tenacious attempt by Heathrow and its investors to capture the regulatory regime for the purposes of transferring onto consumers selected downside volumes risks assigned to it and richly remunerated at the Q6 periodic review; whilst Heathrow's requested RAB adjustment was ultimately rejected by the CAA[212] the process consumed significant time and resources that might otherwise have been applied to this periodic review

[210] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 33
[211] CAA letter from CEO Richard Moriarty to Department for Transport Permanent Secretary Bernadette Kelly, "Airport National Policy Statement: the CAA's approach to economic regulation of the expansion of airport capacity at Heathrow", p4, part of a serious published at this link
[212] CAA CAP2140, "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", para 4

14.17. In addition, Heathrow's business plans and the consultations throughout this periodic review have been significantly later than planned, both as a result of clear difficulties during the pandemic, but also an apparent lack of urgency to conclude this review; we are now eight months into the control period but the periodic review is yet to be concluded, a situation that is detrimental to consumers and caused serious issues at the annual rate card consultation in 2021

14.18. The CAA notes that Constructive Engagement ("CE") was a "process for engagement between HAL and its airline customers to enable them to discuss and review HAL's plans and to provide a forum for airlines to set out their preferences on issues such as charges, costs, investment and service quality"[213], yet this failed to achieve any meaningful discussion and engagement, similar to the abortive attempt from January to April 2020 based upon a pre-pandemic expansion business plan that has not been mentioned by the CAA in Final Proposals

14.19. This remains relevant, as Heathrow had proposed to deliver the significant investment required for expansion based upon a continued RPI **minus** 1.5% price profile and at its Q6 cost of capital, demonstrating the extensive gaming of its regulatory levers in its subsequent revised business plans; however, CE was largely fruitless as Heathrow approached the exercise as a series of set piece presentations, with little substantive discussion of real economic issues and through biased analysis designed to support Heathrow's conclusions.

14.20. The main flaw in this process is however the information asymmetry and lack of transparency detailed below.

14.21. In conclusion, this periodic review has been a difficult process, which has not resulted in robust analysis of Heathrow's various business plans or the economic incentives proposed by the CAA to address Heathrow's monopoly power; aspects of the H7 price control were first consulted upon in 2016 and even beforehand, making this possibly the longest and most fraught price control in the history of UK regulation, yet despite this, the H7 periodic review process remains in significant error by not robustly and thoroughly considering the relevant issues

Duties, financeability and holding cap

14.22. We remain of the view that the implementation of a holding cap at a level significantly above the CAA's own underlying position at Initial Proposals was an error through incorporating the regulated company's own lobbying position into the price control rather than being based solely upon the CAA's independent judgement and analysis

14.23. In particular, where the CAA based this decision upon Heathrow's statements about its financeability, we continue to believe that such an approach is contrary to the duties set out in CAA12; for example, where the CAA continues to apply

[213] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 37

judgements primarily on the basis of Heathrow's financeability[214] rather than as a cross check having first considered its consumer-focussed duties, we believe this has led to over compensation for Heathrow and higher charges than necessary

14.24. Heathrow's financeability must only ever be a cross check of decisions made on the basis of the CAA's primary duties, and it is an error of judgement to elevate financeability assessments to a level greater than those primary duties

15. Other comments

15.1. Our specific comments in respect of Notice to modify licence (CAP2365 Appendix C) , Early expansion costs (CAP2365 Appendix E), Capex incentives (CAP2365 Appendix F), Capex incentive framework assessment (CAP2365 Appendix G), WACC (CAP2365 Appendix H), Financial resilience and ring fencing (CAP2365 Appendix I), Policy on re-openers (CAP2365 Appendix J) and Rolling forward the RAB (CAP2365 Appendix K) are set out in Annex one

16. Concluding comments

16.1. The CAA's Final Proposals result in a significant shift of the regulatory regime as a result of its TRS mechanism from an average revenue price cap to a lower-risk hybrid. Furthermore, airlines have been limited in their ability to challenge Heathrow by a vast information asymmetry, with many items held back from airlines as a result of Heathrow's concerns over commercial confidentiality.

16.2. Given the long and difficult nature of this periodic review, which has witnessed extensions of the previous price control, introduction of expansion and Heathrow's unilateral withdrawal, and a downturn in passenger traffic as a result of a major pandemic, the CAA has had many significant issues to consider. Unfortunately, it is our view that these Final Proposals do not address some of these major issues and are in error as a result.

[214] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 19

Yours sincerely,

Alexander Dawe
Head of Economic Regulation
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British Airways Plc

ANNEX ONE: SUPPORTING DETAIL TO CONSULTATION RESPONSE

This Annex One contains further details to support the submissions made in Chapter Three.

1. Passenger forecasts

[Not used]

2. Regulatory framework

[Not used]

3. Outcome based regulation

3.1. In this section 3 of Annex One, we expand on the submissions presented in section 3 of Chapter Three of this response regarding our concerns with the OBR regime as presented in Final Proposals.

Outcomes

3.2. The CAA is correct in stating that "consumers' experience at Heathrow is driven by the outcomes they receive in terms of the overall service"[215], but where the CAA's role is to ensure that "the services HAL provides meet their needs in terms of their range, availability, continuity and quality"[216], it must ensure that its regulatory regime is applied only to "aspects of airport operation services that are directly within HAL's control"[217]

3.3. This is since the service provided by Heathrow is clearly delivered only in specific and measurable areas, such as the baggage system, security screening, services for Passengers with Reduced Mobility ("PRM"), provision of boarding gate, check-in and passenger mobility infrastructure amongst others; it is the output of these that is ultimately important to consumers rather than the specific inputs to these areas

3.4. However, airline networks and our relationship with consumers is wholly outside the scope of Heathrow's regulatory price control, and as a result, we welcome the CAA's recognition that "the services that HAL provides to airlines should remain a

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[215] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.2
[216] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.1
[217] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.2

key part of the new framework as these directly affect the service quality provided to consumers"[218]

3.5. We agree with the CAA that "the role of outcomes is to help identify overarching aspects of airport operation services that are most important to consumers and which can then be reflected in a more detailed set of measures"[219]. However, we remain significantly concerned that "these outcomes can be traced back to the results of HAL's consumers research[220], which as is not produced independently

3.6. Therefore, it is our view that these outcomes should be significantly updated to reflect the functioning of an airport and Heathrow's role in delivery of these services, either directly or indirectly; as a result, we support the CAA's view that "it may be useful to revisit these at the time of future period reviews, drawing on the experience of applying OBR in practice at Heathrow"[221], though this is based upon our view that they are not at present an appropriate incentive on Heathrow

Measures

3.7. We are particularly concerned that the CAA view Heathrow's position as being "best placed to co-ordinate inputs from multiple parties, including for example identifying any problems emerging and encouraging all parties to work together to the benefit of consumers"[222]; Heathrow is a monopoly provider of airport operating services, and as a result of the lack of effective competition is not incentivised to place consumer interests at the core of its business unless specifically incentivised to do so by the CAA's regulatory price control

3.8. This is most notable in the current, difficult operating environment where Heathrow has been slow to act to bring capacity back, and key bottlenecks exist within its operation; in particular, it has been significantly short-staffed in PRM service and pass issuance, yet continues to claim incorrectly that it has not been responsible for any failure to deliver capacity in this recovery period

3.9. As noted in Chapter Three of our response, the CAA has effectively allowed the Q6 regime SQRB to be weakened by allowing the focus of OBR to drift, becoming less focussed and less directly aimed at ensuring Heathrow's actions are appropriately incentivised, which is the main function of service quality targets within a monopoly's economic price control

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[218] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.3
[219] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.45
[220] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.44
[221] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.74
[222] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.46

3.10. Whilst we agree with the CAA that "consumers do not necessarily distinguish between those parts of their journey provided by HAL or those provided by other parties"[223], these facts do not alleviate the responsibility on the CAA to ensure that Heathrow delivers its contribution to those outcomes through the specific measures in places through its new OBR scheme, and it is imperative that the CAA correct its errors by ensuring that its measures are focussed on Heathrow's activity as funded by its operating expenditure allowance

3.11. Nevertheless, we agree with the CAA's position that OBR "should not be extended to cover almost exclusively airline activities over which HAL has very little or no control at all"[224]; it is incompatible with a regulatory price control over a monopoly business to mark its performance on metrics that are not relevant to controlling its monopoly power, and ensuring that its operating expenditure is maintained to ensure delivery to an appropriate level of service quality

3.12. As a result of the very real incentive for monopoly businesses to reduce operating expenditure between periodic reviews, we continue to disagree with the CAA that its particular distinction between "measures with financial incentives and those with only reputational incentives was based on the degree of control that HAL is likely to have over specific aspects of service quality"[225], a distinction that is not appropriately rationalised

3.13. Whilst we would never advocate placing inappropriate incentives on Heathrow for delivery of a service over which it has little or no control, the extent of operating expenditure is of far greater relevance as to whether it should be financially incentivised or not; for example, the performance of the Wi-Fi service is delivered at very low levels of operating expenditure, being far more based upon capital expenditure, which is itself at immaterial levels for Wi-Fi compared to other costs

3.14. As a result, the CAA appears to misunderstand why airlines believe that "there should be reputational incentives only for measures such as Wi-Fi performance, helpfulness/attitude of security staff and hygiene safety tests"[226], since it is not that Heathrow cannot control these particular measures, but that the CAA has neither demonstrated that they are problematic, nor that its proposals will influence the level of operating expenditure incurred to deliver the higher standards

3.15. Instead, such areas appear to be a nearly-free pass to Heathrow to blunt the effect of its rebates over measures that are easier to achieve than those that required significant management effort and/or are particularly problematic at present; in

[223] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.46

[224] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.47

[225] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.48

[226] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.48

particular, PRM service standards, security and baggage performance fail to deliver reasonable performance at present, yet the CAA's proposals are not sufficiently focussed on those particular areas to ensure appropriate consumer outcomes

3.16. Heathrow is naturally incentivised to disagree to placing a financial incentive over an area where its task is difficult, or potential savings achieved by reducing operating expenditure are particularly material; the CAA should therefore tailor its OBR measures and the value attributable through targets specifically to areas that are problematic, require material operating expenditure, and where the potential for detriment in consumer outcomes is significant

3.17. **Control posts**: we are disappointed to see the CAA propose to retain "groupings of control posts rather than addressing them individually"[227], though welcome the inclusion of control posts that appear to have fallen outside of previous licence definitions, noting that these additional posts must continue to be measured whilst they remain operational

3.18. We have presented abundant evidence related to the operation of vehicle control posts and the detrimental effect of their grouping on actual outcomes for vehicles; it should be clear to the CAA that averaging out performance undermines the delivery of outcomes to any one specific user, and whilst we should not impose unreasonable performance requirements on Heathrow, neither should a level of failure be acceptable as an outcome

3.19. **Baggage systems**: timely delivery of baggage from the system is critically important to aircraft being able to depart on time; whilst we agree that "it is very important from a consumers perspective that as many bags as possible travel on the same aircraft as their owners"[228], baggage misconnects are a separate issue entirely from that of timely delivery

3.20. Delivery from the departures baggage system is the critical point at which responsibility for baggage is passed to airlines and their handlers in the baggage lateral, where unit load devices ("ULDs") are made up or loose loads collected; Heathrow is solely responsible for the in-system performance of baggage, and this measures isolates the critical responsibility of Heathrow in this regard

3.21. As a result, we do not agree with the proposal not to introduce financial incentives over the timely delivery measure, and it is imperative that the CAA correct its error by including this within the financial incentives; attributing responsibility for failures within the system that is wholly within Heathrow's control is far from onerous, and would have ensured that Heathrow was financially incentivised during the numerous outages of its baggage systems over the course of 2022

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227 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.77

228 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.50

3.22. The CAA is wrong to believe that Heathrow might voluntarily "play a co-ordinating role for example in identifying other specific problems that can be addressed by the relevant parties working together"[229]; as described above, a monopoly has no such incentive to act without regulatory mechanisms specifically incentivising it to do so, and AlixPartners notes "we find it concerning that the CAA assumes that HAL work for the consumers' benefit. The fact that this is not true even justifies its regulatory role"[230]

3.23. Nevertheless, we support the CAA's proposed "threshold for the timely delivery from the baggage system measure at 30 minutes"[231], which is important in allowing baggage make-up to take place on time, and services to depart on schedule; this is not unreasonable given minimum check-in times and distances that need to be driven between baggage laterals and aircraft parking stands

3.24. **Stand facilities**: the CAA is correct in its acknowledgement that combining these measures had not been agreed between Heathrow and airlines., We therefore welcome the CAA's decision to revert to "four measures covering each type of asset separately"[232]. This is consistent with the airlines' the intention which had been to ensure that new measures covering facilities available at stands were included in the OBR framework, though separately incentivised themselves

3.25. This is supported by AlixPartners who note that otherwise "HAL could still meet its target by focusing on two or three asset types only and delivering poor service quality for the remaining ones"[233]; this is important where "limiting the number of extremely poor customer experience is a desirable objective in itself, as well as improving the average customer experience"[234]

3.26. **Check-in infrastructure**: we agree with the CAA that "HAL should face financial incentives in relation to the availability of check-in infrastructure"[235], though disagree that this should be confined "to "common use self-service" ("CUSS") and "self-bag drop kiosks", so it will not also cover baggage belts in the check-in area"[236]

3.27. No evidence has been presented that airline software is relevant to failures of baggage belts in the check in area, and since the failure of these belts is the primary area of failure of check-in infrastructure, its exclusion would be counterintuitive

229 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.51
230 AlixPartners, Comments on the CAA's Final Proposals, section 12
231 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.77
232 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.52
233 AlixPartners, Comments on the CAA's Final Proposals, section 12
234 AlixPartners, Comments on the CAA's Final Proposals, section 12
235 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.49
236 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.49

3.28. Nevertheless, we agree with the CAA that the "proposed licence changes include an additional exclusion so that HAL does not have to pay rebates for faults that are caused by airlines"[237]; this would be a counterintuitive outcome of regulation, though we expect such situations would be easily alleviated under existing mechanisms

3.29. **Departure gate facilities**: we continue to disagree with the CAA that "the airlines' proposed measure for "departure gate facilities" is a lower priority than some of the other new measures"[238]; we are reliant upon the facilities at the departures gate, and in particular the self-boarding gate systems to enable the departure of our aircraft, and their unavailability has a significant effect on consumers through delays to the boarding process

3.30. The CAA is in error to suggest that "poor performance may cause inconvenience for airlines and possibly passengers, but seems unlikely to be as disruptive as, say, a failure of check-in kiosks or the departures baggage system"[239]; failure of self-boarding gates results in immediate delays to boarding as airlines need additional staff to process passengers, and processes become more manual as a result, and it is imperative as a result that the CAA correct this error by including these assets within its OBR framework

3.31. **Cleanliness**: we continue to note that back of house cleanliness is an issue, and without any incentive to clean these areas to an appropriate standard, airlines are unable to rely on any mechanism that supports any reasonable clean standard; we are disappointed that the CAA might "consider such issues should be addressed at an operational level between airlines and HAL"[240], particularly when the cleanliness of such areas has a direct bearing on staff who deliver service to consumers

3.32. **PRM service**: we are disappointed that greater incentives have not been placed on Heathrow to deliver improvements in its provision of PRM service, with the CAA retaining "HAL's proposed measure of overall satisfaction with the special assistance service"[241]; whilst we welcome that this is more tightly defined than Heathrow's wider group, this is still insufficient to support the required outcomes

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[237] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.49

[238] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.56

[239] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.56

[240] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.56

[241] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.78

3.33. Whilst we recognise that "HAL's service to PRMs is also monitored under CAA's accessibility framework."[242], we stress that the purpose of this framework is not to ensure delivery of outcomes based upon economic regulation resulting from the specific requirements of consumers at Heathrow; as a result, whilst we welcome the CAA's current engagement, the CAA must not conflate the framework with customer requirements at an airport that hosts connecting, network airlines

3.34. **Measurement issues**: daily measurement is an important topic, and whilst we agree that its introduction might not be straightforward, we are disappointed that the CAA has not given this further consideration at these Final Proposals; this is further reflected in comments by AlixPartners, who "consider that limiting the number of extremely poor customer experiences is a desirable objective in itself, as well as improving the average customer experience"[243]

3.35. Whilst we therefore welcome the CAA's intention "to give it further consideration in advance of the mid-term review"[244], we are concerned that this would be too late for consumers affected; AlixPartners notes that "this approach fails to capture how poor the service quality is for a minority of passengers. Indeed, if the passenger experience of a few passengers within one day, or one flight, was extremely bad, Heathrow can easily balance this over the following weeks and meet its monthly target"[245]

3.36. We disagree that this is related to the question of "whether performance standards should be harmonised for central and transfer security queues"[246], which was previously an objective at the Q6 periodic review and has now been significantly delayed; similarly consumers and airlines were promised new measurement systems for security queues at that review and these have yet to be installed, limiting visibility at this periodic review of real queue lengths

3.37. Finally, we have presented evidence that measures that consider asset availability over a full 24-hour period (e.g. jetties and stands) are ineffective as the rebates are impossible to trigger when assets fail in general usage when they are required; we have pointed out that none of these measures are effective, since the CAA's measurement captures all times when the asset is not actually required, and it is important that this significant error is corrected by the CAA as a result

3.38. Consider jetties, which only realistically fail when being moved to attach to or detach from aircraft, meaning their availability when statis is irrelevant to the question of Heathrow's service provision; if the jetty were to fail, requiring an

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242 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.78
243 AlixPartners, Comments on the CAA's Final Proposals, section 12
244 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.53
245 AlixPartners, Comments on the CAA's Final Proposals, section 12
246 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.54

engineer to attend, a significant delay to consumers might result if that asset were out of use for 30 minutes, yet this would only be 1/48th of a 24-hour day, or just over 2% of time under the CAA's present measurement system

Targets

3.39. We are disappointed with the targets that the CAA has set, which in many cases are weaker than should be the case, and fail to hold Heathrow accountable to the same service standards that were in place during Q6; this is reinforced by AlixPartners who note that "CAA proposed a set of targets that does not address the concerns expressed by the airlines during the Consultation phase"[247] resulting in a situation where "HAL would have no incentive to perform better, or in some instances, maintain its performance"[248]

3.40. As noted by AlixPartners, "the CAA does not rely enough on the evidence submitted by Arcadis, the independent experts it commissioned, when setting HAL's targets"[249]; it is imperative that the CAA correct for this error by using the advice of its independent expert to set targets, rather than relying mostly upon Heathrow's proposals to set targets

3.41. As a starting point, it is logical that Q6 targets should form the minimum baseline for targets in H7, and being supported by years of evidence should be eminently achievable; the CAA must correct for this significant error, where despite significant investment in service quality over Q6, its proposals make it acceptable for targets to decline over H7, and service quality to reduce as a result

3.42. It is poor regulatory practice for the CAA uses Heathrow's proposals as a starting point, particularly where AlixPartners notes that "like any regulated business, that could make it profitable to under-forecast passenger traffic, overstate costs, etc. The same argument applies here, and HAL would directly benefit from proposing lower targets that the airport can more easily achieve (incentive effect) and also from setting lower standards for the next price control period (ratchet effect)"[250]

3.43. Furthermore, we expect that certain targets should be modified as a result of capital investment programmes throughout H7 as greater efficiencies are delivered, which in turn permit service quality improvements; we note the current "challenges HAL faces in reinstating services"[251], though consider reducing targets to accommodate such situations to be incompatible with the CAA's £300m RAB adjustment, a significant error that the CAA must therefore correct

[247] AlixPartners, Comments on the CAA's Final Proposals, section 12
[248] AlixPartners, Comments on the CAA's Final Proposals, section 12
[249] AlixPartners, Comments on the CAA's Final Proposals, section 12
[250] AlixPartners, Comments on the CAA's Final Proposals, section 12
[251] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.60

3.44. This is since the CAA previously stated that the RAB adjustment was made where Heathrow had "set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 **and beyond**"[252]; this has clearly not occurred with the reduction in standards set out in the Final Proposals, and where the incentive effect of the RAB adjustment is clearly ineffective and entirely irrational

3.45. Where the CAA has limited data at present for certain measures and has set cautious targets over some measures in these Final Proposals, are concerned that the CAA has proposed targets that are weaker than suggested by its advisors; this is reiterated by AlixPartners who note that "where HAL did not submit evidence, the CAA deviated from Arcadis' recommendations, for instance in respect of the new check-in infrastructure measure"[253], and "even though the dataset used in Arcadis' assessment is limited in time, the last few months before the pandemic suggest that HAL would achieve a potential 99% availability target"[254]

3.46. As a result, it is important that the CAA correct its error and implement targets as proposed by its independent advisors, being at least as rigorous as were in place for Q6; we further reiterate our views set out in our response to Initial Proposals that targets are set at appropriate levels to reflect Heathrow's actual achieved performance

3.47. The importance of this is demonstrated by AlixPartners who observe that "the baseline target for security queues time provides no incentive for HAL to improve its performance. The CAA requires that 97-99% of the security queue time are under 5 minutes for central search and 10 minutes for transfer search. However, Arcadis noted that "HAL has consistently exceeded the 95% and 99% target in every month in T2 except for around Q2/Q3 2020". Similarly, for transfer search, Arcadis noted that "given the IP targets are to be maintained at Q6 levels, they are considered achievable"[255]

3.48. Similarly, we continue to disagree with the CAA's approach of "setting targets at the bottom end of the possible range of stretch targets suggested by our consultants"[256]; this approach is flawed because it will fail to deliver the very aim of outcome based regulation (i.e., ensuring quality service and incentive performance improvements) whilst unduly rewarding Heathrow to the direct detriment of consumers, and whilst some targets might rise at a mid-term review[257], this is too late for consumers who suffer from reduced service. As set out in the Alix Partner's

[252] CAA CAP2140, "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", para 4.15
[253] AlixPartners, Comments on the CAA's Final Proposals, section 12
[254] AlixPartners, Comments on the CAA's Final Proposals, section 12
[255] AlixPartners, Comments on the CAA's Final Proposals, section 12
[256] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.81
[257] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.80

report, the CAA should at least adopt the midpoint of Arcadis' recommended range or otherwise justify why a more cautious approach is justified

3.49. AlixPartners also comments on this practice, noting that "it is unclear why the CAA commissioned an independent expert, then used the lower bound of its suggested range, rather than the mid-point[258]; further, they state that "Arcadis analysed Heathrow's historical performance across terminals to set appropriate target ranges. Hence, nothing suggests that this approach is overly optimistic and would justify adopting the lower bound rather than Arcadis' mid-point"[259]

3.50. As a result, the CAA must correct its error as a priority and adopt AlixPartners' proposed approached, which is to "fully rely on the analysis of independent experts, i.e., the target range mid-point. Otherwise, the CAA should provide evidence to justify why the lower end of Arcadis' suggestions seemed more appropriate"[260]

3.51. Where the CAA has not yet proposed targets, we stress that baseline data is actually available for airport departures and arrivals management within the Airport collaborative decision-making ("A-CDM")[261] tool that has been in place for a number of years at Heathrow; as a result, the CAA should ensure that it requests the necessary data from Heathrow in order to set targets for these measures

3.52. AlixPartners also observe that "the CAA should have commissioned further research on these measures in order to provide a robust approach to setting appropriate targets. Not setting targets means that HAL will have very limited incentives to address these four service quality criteria during the early stage of the H7 period"[262]; consumers should not have to wait for this error to be corrected at the mid-term OBR review, and the CAA should seek to rectify this immediately

3.53. For cleanliness, there are no observable uncertainties over "passenger perceptions and priorities, which might affect the cleanliness measure in particular" nor "possible questions about how passengers will expect to find their way around airports in future"[263]; consumers expect the same standards as before the pandemic, and place value upon an environment that delivers to the same good quality service standards

3.54. Specifically we are concerned therefore that the CAA has reduced its targets for some measures where it had adopted Heathrow's proposed target for Initial Proposals, then reduced its target for Final Proposals due to supposed changes in interpretation of the survey question; without independent research, this process

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258 AlixPartners, Comments on the CAA's Final Proposals, section 12
259 AlixPartners, Comments on the CAA's Final Proposals, section 12
260 AlixPartners, Comments on the CAA's Final Proposals, section 12
261 Eurocontrol, Airport collaborative decision-making
262 AlixPartners, Comments on the CAA's Final Proposals, section 12
263 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.81

in particular appears to have largely adopted the position of the regulated company in error, resulting in a target that "is at the lower end of the range that Arcadis advised us that it considers to be achievable"[264], and must be corrected as a priority

3.55. The presence of this error is reinforced by the statement that "the remaining targets for reputational incentives…are generally based on HAL's proposals"[265]; it is concerning that the only area where the CAA has pushed back on Heathrow's proposed target has instead resulted in that measure being downgraded to a reputational rather than a financial incentive, where the CAA "proposed a target of 98 per cent of bags being delivered not less than 30 minutes before the scheduled departure"[266], a target that we have shown should be at a 99% level

3.56. AlixPartners further observes that these decisions demonstrate "that the CAA placed a lot more weight on the airport suggestions than the independent analysis it commissioned. The CAA needs to justify why Arcadis' suggested lower bound is a more appropriate target than its mid-point"[267]

3.57. We note that differences exist between terminal performance, and recognise that there are "cases where a higher target could be considered for particular terminals"[268]; given the performance is as a result of investment in infrastructure assets embodied in the RAB that does differ across the Heathrow campus, the CAA should aim to ensure that Heathrow is incentivised appropriately to deliver a consistent level of service that is appropriate to the airport charge in force

Incentives

3.58. We support the CAA's continued "reservations about the specific way that HAL had used consumer research findings to generate a proposed set of rebates"[269], preventing perverse outcomes such as a "higher weighting for wayfinding and lower weightings for passenger security queues"[270]; in the circumstances, we therefore support the CAA's approach 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"[271]

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264 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.82
265 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.83
266 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.83
267 AlixPartners, Comments on the CAA's Final Proposals, section 12
268 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.84
269 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.61
270 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.61
271 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.62

3.59. Specifically, we support the CAA's proposal not to implement "HAL's proposed rebalancing of rebates for 5 minute and 10-minute security queues, which appears to be a late change based on limited evidence"[272]; we agree with the CAA that we have not discussed such a change with Heathrow, and this should not be included in Final Proposals as a result

3.60. We also agree with the CAA that Heathrow "does not make a strong case for increased bonuses"[273], and agree that "once performance has reached a certain level then the incremental benefits from further improvements may be small"[274]; in particular, Heathrow's approach does not appear to focus upon the fundamental rationale for bonuses, which should be to focus upon incentivising the improvement of particularly problematic areas

3.61. Finally, we agree with the CAA that the "current knife edge system of rebates is more suitable for H7 than HAL's proposed sliding scale incentives"[275]; this is particularly the case where in implementation, Heathrow's proposals would undermine the strong incentive effect of achieving a certain level of performance, and allow moderate underperformance to be weakly penalised

3.62. We support the CAA's reduction of rebates payable over Wi-Fi performance, though are concerned that the attitude and helpfulness of security staff is the sole point of contact that Heathrow's staff have on a regular basis with all passengers; whilst we continue to have significant concern over the manner in which surveying is conducted, it is concerning that the CAA might reduce Heathrow's incentives to focus on this specific area

3.63. As noted above, we agree with the separation of rebates for stand facilities with weighting based upon their operational importance and ultimately consumer value; and support the application of bonuses to the problem area of security queues for transfer passengers, agreeing that "it is a measure that is important to consumers and where improved performance may directly benefit them"[276]

3.64. To be clear, it is our view that bonuses must be focussed upon particularly problematic areas and designed in a way that solves the problem identified; This view is shared by Alix Partners who state in their report that "the CAA should aim to design its targets and bonuses to incentive performance improvement from HAL" we therefore believe it is an error to continue to apply bonuses to general

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272 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.64
273 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.65
274 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.65
275 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.66
276 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.87

cleanliness and wayfinding, particularly when measured by such inaccurate means as the survey, and when there is abundant evidence that the measure has delivered windfall gains to Heathrow during Q6 as a result of no particular investment in operating expenditure to do so, and where the CAA's own advisors have identified that "HAL was already meeting the bonus threshold in several terminals in 2021, based on Arcadis' analysis"[277][278]

3.65. Furthermore, we question the logic for applying bonuses to security queues where the target itself is suppressed compared to that in Q6; we agree that security queuing has been a significant issue recently and as a result application of bonuses in this area is appropriate to drive greater operational performance, but this should be on the basis of the performance levels achieved prior to the pandemic, otherwise the incentive risks paying Heathrow windfall bonuses to deliver proven levels of performance, undermining the incentive as a result

3.66. AlixPartners comment that such "bonus targets seem easily reachable based on HAL's previous performance and do not incentive any performance improvement"[279]; the CAA must therefore correct for these significant errors, which risk reduce consumer service quality during H7, and where is particularly important to avoid the perception that the CAA has made it easier for bonuses to be earned at the direct cost of service quality outcomes for consumers

Continuous improvement

3.67. We note that airlines have greater operational expertise than the CAA, and specific information from their own organisations as to the true nature of any operationally disruptive event; we therefore disagree with the CAA's "proposal that would allow us to make binding decisions on disputes about exclusions to the OBR regime during major operational disruption events"[280], and believe the existing approach is effective at present

3.68. Nevertheless, we welcome the statement that the CAA "expect to see evidence that all parties have made a genuine attempt to resolve the disagreement on a bilateral basis, including if necessary with senior Executive involvement, before referring the matter to us"[281] and are reassured that if the CAA "decline to consider a case, then the airlines will still have the final say"[282]

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277 AlixPartners, Comments on the CAA's Final Proposals, section 12
278 CAA CAP2366C OBR Phase 2 Targets Assessment, Arcadis, June 2022, p22
279 AlixPartners, Comments on the CAA's Final Proposals, section 12
280 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.89
281 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.89
282 CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.69

3.69. In addition, we agree with the CAA that there should not be scope for "an alternative force majeure mechanism or to refer disputes to a third party"[283], and welcome the CAA's assessment on Heathrow's additional exclusions being "too broad in scope, disproportionate or are already adequately covered by existing exclusions."[284]

3.70. Whilst we would have preferred the CAA to have finalised its OBR framework during this H7 periodic review, we welcome the ex-ante notice that the CAA expects to "carry out a mid-term review of the OBR framework"[285]; however, whilst the list of potential issues for consideration is long, the CAA would be in error to limit its ability to adjust any area of the OBR framework should evidence emerge that it is not functioning as intended

3.71. As noted by AlixPartners, "mid-term review is an important feature of a regulatory regime where there is a degree of uncertainty"[286], and that "a mid-term review of OBR targets is necessary given the uncertainty around appropriate targets"[287]; this is particularly relevant where there have been "material changes in measures, partly as a result of the transition from the old SQRB to OBR"[288]

3.72. In particular, we fundamentally disagree with the CAA's suggestion "if a target appears potentially too low we would not generally expect to make any adjustment until the next price control review"[289]; this appears to be particularly asymmetric in nature given the downward adjustment to targets at this periodic review from the previous price control, and the clear evidence that Heathrow has presented targets skewed in favour of its arguments, which the CAA has largely adopted

3.73. As a result, it is imperative that the CAA correct this important error if targets have been set too low, where AlixPartners view that "allowing a mid-year review would provide the sufficient timescale for Arcadis, or another adviser, to conduct that research"[290]; in addition, performing "a mid-term review would allow the CAA to gather sufficient reliable data to do this for all measures"[291]

[283] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.70
[284] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.70
[285] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[286] AlixPartners, Comments on the CAA's Final Proposals, section 12
[287] AlixPartners, Comments on the CAA's Final Proposals, section 12
[288] AlixPartners, Comments on the CAA's Final Proposals, section 12
[289] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[290] AlixPartners, Comments on the CAA's Final Proposals, section 12
[291] AlixPartners, Comments on the CAA's Final Proposals, section 12

3.74. Therefore, the CAA would be in error to restrict itself to only consider "in a strictly limited number of cases…a possible increase in targets"[292] and must consider all targets as a result; this is a critically important error that must be corrected, particularly for the security queuing measures, targets and incentives that will be inevitably require adjustment following the security transformation programme

3.75. We support the CAA's consideration at that mid-term review of matters such as target granularity, control post groupings and security queue harmonisation, along with adjustments that "are specifically required as a result of new investment projects that have been agreed between HAL and airlines"[293]; we believe that such adjustments must be a mandatory part of the delivery of any investment project as part of the Gateway governance process, included as part of the CAA's new capital efficiency incentives

3.76. This is particularly important in the security transformation programme, where the expected operational efficiencies would result in the OBR incentive becoming significantly weaker following the introduction of the regulated security programme; given the CAA's recognition that this programme might "include any proposals to rebalance the rebates for different security queue times"[294], we highlight the conflict with the CAA's earlier statement that "if a target appears potentially too low we would not generally expect to make any adjustment until the next price control review"[295]

3.77. We recognise that Heathrow and airlines may agree to adjust aspects of the OBR framework, though caution the CAA that this is incredibly unlikely given Heathrow's monopoly power and the CAA's regulatory incentives on Heathrow to achieve savings compared to its price control settlement; hence we support the CAA's adjustment to its licence modification process~~,~~[296]

4. Operating expenditure

4.1. As set out in Chapter Three of this response, we agree with the CAA that "setting robust estimates for opex and commercial revenues protects consumers' interests by incentivising efficiency, while allowing HAL sufficient revenue to operate to an appropriate standard"[297]; however, we are concerned that since Initial Proposals,

[292] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[293] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[294] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[295] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.90
[296] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.92
[297] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 54

the CAA has "increased our estimates of opex to allow for higher staff numbers"[298], which to be acceptable must be fully justified based upon both passenger volumes and service quality requirement

4.2. The CAA's approach to operating expenditure, described as combining "detailed bottom-up expert scrutiny of each opex category, based on the range of evidence available, with top-down review of the estimates derived from our bottom-up analysis"[299] is not an explanation that is consistent with the assessment of AlixPartners, who notes that "the starting point of CTA's original assessment of HAL's opex was based on a very high-level assessment of HAL's top-down financial model, without detailed bottom-up analysis of the actual costs that would be incurred"[300]

4.3. In addition, airlines have not been offered any opportunity to scrutinise new evidence that has been presented by Heathrow in its RBP Update 2, and remain concerned that it has continued to overstate its potential cost base. As Alix Partners state in their report "There is no robust evidence that the CAA has set allowance at the efficient level of HAL's opex". If opex allowances are not set at the efficient level, then HAL will earn windfall profits and/or have reduced incentives to its minimise costs.

4.4. We expand on this below.

Overall approach

4.5. CTA's overall approach appears on the face of it to be sensible by using a base-step-trend method, and we agree with the choice of "2019 as the base year for its analysis"[301]; we further agree that many adjustments are required where "out-turn costs in 2019 were not representative of the underlying costs that were expected to be incurred in future years"[302], particularly in the case of expansion-related costs

4.6. Whilst we agree that it was necessary for CTA to develop "detailed modelling for operational and non-operational staff costs to replace HAL's proposed top-down elasticity assumptions applied across all categories of people costs"[303], which we agree was not supported by evidence, it is our view that this is required across all cost categories due to the lack of information provided by Heathrow on its cost

298 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 56
299 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.5
300 AlixPartners, Comments on the CAA's Final Proposals, section 5
301 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.11
302 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.11
303 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.12

base; in addition, we support the application of a greater frontier shift than proposed by Heathrow to reflect productivity gains

4.7. We welcome the CAA's approach where "the results of our work have been sense checked against historical trends in overall opex in absolute terms and on a "per passenger" basis"[304]; however, we observe that where the CAA state that "CTA's estimate of opex per passenger in 2025 is broadly in line with out-turn opex in 2019 (in real terms)"[305], being when passenger volumes reach pre-pandemic levels in the CAA's passenger modelling, this in fact suggests that no efficiencies have been achieved in real terms in Heathrow's cost base

4.8. More importantly, as noted by AlixPartners, "HAL appears to have provided limited detail or justification for its costs, and thus CTA's original opex assessment is likely to both lack precision and overstate efficient costs. We consider that the CAA should have at least considered data on per-passenger opex at comparable UK or global airports, as a way of testing the rigour and reliability of HAL's data"[306]

4.9. As a result, we are disappointed with the CAA's explanation that "we consider that the opportunities that HAL has had or will have to make cost savings compared to 2019 are broadly offset by the impact of the economic challenges (or "headwinds") that the airport will likely have to deal with over the H7 period"[307]

4.10. This approach is deeply concerning, and AlixPartners judge this to have resulted in "on selective information provided by HAL to justify certain cost increases, which it has then asked CTA to apply to produce a revised estimate. HAL's incentives will be to disregard lines of costs or cost items where cost allowances were particularly generous and focus instead on providing focused justifications on a bottom-up basis for various increases"[308]

4.11. We reiterate that information provided by Heathrow has not been subject to any scrutiny by airlines, and as a result, the basis of CTA and the CAA's Final Proposals have not been thoroughly tested; we recognise that being forecasts, CTA has had to make a "relatively large number of assumptions on the detail of HAL's cost base to complete its analysis"[309], though it is important that the detail of these assumptions is based upon sound reasoning and judgement of Heathrow's business, and where airlines have significant expertise in airport operations that allows us to judge the appropriateness of Heathrow's cost base, should be consulted on the detail provided by Heathrow

[304] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.41

[305] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.59

[306] AlixPartners, Comments on the CAA's Final Proposals, section 5

[307] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.60

[308] AlixPartners, Comments on the CAA's Final Proposals, section 5

[309] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.63

4.12. As a result, the CAA appears to have made a manifest error by not starting its analysis based upon concrete information about Heathrow's cost base; AlixPartners observe that "assessment of HAL's opex was based on a very high-level assessment of HAL's top-down financial model, without detailed bottom-up analysis of the actual costs that would be incurred, their justification and business as usual cost reduction programmes"[310]

4.13. Where both the information provided on Heathrow's cost base and the detail of the calculations provided has not been disclosed, we endorse AlixPartners' view that "HAL is being rewarded for providing poor quality information at the outset, and in an environment where it reaps 100% of the benefits from any cost reductions below forecast"[311]

4.14. It is therefore incumbent on the CAA to correct its errors by performing detailed, bottom-up analysis of Heathrow's cost base, a view shared by AlixPartners who suggest that "there would appear to be strong merit in the CAA revisiting all of HAL's opex forecasts, as well as disclosing to the airlines the precise basis of these estimates so that they can be challenged"[312]

4.15. We are concerned that where the CAA's use of "inflation indices that differ from CPI (such as the index for energy costs) to specific categories of opex"[313], there must be based upon robust forecasts of those price indices; given the CAA's existing position that CPI forecasts themselves been difficult to source in the absence of significant gilt issuance, we are concerned that more bespoke forecasts may be excessively inflated in error due to current market conditions.

People costs

4.16. We note that following provision of additional information from Heathrow, CTA has performed "bottom-up modelling of a bespoke queuing model which used this additional information and also reflected inefficiencies inherent in the rostering process"[314]; this has resulted in a highly material change "increasing estimated opex by £331m"[315], an extraordinary sum that appears to depend entirely upon "information provided by HAL on the sequencing of its security transformation programme and the likely timing of costs and benefits of the programme"[316]

[310] AlixPartners, Comments on the CAA's Final Proposals, section 5
[311] AlixPartners, Comments on the CAA's Final Proposals, section 5
[312] AlixPartners, Comments on the CAA's Final Proposals, section 5
[313] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.78
[314] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.49
[315] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.61
[316] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.61

4.17. Based upon our observations as to the maturity of the security transformation programme, its conservative assumptions over delivery, and the significant excess of staff numbers compared to requirements set out by manufacturers of new equipment that we set out in our response to Initial Proposals, we remain concerned that figures presented by Heathrow are potentially greater than necessary to provide an efficient allowance for people costs

4.18. In addition, nowhere does the CAA appear to consider a mechanism to deal with the fact that all Heathrow's employee contracts that are inflated by 7.5% due to the employment of all staff through a Shared Services Agreement with LHR Airports Ltd[317], a fact we have highlighted repeatedly throughout this process, and which by failing to consider has raised estimates of operating expenditure in error by not being taken into account; this clear error must be corrected through a near 7% or £373m (2018p) downward correction in people costs to reflect the benefit taken by Heathrow at this entity, which sits outside of the Heathrow (SP) Ltd group of companies

Utility costs

4.19. We note that CTA has "increased its estimate to allow for updated higher forecasts by HAL of energy cost inflation"[318], yet it is our understanding from involvement in Heathrow's ORC charges that many energy costs are in a hedged relationship which somewhat insulates Heathrow and users from changes in energy prices; we understand that these apply to both energy used by Heathrow and that charges through Other Regulated Charges ("ORCs"). To the extent the CAA has not investigated this hedging arrangement, it must do so. Failure to consider this information would be irrational. Further, if it is as we understand then there would appear to be little evidence to support a significant rise in opex on account of energy cost inflation

4.20. Furthermore, we are concerned that the rises incorporated somewhat reward Heathrow for market price uncertainty whilst failing to return energy price declines to consumers when they fall again, as is usual in cyclical commodity markets; we therefore suggest the CAA might consider how consumers could benefit from eventual energy price falls and avoid creating windfall gains for Heathrow when such declines occur

Other operating costs

4.21. We understood from the CAA's analysis that "while insurance premiums have increased markedly since mid-2019, the current trend appears to be downwards"[319],

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317 LHR Airports Ltd, Annual Report and Financial Statements for the year ended 31 December 2020, Accounting Policies, p25

318 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.61

319 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.52

therefore we cannot reconcile the CAA's first statement with CTA's analysis that it "has increased its estimate primarily as a result of further analysis of insurance costs, which have been updated using forecasts derived from Swiss Re. This change increases estimated opex by £43m"[320]; the CAA must correct this apparent error and reflect the current downward trend in premiums

Additional provisions

4.22. We note that "CTA estimated the ongoing impacts of the pandemic on both cleaning and covid-19 enforcement costs using a specific adjustment to represent the increased opex"[321]; however, with the removal of all the UK Government's restrictions related to the pandemic, we are unclear how this continued allowance can be justified due to the lack of any requirement for such additional activity

4.23. Whilst "CTA has reduced the activities undertaken as covid-19 precautions and terminated additional costs at the end of 2022"[322], we note the UK Government's restrictions ended at the start of 2022; as a result, allowing additional operating expenditure for any longer would not be appropriate and it would be an error not to remove them from the opex calculations

Business rates

4.24. We are concerned with the CAA's approach to business rates, which appears to suggest an asymmetric application of out-turn business rates in favour of Heathrow; whilst we agree with the CAA that "we expect that the negotiations between HAL and the VOA for the next business rates cycle will have concluded before we come to make the final decisions on the H7 process"[323], it does not appear proportionate to disapply the incentive mechanism that has underpinned the negotiations to date

4.25. Furthermore, the CAA's suggested approach that seeks to "conduct a fuller review to determine whether HAL has acted reasonably in seeking to minimise the level of business rates payable"[324] suggests that an expected increase in business rates will be passed onto consumers in full, raising the value incorporated in Final Proposals from that of £119m per year (2020p), leaving consumers exposed to the risk resulting from Heathrow's conduct in the current revaluation process

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[320] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.61
[321] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.62
[322] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.79
[323] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.67
[324] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.68

4.26. This would be in error, since it would in effect disapply an incentive that has yet to fully play out through the current round of negotiation, creating a disincentive for Heathrow to finalise its negotiations in the best interests of consumers; this is particularly concerning where early read-out of the negotiations suggests the VOA might take a particularly hard line against Heathrow, raising rates substantially as a result of a change in the basis of calculation, and the CAA must act to reapply this incentive for this current revaluation cycle

Pension deficit repair costs

4.27. We are disappointed that Heathrow had not previously disclosed the strong position of its pension scheme to the CAA, where its accounts disclose that "at 31 December 2021, the BAA Pension Scheme is in a net surplus position of £343 million, comprising of scheme assets measured at fair value of £4,886 million and scheme liabilities of £4,543 million. Based on legal advice obtained, the Directors have deemed it appropriate to recognise the surplus in full on the basis that there is an unconditional right to refund and therefore no requirement to restrict the surplus as measured under IAS 19"[325]

4.28. Given that "at 31 December 2021, the largest single category of investment was a liability driven investment ('LDI') mandate"[326], which are "portfolios of bonds, repurchase agreements, interest rate and inflation derivatives which are intended to protect the Scheme from movements in interest rates and inflation, so that the fair value of this element of the portfolio moves in the same way as the fair value of Scheme's obligations", we see no reason for any continued pension deficit repair costs once the valuation has concluded

4.29. In particular, we note that "the September 2018 funding valuation identified a shortfall of £123 million, and LHR Airports have agreed deficit repair contributions of £20 million per annum (previously £23 million) to eliminate the September 2018 funding valuation deficit by 2022"[327], and we expect such payments to therefore cease alongside the conclusion of the actuarial valuation, which the CAA must reflect as a result of this new information to avoid material error

4.30. We also note that "The Directors have concluded that the group has an unconditional right to a refund under IFRIC 14 and therefore there is no requirement to restrict any IAS 19 surplus, and hence also appropriate not to recognise any additional liabilities in respect of minimum funding requirements"[328]; we therefore expect the CAA to take account of any monies refunded from the pension scheme to benefit consumers

4.31. The CAA must therefore apply a RAB deduction of £343m to reflect this benefit, representing the windfall gain to Heathrow resulting from current circumstances;

325 Heathrow (SP) Ltd, Annual Report and Accounts, 2021, p.156
326 Heathrow (SP) Ltd, Annual Report and Accounts, 2021, p.200
327 Heathrow (SP) Ltd, Annual Report and Accounts, 2021, p.202
328 Heathrow (SP) Ltd, Annual Report and Accounts, 2021, p.126

this is in line with Heathrow's directors' view of the ownership of this surplus, and would allow consumers to benefit from their past funding of pension deficit repair costs

Passengers with Reduced Mobility

4.32. We agree with the CAA that "HAL's proposed costs for PRS, which HAL considers to be 39% of passengers, appear to be conflated with the narrower category of disabled and less mobile passengers who use the Special Assistance service"[329], and support its assessment that has "accepted CTA's "base case" estimates for PRS costs, as we consider that HAL has not justified the need for additional opex for this wider group of passengers"[330]

4.33. We see no case for expanding the range of services provided by Heathrow, when Heathrow's delivery of the current PRM service is subject to significant scrutiny as a result of operational delivery failures; since these are well-known to the CAA in its role where "HAL's service to PRMs is also monitored under CAA's accessibility framework."[331], which we do not repeat here as a result

CAA licence fees

4.34. We note the CAA's commitment to "consult on a rebalancing of CAA licence fees across regulated airports and our expectation that this is likely to increase the fees paid by HAL"[332]; we are concerned that having already made the decision that Heathrow's regulatory fees are likely to increase, that this does not appear to be a particularly robust consultation process

4.35. Since we have no visibility of the CAA's licence fee charges and the makeup of its costs in this area, we are concerned that an "additional allowance is £0.75m (in nominal terms) for the years 2023 onwards"[333] somewhat pre-judges the outcome of the consultation and leaves consumers worse off were that increase not in fact to be the outcome of the consultation

5. Commercial revenues

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[329] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.74
[330] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.74
[331] CAA CAP2365B, "Economic Regulation of Heathrow Airport: H7 Final Proposals Section 1: Regulatory Framework", para 3.78
[332] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.75
[333] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 4.75

5.1. To supplement section 5 of Chapter Three of our response we set out below our detailed comments on the CAA's approach to management stretch and modelling overlays. We also set out in this Annex One our specific comments on those matters that make up commercial revenues such as surface access, cargo, property and terminal drop-off charges

Management stretch

5.2. We agree with the CAA that "it is appropriate in the interests of consumers to set challenging but achievable targets for HAL, including a component relating to annual, year-on-year improvement in performance"[334]; however, the present, greater difference between CPI and RPI[335] might suggest a higher management stretch target is in fact required "in order to capture HAL's own assessment of the potential for revenues per passenger to grow faster than general inflation"[336]

5.3. We further agree that "historical experience provides important insights into the underlying rate of increase in commercial"[337], therefore fail to understand why the CAA has chosen a 1% target, where "evidence collated by CTA indicates that a 1% figure is towards the low end of what HAL has achieved in the past"[338]; as a result, we disagree with the reduction of the "2% management stretch per annum in real terms to an assumption of 1%". Alix Partners in their report state recognise that the "CAA should consider a management stretch target between 1.5% and 2%, instead of the minimum 1% assumption. It would be prudent and in the interest of consumers to choose a higher, yet still achievable target."

5.4. AlixPartners notes that "1% is the minimum target required "to capture HAL's own assessment of the potential for revenues per passenger to grow faster than general inflation"[339], where "by moving the upper bound of its management stretch estimate down from 3% to 2%, the CTA clearly confirmed that the use of a 2% management stretch target was reasonable despite HAL's criticism"[340]; in addition, "we consider that the additional evidence provides no reason to move away from CTA's IP of a 2% management stretch, especially considering that CTA already excluded "non-controllable" revenues"[341]

5.5. The CAA must correct this error by following its advisors' estimate of appropriate management stretch and raising this back to 2%, applied across all relevant

334 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.32
335 Bank of England, Monetary Policy Report, May 2022
336 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.32
337 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.34
338 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.35
339 AlixPartners, Comments on the CAA's Final Proposals, section 6
340 AlixPartners, Comments on the CAA's Final Proposals, section 6
341 AlixPartners, Comments on the CAA's Final Proposals, section 6

categories of commercial revenue; in addition, by not applying this stretch to property revenues, Heathrow is at risk of being systematically under-incentivised to develop these revenue streams to the detriment of consumers

Modelling overlays

5.6. We support the CAA's view that "using a top-down overlay remains the most appropriate method for transparently reflecting the range of tax changes"[342], and agree that "HAL's bottom-up modelling of the effects of the tax changes is less practicable given the lack of available detail"[343]; nevertheless, we are concerned by the assertion that "introduction of VAT on some products will require HAL to accept lower margins from affected retailers"[344] and believe that this continues to overstate the actual effect

5.7. As explained by AlixPartners, "this assumption would suggest that retailers will have no or limited response to unfavourable tax and duty changes. However, we would expect retailers to adopt mitigating strategies to offset these charges and preserve profits, including that their suppliers would reduce their wholesale prices to some degree to maintain their airport sales"[345]; as a result, the CAA must correct this error by altering its approach to tax and duty changes to reflect likely mitigating strategies that retailers might take

5.8. We also understood that the CTA modelling work accounted for distribution of passengers by market, therefore we are unclear why there is now a further need for "an overlay to deal with adjustments to the 2019 retail sales per passenger for the new distribution of passengers across the eight geographic markets"[346]; given the basis of bottom-up forecasting has previously been based upon market analysis of passengers, this should already be the basis of commercial revenue calculations, driven by elements of the passenger forecasting model, and the CAA must correct its approach to ensure consistency

Surface access

5.9. We note the CAA's assertion that "there is broad agreement that the pandemic has led to passengers moving away from public transport towards private transport modes"[347], though we are concerned that by adopting "HAL's approach for mode

[342] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.39
[343] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.39
[344] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.55
[345] AlixPartners, Comments on the CAA's Final Proposals, section 6
[346] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.41
[347] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.44

share analysis”[348], this is on the basis of yet another model that has not been released to airlines or been subject to independent scrutiny; this add to concerns raised by AlixPartners in relation to the process as a whole, and must be addressed by the CAA before concluding this periodic review

5.10. We are concerned by the reduction of revenues from Heathrow Express, where in the first round of CE in March 2020, Heathrow stated “it is the intention of Heathrow Express to use its marketing and pricing levers to mitigate the impact of Crossrail as far as possible”[349]; subsequent Heathrow’s statements regarding the revenue impact in its RBP Update 2 suggest instead that “to maximise revenues, HEx should maintain a price premium to Crossrail – the incremental volumes from price matching do not compensate for the reduced revenue per passenger”[350]

5.11. As a result, Heathrow’s proposed overlay based upon flat fares is incompatible with its previous statements that it would use pricing levers, and in addition is counterintuitive since yield management depends upon managing price to stimulate additional volumes; the CAA is therefore in error to use this flat fares overlay in addition to the Crossrail impact overlay, despite profiling it in a different manner than proposed by Heathrow, and it is imperative to correct for this

5.12. In addition, the CAA has adopted Heathrow’s approach to the positive manual parking overlay “to represent the estimated growth of Average Transaction Values”[351], yet Heathrow’s modelling has been based upon the assumption “that as passenger numbers increase this overlay would return back towards zero”[352]; this does not seem consistent with changes in mode share referenced above, and if there is any inconsistency within mode share modelling (which has not been released to us), the CAA must correct for this error as a priority

Cargo

5.13. We agree with the CAA that freighter flights using passenger aircraft “have been increasingly used for regular passenger flights during the period when passenger volumes have begun to recover”[353]; given the errors identified in Heathrow’s analysis, we agree with the CAA that it should use a “bottom-up approach to forecast cargo revenues, linking the number of freighter and preighter movements to the recovery in passenger volumes”[354]

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348 CAA CAP2365C, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues”, para 5.45
349 Constructive Engagement, Commercial Revenues, 9th March 2020
350 Heathrow Revised Business Plan Update 2, para 5.13.6
351 CAA CAP2365C, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues”, para 5.45
352 Heathrow Revised Business Plan Update 2, para 5.14.6
353 CAA CAP2365C, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues”, para 5.48
354 CAA CAP2365C, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues”, para 5.50

5.14. We agree with the CAA that cargo is a category of aeronautical revenues[355], yet is considered within the commercial revenue category; in line with our previous comments in this area, we consider that it is an error to retain cargo as a commercial revenue within the price control model where slots can and have been used for cargo flying and substituted for passenger flying, which could distort the incentives within the single till and result in consumers paying more than required

5.15. As a result, the CAA must correct for this by considering how to incorporate cargo revenue properly into the airport charge to reflect the substitution of slots; Heathrow themselves have noted "flying cargo in and out of Heathrow shares much of the same infrastructure as passenger movements. It is our intention to recognise this by introducing a weight-based charge for departing cargo into the aeronautical charging structure"[356]

Property

5.16. The CAA states that "property revenues during H7 will largely be determined by the decision on property "Guide Prices", being the prices levied on HAL's tenants for rental or lease payments that are published annually and subject to consultation with those tenants"[357]; however, it is our understanding that Guide Prices only apply to terminal accommodation for which Heathrow is the sole, monopoly provider, and within which the escalation formula introduced **by the CAA itself** has anyway vastly outperformed the wider commercial property market

5.17. We are therefore concerned that in adopting Heathrow's revised approach, which we assume is that stated in its RBP Update 2, of suggesting that "Heathrow has made an agreement with its tenants to hold rents at 2019 levels until aviation demand recovers"[358], that this significantly under-forecasts revenues; the CAA must correct for this error as a priority to ensure revenues not unduly depressed

Terminal drop-off charge

5.18. We are particularly concerned over modelling errors identified in the Terminal Dropoff Charge ("TDOC"), where the values that were the basis of airline approval of the project in capital governance approvals have been undermined by the identification of a material error; such errors risk undermining the entire capital governance process, and since we have not been able to scrutinise this subsequent calculation, this appears to be another example of an asymmetric adjustment in Heathrow's favour upon presentation of additional information that has not been scrutinised by airlines

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355 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", note to para 5.1

356 Heathrow Airport Charges for 2022 consultation, para 4.37

357 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.37

358 Heathrow Revised Business Plan Update 2, para 5.18.1

5.19. In addition, it is not clear to us that the removal of pick-up passengers from the forecasts have now been included within car park revenue forecasts; as noted by AlixPartners, "while passenger pick-ups, according to HAL, are not liable for drop-off charges, they should still be included in the commercial revenues allowance for HAL in the form of car parking revenues"[359]

5.20. Given general uncertainties associated with the new revenue stream, we support the CAA's application of risk sharing 65/35%, which "represents a reasonable compromise between controlling for these risks and uncertainties"[360]; whilst, we recognise the additional uncertainty that may result from legislative changes, it is our view that an intent to "review the actual level of TDOC revenues around the second half of 2024"[361] might be highly asymmetric in favour of Heathrow given the risk sharing protections above and in error as a result

5.21. Furthermore, it is not clear why the risk sharing referred to above might also end in 2024, when it is forecasting for the whole of the price control period that is uncertain as a result of it being a new charges; as a result, it is our view that the proposal to "retain the 65:35 risk sharing as set out in Initial Proposals for 2022 to 2024"[362] is flawed as this should apply up until 2026, being discontinued only in the event of an adverse legislative change

6. Capital expenditure

6.1. To supplement our response at section 6 of Chapter Three, we set out below are further comments on the proposed size of the capital envelope in the Final Proposals and the importance of Heathrow working with the airline community to (re)prioritise investments.

Proposed size of the capital envelope is not supported by evidence

6.2. We agree with CAA that capital expenditure allowances incorporated into the price control must only represent efficient investment in projects that are required by consumers and airlines. However, we remain concerned that the size of the capital envelope (and the capital projects included in such capital envelope) as decided by CAA in Final Proposals do not meet this reasonable and clear test.

6.3. Further, we believe that CAA's Final Proposals are in error as its decision to increase the size of the capital envelope from £2.4B in its Initial Proposals to £3.6B – and increase of 50% - is based on a fundamental lack of meaningful and credible

359 AlixPartners, Comments on the CAA's Final Proposals, section 6
360 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.74
361 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.77
362 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 5.78

supporting evidence from Heathrow. It is concerning that CAA would permit such an increase in the capital envelope given its own observation that “both the quality and depth of evidence supplied by [Heathrow] in its update RBP on capex estimates [is] generally poor for that stage in the price control process”.

6.4. We have previously provided clear evidence that demonstrates that, based on past delivery performance, Heathrow would be operationally incapable of delivering a capital investment program of this size. The impact of incorporating an overinflated capital program into the price control will be consumers paying overly inflated passenger charges for the period.

6.5. CAA’s decision to permit a £1.2B increase in the size of the capital envelope, despite (1) its own observations and concerns on the quality of evidence supplied by Heathrow; and (2) our conclusion that Heathrow will not be able to deliver a program of such size is therefore extremely surprising.

6.6. We recognise that, from time to time, new capital investments may be identified during the price control period. Should this be the case, we support CAA’s conclusion in its Final Proposals, that such new investments “will need to be strongly supported by evidence and in the interests of consumers”. Given CAA’s strong and right conclusion on this point, we are surprised therefore that CAA would permit an increase in the existing capital envelope without credible support or evidence from Heathrow and therefore conclude CAA’s Final Proposals are in error by irrationally including a large volume of proposed investment not supported by credible evidence.

6.7. The decision leads us to conclude that CAA’s rationale for making such a decision in its Final Proposals is to continue to artificially inflate the size of the RAB to improve the financial stability of Heathrow for the price control period and/or overly inflate passenger charges for the price control period to support Heathrow’s financeability. It is not acceptable that Heathrow be permitted to include an allowance for capital investment that is poorly scoped, and doing so, would be in contradiction to CAA’s duties in CAA12. An over-inflated capital envelope should not be considered an “easy give” to Heathrow by CAA.

<u>Heathrow must work with the airline community to (re)prioritise investments</u>

6.8. We encourage CAA to require Heathrow to meaningfully engage with the airline community during the entire life cycle of capital investments made on behalf of the consumer. We believe we play a unique role in regulated industries whereby we, as the airline community, can directly represent the needs of our customers with the regulated entity and to ensure efficient investment of scarce resources.

6.9. Heathrow has, in the past, not acted like a commercial business when making capital investment decisions. In fact, rather than encouraging efficiency, the regulated framework encourages inefficient and suboptimal decisions that increase the overall size of the investment rather than seeking to deliver the most efficient solution for the consumer.

6.10. Further, as new capital investments are identified, Heathrow is encouraged to simply increase the size of its capital envelope rather than seek appropriate trade-offs or compare return on investment between projects within the existing capital envelope.

6.11. A bigger capital envelope cannot be the default answer for capital decisions, and we strongly encourage CAA to require Heathrow to work with the airline community to reassess and reprioritise the projects within its capital plan rather than simply proposing new investment.

6.12. The CAA has further failed to address our repeated questions over the level of leadership and logistics expenditure assumed for the H7 price control; it would be incorrect to continue to assume that this is a fixed 17.5% of any project by value where there is a significantly less complex capital programme, and the CAA must correct this error in its proposals as a priority

6.13. We note that Arcadis studied the appropriateness of some fixed percentage elements in Heathrow's capital expenditure, but not only is the page referenced by the CAA in the Arcadis report redacted, but the appendices referred to have not been provided to us; we therefore remains on the conclusion that a fixed 17.5% charge for leadership and logistics is inflated in error

7. Capital incentives

7.1. As set out in section 7 of Chapter Three of our response, we agree with the CAA that "stronger incentives are needed to protect the interests of consumers from the increased costs that they would otherwise face were HAL to make inefficient capex investments"[363]; given the difficulties faced by the CAA in conducting ex post reviews of capital efficiency, the extreme nature of cost over-runs on particular projects, and the gold-plating of capital projects as evidenced by the persistently elevated nature of the RAB and airport charges, these measures are long overdue

7.2. AlixPartners supports this approach, noting that "it is difficult for the CAA to judge the efficiency of a capex project after the event. Where this is the case, ex post assessments provide no financial incentive for HAL to be more efficient, with the consequent possibility that airlines, and so consumers, will overpay for capex projects that could have delivered more efficiently"[364]

7.3. In particular, the introduction of these incentives will ensure that delivery is focussed upon outcomes agreed upon with airlines during assessment of capital projects, and furthermore that this applies to all new capital projects; unfortunately

[363] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 91
[364] AlixPartners, Comments on the CAA's Final Proposals, section 7

however, the incentive rate of 25%, is far below comparable regulatory incentives in other sectors nearer 50%, which will not therefore have the intended effect

7.4. To support the comments we make in section 7 of Chapter Three, we set out below our detailed comments on the capital incentives regime presented in the Final Proposals generally, as well as our specific comments on the capex categories and delivery obligations, the incentive rate and symmetry, the uncertainty mechanism and governance matters.

General comments

7.5. We agree with the CAA that the previous ex post framework has significant limitations, including "a high bar being set for costs to be excluded on the basis of inefficiency, even where out-turn costs are much higher than the expected budget"[365]; in addition, we agree that this approach "does not offer any incentive to find efficiencies in the delivery of a project to outperform budget expectations"[366], where value engineering can deliver significant savings for consumers

7.6. AlixPartners agrees further, noting that "there is substantial information asymmetry between HAL and the CAA, such that it is difficult for the CAA to determine that capex was inefficient after the event, and ex post assessments create regulatory risk"[367]; this can be solved by exposing Heathrow "to downside risk – in a fully competitive market inefficient companies make lower profits, and this creates incentives to be efficient"[368]

7.7. As a result, we continue our support capital efficiency incentives, which we believe will ensure more efficient outcomes, which "together with delivery obligations should ensure that HAL is focussed on achieving cost efficiency while still delivering the infrastructure to the time and quality expected"[369]

Capex categories

7.8. We are satisfied that the set of capital expenditure categories proposed and based upon Heathrow's business plan, cover the full range of expenditure proposed during H7; we disagree with Heathrow's "view that ex ante incentives should only apply to the proportion of its portfolio where risk was relatively low or where projects were generally 'repeatable' and benchmarkable"[370], and welcome the

[365] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.16
[366] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.16
[367] AlixPartners, Comments on the CAA's Final Proposals, section 7
[368] AlixPartners, Comments on the CAA's Final Proposals, section 7
[369] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.79
[370] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.24

CAA's proposals to cover all categories with incentives as a result, though "with the exception of certain pass-through costs and Core projects that have progressed through G3 prior to Q4 2022"[371]

7.9. We agree with the CAA that differing risk and uncertainty is not a relevant factor in developing this approach, and that "by the time each project arrives at the G3 gateway, regardless of programme, HAL should have sufficient information to set a capex estimate"[372]; it is also relevant that, as noted by Arcadis, "the capex programme HAL has proposed for H7 is, overall, one that does not carry significant risks that HAL cannot be reasonably expected to manage and has a relatively high degree of controllability"[373]

7.10. It is important to recognise that – should capital only have been partially covered by incentives – that this "would likely lead to significant additional complexity and a potential risk of gaming through the allocation of expenditure to different categories"[374]; we therefore agree with the CAA that there is "no compelling evidence to suggest that a more limited application of incentives is required or would be appropriate"[375], and efficiency incentives should be implemented therefore across all capital expenditure categories

7.11. However, we are disappointed that Heathrow did not produce well-developed delivery objectives for each capital expenditure category; whilst we therefore support the CAA's solution to use "performance against project-level delivery obligations (set at G3) as the basis for any adjustments to capex baselines due to under delivery"[376], we caution that Heathrow's aversion to the new incentive will have to be carefully managed by the CAA, warranting deeper involvement in the capital governance process, particularly when setting delivery obligations at G3

7.12. We agree that "objectives are important to articulate the strategic outcomes that HAL will seek to achieve and the indicators it will use to determine how successful it is being"[377], and therefore support those developed in the Arcadis report[378],

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[371] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.32
[372] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.28
[373] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.29
[374] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.92
[375] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.92
[376] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.85
[377] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.86
[378] CAA CAP2366G Review of CAA's capex categories and delivery objectives, Arcadis, June 2022, p41

though expect objectives to be developed for the asset management and compliance programmes

Incentive rate and symmetry

7.13. The CAA state that a "25% is an appropriate incentive rate as we expect this to be sufficiently powerful to influence HAL's behaviour in driving efficiency without unduly exposing it to significant financial risk"[379]; we disagree with this statement, and it is imperative that the CAA correct this error, which will otherwise lead to a weak incentives being placed upon Heathrow for reasons we set out below

7.14. We understand that Heathrow have stated that "the proposed range would expose it to excessive financial risk"[380] and that "many of these projects are so inherently complex that strong financial incentives against baseline expenditure exposes it to unlimited downside risk"[381], suggesting that a rate of between 13% and 15% would be more appropriate

7.15. We refute Heathrow's position, and agree with the CAA that it has not presented persuasive evidence that incentives are inappropriate, and agree with the CAA, who "do not regard our proposals for incentives as having a disproportionate or unmanageable impact on HAL's financeability"[382], and further that Heathrow is not exposed to unlimited downside risk since it "has control on the level of capex it undertakes and under our proposed arrangements it will be aware of what baseline it is performing against"[383]

7.16. Given that the CAA "recognise the view of airlines that higher incentive rates are typically applied in other sectors"[384], the CAA has made an error by showing undue caution in the application of the incentive rate; we refer to comments from AlixPartners, who note that "the fact that HAL has never faced ex ante capex incentives is highly relevant, but for different reasons than those considered by the CAA"[385], since "we would expect there to be material scope for HAL to improve its delivery of capex projects"[386]

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379 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.93

380 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.33

381 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.34

382 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.38

383 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.39

384 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.41

385 AlixPartners, Comments on the CAA's Final Proposals, section 7

386 AlixPartners, Comments on the CAA's Final Proposals, section 7

7.17. The fact is that a 25% is incredibly weak by reference to other industries, based upon evidence we set out in our response to Initial Proposals, and described as such by the CAA's own advisors; even the CAA's own analysis suggests that "in the scenario of an extreme level of overspending (30% above the capex baseline), the application of a 25% incentive rate would result in a reduction in HAL's average pre-tax Return on Regulatory Equity ("RORE") during the H7 period of around 0.6%. In our view, this is a relatively modest exposure to downside risk in the context of the other uncertainties that HAL faces during the H7 period"[387], further noting the lack of complexity in the H7 capital programme combined with Heathrow's past record of delivery within G3 budgets

7.18. As a result, AlixPartners opines that "HAL should face downside risk under incentive-based regulation; this provides incentives to be efficient. Moreover, if the rate were to be 50%, this downside risk would still only be c1.2% reduction in HAL's RORE (i.e. 2 x 0.6%). Accordingly, in our view, the incentive sharing rate for overspend should be 50%[388]; we agree with this view, which would ensure Heathrow's efficiency incentives are at least as good as those in operation in other, more complex regulatory regimes

7.19. Further, the CAA state that "it is prudent to adopt a relatively cautious approach in the first instance so that we can mitigate the effect of any unanticipated impacts that might arise"[389], yet as noted by AlixPartners, "the most likely outcome is that HAL will then seek to deliver capex projects more efficiently"[390]; the CAA has not identified any likely risks that might emerge from using a higher rate more in line with other sectors, and we view such undue caution as being evidence of another decision skewed in favour of the regulated entity as a result

7.20. It is important to note the key incentive effect that a higher rate encourages, where "to provide incentives for information revelation, higher sharing rates may be appropriate if the regulated entity has submitted good quality information as to efficient costs. It can then receive a higher share of any cost savings from a transparent and efficient base"[391]; however, where the CAA simply state that "HAL will be required to provide high quality information in support of its proposals"[392] as noted by AlixPartners, "this statement simply assumes away the information asymmetry issue…regulatory challenge, support from independent consultants, and stakeholder engagement can only ameliorate this asymmetry"[393]

[387] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.95
[388] AlixPartners, Comments on the CAA's Final Proposals, section 7
[389] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.98
[390] AlixPartners, Comments on the CAA's Final Proposals, section 7
[391] AlixPartners, Comments on the CAA's Final Proposals, section 7
[392] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.43
[393] AlixPartners, Comments on the CAA's Final Proposals, section 7

7.21. As a result, the CAA must apply a higher sharing rate, where "higher sharing rates increase incentives for efficiency, by offering companies the opportunity to keep a proportion of the underspend"[394] to incentivise this high quality provision of information that will allow the incentive to operate effectively; the CAA must therefore raise the incentive rate, which is at present an error in its proposals

7.22. We further note errors in the CAA's approach to the symmetry of the incentive, which it does not believe is appropriate where "asymmetric rates are typically applied in sectors where the incentive rate has a dual function and generally reflects submitted costs that the regulator considers are higher or lower than its own assessment of efficient costs"[395]; we disagree with this assertion, which we believe is an incorrect assessment of the function of an asymmetric sharing rate

7.23. As noted by AlixPartners, "the CMA viewed that symmetric rates should be used as a reward only to those companies that submitted acceptable business plan costs…accordingly, at G3 it would be wholly appropriate to incentivise HAL to submit high quality information on capex costs as it would otherwise face a less favourable sharing rate as regards the proportion of cost savings that it is allowed to retain"[396]

7.24. As a result, it is imperative that the CAA correct this error, and apply an asymmetric rate to Heathrow's capital incentive; we support the proposal by AlixPartners that "HAL retaining 40% of cost savings (i.e. 10 percentage points lower than the sharing of overspends) if the capex plan quality is not high would seem entirely reasonable, and retain a sensible balance as to overall incentives"[397]

Delivery obligations

7.25. We agree with the CAA that "delivery obligations are essential to ensure that the underlying capex baseline reflects the scope, quality and timing of the infrastructure that is to be delivered"[398]; further, where these are not achieved, we support that Heathrow "should be compensated for by a proportionate reduction to the capex baseline of a broadly equivalent value to the obligation not delivered"[399]

7.26. It remains disappointing that limited information from Heathrow requires an amended approach "to use performance against delivery obligations on a project-

[394] AlixPartners, Comments on the CAA's Final Proposals, section 7
[395] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.43
[396] AlixPartners, Comments on the CAA's Final Proposals, section 7
[397] AlixPartners, Comments on the CAA's Final Proposals, section 7
[398] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.100
[399] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.100

level basis as a means of adjusting the capex baseline"[400]; this highlights the information asymmetry issues covered in our earlier commentary on the incentive rate, further suggesting that the CAA cannot assume that high quality information will be provided unless it is otherwise incentivised with a higher incentive rate

7.27. Nevertheless, we support the CAA's proposals, which at G3 require "delivery obligations: we expect these to incorporate a project's expected output, quality and timing"[401] using "weightings to determine what proportion of baseline capex is to be associated with performance against each delivery obligation"[402]

7.28. Whilst we recognise that "the opportunity still exists for HAL, in agreement with airlines to identify whether certain projects can be sensibly grouped together into tranches so that their performance is assessed against higher-level and more strategic delivery obligations"[403], we caution that Heathrow's approach to programmes could entail a significant loss of detail for specific projects, undermining the CAA's approach to capital efficiency incentives as a result

7.29. We also note that Heathrow has "suggested an alternative proposal, whereby a more general Scope Obligation would replace the delivery obligations"[404] along with a number of criticisms of the CAA's delivery obligations; we specifically refute Heathrow's criticisms as being unfounded, unevidenced and incorrect, and support the CAA's response to Heathrow's proposals and those criticisms in its entirety

7.30. Specifically, we reiterate the CAA's view that "we do not agree with HAL that the performance against the OBR framework should be the primary means of assessing effective capex delivery"[405]; whilst we agree that "delivery obligations could include improvements to specific OBR targets, likely alongside other delivery obligations"[406], the fact remains that OBR targets incentivise operating expenditure to deliver outcomes rather than capital expenditure in support of those activities

Timing incentives and triggers

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[400] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.102

[401] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.105

[402] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.105

[403] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.108

[404] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.113

[405] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.52

[406] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.52

7.31. We are disappointed that the CAA has "decided not to apply separate timing incentives associated with the delivery of projects against agreed deadlines"[407], even in the case of exceptional projects; whilst we agree that "the scope and design of delivery obligations will include a timing element, and the capex baseline for projects that are not delivered against agreed deadlines will be adjusted downwards"[408], the CAA does not now offer consumers protection against Heathrow's incentives to delay capital expenditure, resulting in later delivery in H7 of capex categories than envisaged at this periodic review

7.32. As noted by AlixPartners, "we are concerned that the loss of explicit timing triggers as existing in Q6 could have the unintentional consequence of providing HAL with an incentive to delay some capex programmes"[409]; given the CAA's extensive commentary on reasons why ex post assessments of capital efficiency are difficult to apply in practice, we find unconvincing its explanation that "our enforcement powers could be used where we find evidence that HAL has not been acting in an economic and efficient manner"[410]

7.33. We believe this reasoning is inconsistent, and it is important that the CAA correct this error by ensuring that its previously proposed timing incentives remain in place for capex categories and exceptional projects; we disagree with Heathrow that retaining timing incentives "would result in them being (at least) doubly penalised for late running projects"[411], since there otherwise remains a clear incentive for late delivery of categories towards later in price control that is now unaddressed

Uncertainty mechanism

7.34. We remain firmly of the view that "HAL should be required to demonstrate to the CAA that it can explain the requirement for the additional expenditure and that it has sought the agreement of the airline community with its proposals"[412]; whilst we are extremely disappointed that the CAA has incorporated unnecessary and unsubstantiated sums within its allowanced for capital expenditure, we believe that a cap on expenditure is required to ensure out-turn expenditure is not excessive, even considering new capital efficiency incentives

7.35. This is in line with our proposals based upon the UK Government's legislation for the development and economic regulation of new nuclear power capacity at

407 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.117

408 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.118

409 AlixPartners, Comments on the CAA's Final Proposals, section 7

410 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.122

411 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.55

412 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.73

Sizewell C[413], recognising best regulatory practice to ensure consumers are protected from extreme levels of over-spending; and we agree that the mechanism will only apply for "capex associated with new scope/projects/ programmes that were not anticipated in the H7 capex plan, and which cannot be accommodated within the associated capex envelope"[414]

7.36. However, given the additional capital expenditure incorporated above, the CAA has undermined its own mechanism in error by already providing for significant, additional margin above Heathrow's substantiated capital expenditure plan; it is therefore our view that the 5% margin over the capital expenditure envelope for H7 is unnecessary and in error, which the CAA must correct by removing as a result

Governance

7.37. We welcome the CAA's assessment that our governance recommendations "provide a useful basis for further discussion between HAL and airlines to clarify and where necessary enhance existing information requirements"[415]; in particular, we endorse the view that "significant involvement of airlines in the capex governance process helps to deliver better outcomes for consumers"[416]

7.38. We further agree that there is "no reason why the information we are requiring to be made available at G3 would not already form an essential part of a such a critical investment gateway"[417], and along with Heathrow, continue to express "a strong view that the CAA needs to be involved in working with HAL and airlines to update the governance documentation"[418]

7.39. As a result, we will support the CAA in its work to update the governance arrangements, which "will mean that ex ante incentives will apply to projects that progress through G3 to Core during or after Q4 2022"[419]

8. Other regulated charges

8.1. Other regulated charges are those services provided by Heathrow that are neither consumed on a per passenger basis, nor can be feasibly delivered by other

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413 Nuclear Energy (Financing) Act 2022

414 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.128

415 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.71

416 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.69

417 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.69

418 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.68

419 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 7.147

providers; in general, we support the CAA's move to a marginal cost approach, removing the distortive effect of annuities derived from the RAB alongside allocated costs that would otherwise reduce or remove incentives for efficiency

Marginal cost approach

8.2. We agree with the CAA's approach to move ORCs to a marginal cost based approach, allowing charges to be focused on costs that can be influenced, and simplifying the calculation whilst ensuring the structure can better accommodate traffic variation; we therefore agree that the CAA should remove "fixed and allocated cost elements from the ORCs where practical and reasonable and including these elements in the airport charges (which will have the additional protections offered by the TRS arrangements"[420]

Scope of ORCs

8.3. In line with the principle that ORCs should relate to services that are not necessarily consumed by all passengers, we agree with the CAA's removal of "check-in desks and automated check-in facilities, gas, heating, and common IT services (including WLAN) could be removed from ORCs"[421], since this reflects that fact that these services are common use for the benefit of all consumers

8.4. We further support the CAA's view that flexibility in the definition of ORCs may be valuable in the future, therefore agree to the inclusion of "provisions that will give HAL and airlines the opportunity to agree to add new Specified Facilities to (or remove them from) the list of ORCs in Condition C2 if (i) they collectively consider this to be in the interests of consumers in the future and (ii) we agree"[422]

8.5. We caution that such flexibility should not be used as a means to recover operating expenditure separate from the airport charge, where it is expected that Heathrow should already be providing a service that has been considered part of the airport charge at this periodic review; otherwise, such a mechanism might be misused by allowing Heathrow to avoid its obligations to spend and deliver services that have already been funded by consumers through airport charges

8.6. Whilst we support "HAL's proposal to remove bus and coach services from the ORC framework so that they can move onto more dynamic commercial arrangements"[423], we continue to oppose the inclusion of winter resilience services,

[420] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.10
[421] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.14
[422] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.19
[423] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.19

which are already provided on a competitive basis by ground handlers to the suit the operational needs of individual airlines

8.7. We also support the CAA's stance on business rates, which we agree "should largely remain in the airport charge"[424]; it would also appear to be anomalous that business rates not related to airline use are funded by consumers through the airport charge rather than paid for by those businesses operating at the airport, though we caution the CAA against any unintended effects if this proposal becomes complex, and that ground handlers and other airline support businesses must be treated on a similar basis to airlines

Business rates

8.8. We agree with the CAA's approach to business rates, which should not be charged separately through a new ORC, since "bringing such a large sum of fixed costs into ORCs could exacerbate the problem of under recovery of ORC costs experienced over the last two years"[425]; it is also important to ensure that ORCs are set on the basis of "user pays", where otherwise the consumer might be inadvertently funding third party commercial interests

8.9. However, we disagree with the CAA that "it is not appropriate to apply an incentive mechanism for the H7 price control period as this will not promote the interests of consumers in any meaningful way"[426]; whilst we have previously questioned the logic of this incentive, it does not appear proportionate to disapply the incentive mechanism that has underpinned the negotiations to date

8.10. As we set out above in our commentary on operating expenditure, the CAA now appears to propose that an expected increase in business rates will be passed onto consumers in full, leaving consumers exposed to the risk resulting from Heathrow's conduct in the current revaluation process; the CAA must act to correct this error, since it would in effect disapply an incentive that has yet to fully play out through the current round of negotiation

Governance

8.11. We agree with the CAA that changes are required to the governance framework, particularly since "the under recovery of ORCs in 2020-2021 highlighted weaknesses in the existing governance and dispute resolution mechanisms"[427]; we therefore agree with the CAA that its "proposed amendments to HAL's licence to

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[424] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.19
[425] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.21
[426] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.30
[427] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.42

strengthen governance measures are needed to ensure that the ORC arrangements retain flexibility and enable them to continue to deliver benefits to consumers"[428]

8.12. We agree that as a consequence of the "failure of the current dispute mechanisms to resolve issues over the last two years"[429] that "anchoring ORCs arrangements in the licence will ensure a level of certainty is provided to parties as they work together to develop new improved governance protocols and can provide for an effective dispute resolution process"[430]

8.13. We therefore support the revisions to Heathrow's licence, and in particular disagree with Heathrow that such an approach allows the "CAA unfettered regulatory powers which could circumvent the checks and balances in the CAA12 that are designed to protect HAL (as the licensee)"[431]; on the contrary, we view the CAA's approach as proportionate and balanced given the clear issues that have arisen in ORCs during the pandemic

8.14. We further support the CAA's new self-modification process, and in particular that "the CAA will have a role in making the final decision on any changes to ensure that it is in the interest of consumers"[432]; it also appears logical that "if a modification were to be necessary in the interests of consumers, but HAL and airlines are not agreed on it, we should follow the modification process in section 22 CAA12"[433]

8.15. We also agree with the CAA that there is a "pressing need for greater clarity, consultation, and transparency across the ORC governance process"[434]; in particular, we agree that "given the nature of ORCs as a pass-through cost, it is important that airlines and other ORC users are able to seek assurance from HAL that any services that it procures on their behalf are scoped and delivered with ORC users in mind"[435]

8.16. This is appropriate scrutiny of items for which Heathrow is the sole, monopoly provider, and commercial considerations are not relevant since Heathrow is not in

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428 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.54
429 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.55
430 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.55
431 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.47
432 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.59
433 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.60
434 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.61
435 CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.62

competition with any other providers of these services; we therefore echo the CAA's view that "ORC users should have the ability to seek assurance and provide effective challenge from a value for money perspective"[436]

8.17. It is extremely important that the views of airlines are "taken into account before HAL develops the scope of its contracts and puts them out to tender"[437], a situation we have experienced in the renewal of the PRM contract, which ultimately resulted in the loss of certain key measures that held the previous provider to account in the delivery of those services; this is not an acceptable situation

8.18. We are concerned that the CAA has not sought to specify greater provision of information in its licence by "not proposing to make significant changes to the provisions Condition C2 (Charges for other services) related to the types and level of information HAL must provide to the CAA and/or publish"[438]; we expect the CAA to support the process of agreement of "the governance arrangements required under Condition F1"[439] as a result through active engagement

8.19. Nevertheless, this is a significantly weaker than airlines sought as a result of the present difficulties, and we disagree with Heathrow that by "enshrining ORC protocols in the licence that it may be at risk of technical breach"[440]; considering incentives over engagement and provision of high quality information in other UK regulated sectors and companies, this concern appears to be particularly unfounded on the basis of evidence elsewhere

8.20. It is therefore imperative that the CAA correct this error by ensuring that the ORC protocol is enshrined in Heathrow's licence, so as to ensure that its provision of high quality information and engagement with ORC users is appropriately incentivised; we nevertheless welcome the CAA's intention "to publish high level guidance in Autumn 2022 in time for next year on ORC protocols that should assist both HAL and ORC users in developing a new and robust set of ORC protocols"[441]

Non-airline users

8.21. Cost allocation within ORCs is likely to become more complex as a result of the move to a marginal cost approach, but where non-airline fixed costs and annuities remain within the ORC framework; as a result, we welcome the CAA's proposal to

[436] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.63
[437] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.63
[438] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.64
[439] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.64
[440] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.66
[441] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.69

carry out a "one-off review of HAL's allocation of the costs of the Specified Facilities between airlines and non-airline users to validate that they have been allocated on a fair and reasonable basis"[442]

8.22. We also support the ex-ante expectation that the results of this report may require "a change to the Licence, for example through the introduction of a new adjustment term in Condition C1 (Price Control) to ensure that the results of the review would not create windfall gains or losses for HAL"[443]

Dispute resolution and other matters

8.23. Whilst we agree with the intent the CAA to encourage a mechanism to develop for dispute resolution, setting out "high-level principles around which a dispute resolution function should be based"[444], we are concerned that this is not sufficiently concrete to foster the development of such a function; we therefore welcome the forthcoming "guidance on governance protocols and dispute resolution function in Autumn 2022 which will provide further details on the high-level principles and dispute resolution scheme rules"[445]

8.24. We are concerned by the CAA's statement that "OBR proposals are not designed with ORCs in mind and ORC users should work with HAL to ensure efficiency and an appropriate quality of service"[446]; this statement is concerning since Heathrow is a monopoly provider of services, and the CAA cannot in many cases expect service quality to arise from mere negotiation

8.25. Furthermore, we cannot agree with the CAA's view that "wider complaints relating to alleged exploitation of dominant position are a matter for the relevant competition authorities: jurisdiction to determine those matters depends on the particular statutory regime relating to the service in question"[447]; the CAA has the power to investigate competition concerns on a status equal to the CMA, and must therefore take an interest in any complaint raised in relation to services provided within the area at Heathrow at which it holds a dominant position, as recognised in its Market Power Determination ("MPD")

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[442] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.71
[443] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.72
[444] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.73
[445] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.75
[446] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.81
[447] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.81

ORC forecasts for H7

8.26. We are concerned by Heathrow's approach "to base its forecast on the proportion of ORCs charges relative to HAL's opex base"[448] rather than forecasting them directly; ORC costs are relatively more elastic than operating expenditure costs, and as a result, basing them upon a percentage of the overall cost base will tend to under-estimate them as passenger volumes are raised

8.27. Since ORCs are recovered as a revenue stream in the single till forecasts, this will therefore tend to result in the airport charge being elevated compared to a process of forecasting ORCs directly from the bottom-up; as a result, despite raising operating expenditure forecasts in its Final Proposals, the CAA's approach to "the same proportion of opex (that is, 15.5% of opex) over the H7 period"[449] is in error

8.28. It is imperative that this is corrected, since the CAA's proposals appear to have under-estimated ORCs, and over-estimated residual operating expenditure; this results in an airport charge that is elevated compared to that if this calculation had been performed by reference to the constituent costs of ORCs

8.29. The CAA must therefore incorporate information that it has access to in the ORC Governance presentation slides, in which Heathrow has set out calculations of fixed, semi-fixed and variable costs during the pandemic, which we incorporate by reference; in particular, we note that the pre-pandemic total budgeted ORC figure was £281m in 2020, which after the deduction of rates and annuities is unlikely to be as low as the figures forecast by the CAA in its Final Proposals, even accounting for usage and passenger numbers

8.30. In general, we are concerned that as a result of the ORC charging structure, there is an incentive on Heathrow to provide poor quality information in determining operating expenditure, then seek to recover greater amounts through ORCs following conclusion of the periodic review; this is a significant issue, particularly where changes in passenger numbers have such a material effect on the ORC cost base and revenue collections

9. Weighted average cost of capital

9.1. We welcome the CAA's assessment at Final Proposals that "suggests that a lower WACC than our Initial Proposals range is appropriate"[450]; in particular, we welcome the changes resulting from "the application of a higher downward adjustment to

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[448] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.86

[449] CAA CAP2365C, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 2: Financial issues", para 8.87

[450] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 63

the asset beta to take account of TRS arrangements"[451] along with the beneficial impact of higher forecast inflation

9.2. Nevertheless, we remain disappointed that the CAA have not acted upon a number of areas set out in our response to Initial Proposals, noting in particular that the "real post-tax cost of equity of 7.5% (which means **we are allowing equity returns 20% higher than the market average**)"[452]; this is an unacceptable outcome for a regulated business that is subject to numerous regulatory protections unavailable to participants in competitive markets, and entirely irrational

9.3. As a regulated business, Heathrow is subject to numerous regulatory protections unavailable to participants in competitive markets, and it is entirely irrational that Heathrow should be remunerated at a rate greater than market averages whilst benefiting from those protections

9.4. Given the observation by AlixPartners that "TRS is designed to mitigate a proportion of traffic risk and will, therefore, mean that HAL's risk characteristics have greater resemblance to other GB companies that are regulated on the same Regulated Asset Base ("RAB") model as HAL"[453], it is our view that the cost of capital should reflect this through a significantly lower asset beta in particular

Summary of WACC

9.5. We note that the CAA's proposals for an RPI real, vanilla WACC of 3.26% represent "a 135bps reduction on the midpoint of our Initial Proposals range of 3.58%-5.64%"[454], largely resulting from a lower cost of embedded debt, which is "predominantly driven by the increase in the inflation forecast for H7 since Initial Proposals"[455] and we welcome this development

9.6. In addition, we welcome the CAA's application of a TRS adjustment "which we now apply to the entirety of the asset beta, not solely to the pandemic-related component as was the case in our Initial Proposals"[456], along with the use of the

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451 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 63
452 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 64
453 AlixPartners, Comments on the CAA's Final Proposals, section 8
454 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.20
455 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.21
456 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.23

mid-point of ranges rather than assuming an automatic aiming up where such a choice might exist

9.7. However, we note CEPA has identified two material errors within the CAA's approach "that are not supported by precedent and give counter-intuitive results would lead to a more appropriate WACC"[457]. Specifically, CEPA recommend that the CAA reconsiders:

a) "The inclusion of the uplift for relative risk changes in the period pre-2020 and for H7 (excluding enduring pandemic effects and the TRS), given the CAA's pre-pandemic asset beta position"[458]; and

b) "The use of an enduring pandemic effect that departs significantly from empirical evidence and broader precedent on beta"[459]

9.8. AlixPartners also notes that the CAA consider "a reduction in the lower end of the embedded cost of debt, taking account of the collapsing 10-year average and removal of the HAL specific yield, which is now negative in RPI-real terms"[460], particularly as a result of "a deteriorating inflation outlook with forecasts CPI inflation remaining 9.6% in 2023 and 2.6% in 2024 (compared to the FP's OBR RPI forecasts of 5.5% and 2.3% respectively). This will inevitably be mirrored to a further downward revision to the OBR's RPI inflation forecast"[461]

9.9. AlixPartners disagrees with the CAA's approach and has therefore proposed changes to the cost of capital to remedy the identified errors. The suggested changes are: "the H7 WACC mid-point estimate should be reduced from 3.26% to 2.65%"[462], though continues to notes that "if we adopted the lower cost of embedded debt in both the low and high case, as could be argued, the mid-point WACC would reduce further to 2.37%"[463]

9.10. CEPA's analysis also supports such a reduction, CEPA notes that "combining CEPA's mid-point asset beta estimate and the CAA's current view of all other parameters would reduce the real vanilla WACC to 2.48% (from 3.26%)"[464], however this comes with the important caveat that "the CEPA IP response does not include recent market evidence on bond yields and inflation"[465], which would further reduce the WACC estimate and should also be incorporated by the CAA

Asset beta

[457] CEPA Cost of Capital annex
[458] CEPA Cost of Capital annex
[459] CEPA Cost of Capital annex
[460] AlixPartners, Comments on the CAA's Final Proposals, section 10
[461] AlixPartners, Comments on the CAA's Final Proposals, section 10
[462] AlixPartners, Comments on the CAA's Final Proposals, section 10
[463] AlixPartners, Comments on the CAA's Final Proposals, section 10
[464] CEPA Cost of Capital annex
[465] CEPA Cost of Capital annex

9.11. We are encouraged by the CAA's approach, which we believe has been generally sound, an assessment that is endorsed by AlixPartners, who note that the "CAA has made reasonable judgements and applied an appropriate methodology in setting in most of the CAPM inputs"[466]

9.12. CEPA also note that the CAA has responded to its feedback, where "the core issues raised were around comparator selection, relative risk assessment, a balanced evaluation of empirical evidence and weight on longer term evidence. The CAA has now separated out relative risk changes for H7 capacity constraints"[467]

9.13. Pre-pandemic asset beta: we welcome the CAA's acknowledgement that "we have concluded that we agree with CEPA's assessment that a full analysis of relative risk, excluding the impact of the pandemic, may suggest an asset beta for HAL below that of the comparator airports considered"[468]

9.14. However, CEPA continue to observe that "the evidence indicates that a reasonable point estimate of the pre-pandemic asset beta should be lower than the CAA's Final Proposals estimate"[469], and where the evidence suggests that this should be lower, it is important that the CAA correct for this so as to avoid errors in its Final Decision

9.15. **Relative risk**: we welcome the CAA's recognition that "HAL is likely to have exhibited lower risk exposure relative to comparator airports in the absence of the pandemic"[470], however we are concerned by the CAA's subsequent assertion that "the pandemic has effectively eliminated the risk differential that previously existed between HAL and comparator airports"[471]

9.16. In particular, we are concerned that the CAA's asset beta estimate is now inconsistent with its stated rationale, where "the CAA is clear there should be a downward adjustment to initial empirical comparator betas to reflect Heathrow's lower relative risk. Taking CAA's narrative at face value, the onset of the pandemic means that Heathrow is lower risk than comparators, but the size of the risk differential has reduced ('it has narrowed the risk differential')"[472]

9.17. CEPA continues, noting that "our review indicates that the CAA has applied an initial downwards adjustment of -0.013 to the comparator evidence for H7. Any

466 AlixPartners, Comments on the CAA's Final Proposals, section 8
467 CEPA Cost of Capital annex
468 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.60
469 CEPA Cost of Capital annex
470 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.80
471 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.81
472 CEPA Cost of Capital annex

corresponding uplift to reflect the onset of the pandemic should then be no higher than +0.013. Instead, the CAA's proposed uplift is as large as +0.100, i.e. almost ten times larger than the theoretical maximum uplift"[473]

9.18. As a result, CEPA advises that "the CAA's proposed uplift (up to +0.100) for the impact of the pandemic on risk differentials from H7 should be removed. The CAA does not reduce comparator betas for the capacity constraint prior to the onset of the pandemic in a way that is consistent with the proposed uplift"[474], particularly where "the CAA has not presented any evidence to support its uplift of +0.100"[475]

9.19. The CAA's logic for this is not therefore supported by the evidence, as we set out in our response to the passenger forecasting section; as a result, the CAA cannot support its statement that "it is unlikely that HAL will exhibit materially greater excess demand in H7 than comparator airports. In fact, neither HAL nor the airports in our comparator set are likely to fully reach their capacity constraints in the near future"[476], and must therefore correct for this error by removing the 0.1 increase in asset beta as a result of its incorrect relative risk assumptions

9.20. Pandemic impact: we agree with the CAA that "the asset beta estimate should be guided by the evidence, without pre-conceptions regarding its ultimate level"[477], and therefore refute Heathrow's assertions that imply that "a substantial increase in the asset beta is self-evident and obvious"[478]

9.21. However, CEPA note that they "continue to disagree with the CAA's/ Flint's methodology for estimating the size of the pandemic impact on a forward-looking asset beta. While the approach may appear to be built on reasonable assumptions, the use of a singular 'covid window' and pooling observations creates an inappropriate upwards bias"[479]

9.22. As we have noted in our commentary on the asymmetric risk allowance, we do not agree with the CAA's assertion of pandemic frequency that "evidence seems to support a broad range of potential frequency assumptions, distributed symmetrically around 3.5%"[480]; this is particularly relevant since the CAA themselves note that "our midpoint frequency assumption is particularly sensitive

473 CEPA Cost of Capital annex
474 CEPA Cost of Capital annex
475 CEPA Cost of Capital annex
476 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.80
477 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.84
478 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.84
479 CEPA Cost of Capital annex
480 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.116

to the upper bound assumption"[481], and we continue to highlight this important error that must be corrected

9.23. CEPA observe that "in addition to giving counter-intuitive results, the approach is inconsistent with regulatory precedent. Regulators and competition bodies (e.g., CMA) often consider rolling asset beta estimates"[482], and the CAA should therefore modify its approach to ensure it is consistent with that of other regulators by reverting from its pooled approach

9.24. In addition, where "the duration of future pandemic-like events is highly uncertain"[483], we are also concerned that the CAA places too much weight the impact of the pandemic on the asset beta; as noted by CEPA, the CAA's methodology "under the CAA/ Flint 'pooled' approach inadvertently lengthens the period in which there is an observable pandemic impact, with perverse outcomes"[484]

9.25. In particular, CEPA note that the "CAA's upper bound assumes no normalisation until late 2023, with no differentiation between the next 12 months and the pandemic period from early 2020 to early 2022. This is contrary to the short-term observed evidence and has the effect of increasing the pandemic event uplift"[485]

9.26. We highlight that Swiss Economics produced a recent report for Dublin Airport[486], which CEPA highlight "compared asset betas in the pre-pandemic period and the post-pandemic period in advising on Dublin Airport's cost of capital from 2023-26. SE found that in 2021 the asset beta for Aeroports de Paris (AdP) had fallen by c.0.075 and Fraport had fallen by 0.10, relative to the pre-pandemic period . Aena's asset beta increased by 0.14"[487]

9.27. CEPA contrast this "to the CAA/ Flint approach, which assumes that asset betas for the same airports were elevated by around 0.40 (in this example) and would continue to be elevated for up to three years. Increasing the length of the assumed pandemic event is incorrect as there is no evidence that market participants view an airline stock as they did at the start of the pandemic, and is particularly impactful when combined with the pooled approach to estimating beta"[488]; this error must be corrected by the CAA to avoid a result that is neither intuitive nor supported by the evidence base

[481] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.118
[482] CEPA Cost of Capital annex
[483] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.124
[484] CEPA Cost of Capital annex
[485] CEPA Cost of Capital annex
[486] Swiss Economics, Dublin Airport Cost of Capital for 2022 Determination, 11th July 2022
[487] CEPA Cost of Capital annex
[488] CEPA Cost of Capital annex

9.28. **Impact of the TRS mechanism**: we agree with the CAA that in its choice of comparators, "none of the comparators benefit from traffic risk sharing in a way that has significantly mitigated pandemic risk"[489], and agree therefore that "it [is] appropriate to apply a downward adjustment to asset beta values to take account of the impact of the TRS"[490]

9.29. We further welcome the CAA's updated approach that "it would be appropriate to explicitly estimate the impact of the TRS on the pre-pandemic asset beta"[491], and in particular agree that "the best available approach is to apply a reduction that assumes a degree of convergence between the pre-TRS asset beta for HAL and the asset betas for regulated network utilities that are not exposed to traffic risk"[492]

9.30. We note that where CEPA welcome the structure, they also note that "the CAA's assumed proportions could reasonably be higher and generate a slightly larger risk mitigation impact"[493]; this view is endorsed by AlixPartners, who suggest that they "see no reason why a range of 90-100% should not be used for comparing HAL with utility networks, once volume and pandemic risk are accounted for elsewhere in the calculation"[494]

9.31. AlixPartners also comments that "the CAA incorrectly assumes that, compared to UK energy and water networks, HAL is exposed additional risks other traffic variability. Other than traffic volatility, where risk is in any case mitigated by the TRS, and potential forecast bias removed by the various shock and traffic adjustments, there is no reason why HAL is exposed to more systematic risk than the regulated water and energy networks"[495]

9.32. As a result, the CAA should consider updating its assumptions to reflect these observations on risk and the effect of TRS on the asset beta; this will ensure its proposals are fully supported by evidence

Cost of debt

9.33. It is important that the CAA reflect the cost of debt achievable by Heathrow in the market so as to benefit consumers from the lowest cost of capital available; we therefore welcome the CAA's updated approach in light of new inflation information, however we note that the 31st March 2022 end date for its assumption

[489] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.127
[490] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.128
[491] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.144
[492] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.153
[493] CEPA Cost of Capital annex
[494] AlixPartners, Comments on the CAA's Final Proposals, section 8
[495] AlixPartners, Comments on the CAA's Final Proposals, section 8

of information may lead to higher forecasts for the cost of debt than at present, as inflation has continued to remain at more elevated levels than previously forecast

9.34. **Inflation**: we note CEPA's comments that "it is appropriate for those same consumers to pay a real cost of debt that subtracts any inflation risk premium to reflect the protections of the regulatory framework - this avoids consumers facing two costs; first through facing the inflation risk, and second through a higher than required real cost of debt"[496]

9.35. CEPA further note that "If we look at five-year breakeven inflation compared to five-year outturn inflation since the start of 1997, we find that breakeven inflation forecasts have underestimated outturn inflation by 10bps (over the equivalent time horizon). An evidence-based review of inflation forecasts versus outturn does not indicate that using breakeven inflation is problematic or asymmetric"[497].

9.36. It is therefore important to ensure that inflation is treated in an appropriate manner. As such, therefore it is difficult to fully support the CAA's use of OBR forecasts for fixed rate debt where "OBR forecasts yield a lower inflation figure on average over the five years of H7 (4.56%) than the average 5yr RPI breakeven inflation estimates from March 2022 (4.74%), i.e., an 18bps difference. This gives a higher real cost of debt"[498]

9.37. Furthermore, when considering index-linked debt, CEPA note that in contrast to the CAA's apparent difficulties finding the data, "market-based daily breakeven inflation estimates are available over different time horizons"[499]; these demonstrate that CAA figures are "incompatible with market evidence and understates inflation expectations. Use of 10yr breakeven inflation would increase inflation assumptions by 21bps (2.94%) compared to the CAA's assumption, while use of 20yr breakeven inflation would indicate a 54bps differential (3.27%)"[500]

9.38. For new debt, it is not clear that the CAA should deviate from market expectations, where CEPA note that the "CAA's inflation estimate of 2.17% across H7 is incompatible with market expectations. If we use RPI breakeven inflation over 15yr and 20yr horizons, we can infer 15yr inflation in five years' time. The interpolation method finds the implied RPI inflation forecast is 3.98%, based on March 2022 data – this does not indicate the significant fall in expected inflation posed by the CAA"[501], observing as well that Heathrow's debt is rated A- and not BBB

9.39. Therefore, whilst we agree with the CAA that "the nominal cost of HAL's fixed-rate debt portfolio will not change significantly in H7, and hence its overall real cost

[496] CEPA Cost of Capital annex
[497] CEPA Cost of Capital annex
[498] CEPA Cost of Capital annex
[499] CEPA Cost of Capital annex
[500] CEPA Cost of Capital annex
[501] CEPA Cost of Capital annex

of debt will fall due to higher inflation"[502], the CAA must update its proposals to account for these better inflation calculations, along with the most recent information that has arisen as inflation has remained at elevated levels in 2022

9.40. **<u>Embedded debt</u>**: we welcome the CAA's move from a collapsing average to a fixed length trailing average, where AlixPartners comments "the original assumption of 20 years, whilst common in other utility sectors, was not grounded in the reality of the HAL debt structure"[503]

9.41. However, AlixPartners go on to note that "the evidence suggests that a 10-year lookback period should be used for the average of the iBoxx index for the purposes of calculating the cost of embedded debt"[504], particularly where "69% of HAL's Class A debt was issued 10 or less years ago. A calculation based on the data…suggests an average age of between 7.4-11.4 years with a mid-point of 9.4 years"[505]

9.42. Furthermore, the CMA have previously ruled against the application of a positive halo effect[506], CEPA's view is that "the CAA's estimation of a negative halo effect i.e., a HAL-specific premium, is not built upon robust evidence and should not be applied for either embedded or new debt"[507]

9.43. Given the significant data limitations that result in different answers, CEPA suggests that this "must raise questions around the estimation approach or Heathrow's treasury strategy. The CAA must be certain that the 8bps HAL specific premium is consistent with recognising efficient debt costs. The variance in the halo effects should, in our view, have led to the rejection of any HAL specific premium"[508]

9.44. This view is supported by AlixPartners who note that "we find no justification for the addition of the 0.08% "HAL-specific premium" or "Reverse Halo", based on the average difference of HAL's actual issuance spread to that of the iBoxx. (Table H.1 of FP). Effectively, this restores the link between HAL's actual cost of debt and undermines the efficient issuance cost incentive properties of using the iBoxx indices rather than HAL's actual cost of debt"[509]

<u>Conclusion</u>

9.45. We welcome the CAA's assessment of WACC at Final Proposals that reduces its estimates from Initial Proposals based upon the evidence, in particular:

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[502] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 9.231
[503] AlixPartners, Comments on the CAA's Final Proposals, section 9
[504] AlixPartners, Comments on the CAA's Final Proposals, section 9
[505] AlixPartners, Comments on the CAA's Final Proposals, section 9
[506] CMA (2021) Final report. PR19 redetermination. Paragraph 9.750
[507] CEPA Cost of Capital annex
[508] CEPA Cost of Capital annex
[509] AlixPartners, Comments on the CAA's Final Proposals, section 9

a) A lower cost of embedded debt as a result of the significant rise in inflation

b) A reflection of Heathrow's debt structure within the estimation of embedded debt costs

c) The inclusion of an adjustment for TRS across the asset beta

9.46. However, we remain concerned with the CAA's approach in a number of specific areas, including:

a) The inclusion of an uplift for relative risk changes, which is not supported by evidence and is inconsistent with other assumptions

b) The use of an enduring pandemic effect that is contrary to the evidence and upwardly biased as a result of the estimation methodology, which differs from regulatory precedent

c) An adjustment for the TRS mechanism that could reasonably be greater given the comparison to the risk profile at other utilities

d) The use of a 31st March cut-off that excludes significant new information on inflation

e) The application of a halo effect that is not supported by the evidence and undermines other incentive properties

10. Regulated asset base

10.1. The RAB is ultimately the value of efficient capital expenditure incurred by Heathrow that it has yet to recover from consumers through airport charges; the mechanism was introduced in UK regulated businesses in response to a lack of investment in newly privatised businesses, who were otherwise incentivised to fund excessive dividends to the detriment of the capital investment

10.2. However, the RAB has now become an important component of the financial engineering of UK regulated companies, being associated with excessive levels of debt; in the case of Heathrow, the Whole Business Securitisation ("WBS") in place uses the RAB as a key measure of debt capacity, allowing Heathrow's owners to raise significantly more debt than assumed in the notional company, and reduce equity reserves through dividend payments as a result

10.3. It is therefore extremely important that the CAA consider the incentives it sets by reference to the RAB, where consumers might be harmed by the financial engineering that is conducted in other Group entities; it is this financial motivation that has primarily motivated investors to repeatedly request RAB adjustments in response to the pandemic, and the CAA remain alert to requests to alter its regulatory approach in ways that are not consistent with its duties in the Act

Further RAB adjustment request

10.4. We note that the CAA records the fact that "in May 2022, HAL submitted a further report in support of its claim for a RAB adjustment in relation to its covid-19 losses"[510]; we have neither seen such submission, offering yet a further example of Heathrow's attempts to avoid airline scrutiny throughout this process

10.5. We are disappointed that Heathrow has continued to request a RAB adjustment in response to the pandemic, and incorporate by reference our previous submissions on this topic, where we remain firmly opposed to any ex post adjustment, particularly given Heathrow's significant outperformance prior to the pandemic and failure to inject any new equity at its ultimate parent company, FGP TopCo Ltd

10.6. **Legitimate expectations**: We welcome the CAA's view that it "cannot agree with HAL's contention that it had a legitimate expectation that we would intervene as regulator to protect HAL from the financial consequences of an exceptional traffic shock"[511]; furthermore we welcome the CAA's statement that "the CAA was clear, and that HAL's investors should have understood, that downside risks, including pandemic-related risks, were expected to be borne by HAL in accordance with the risk allocation set out in the CAA's Q6 final proposals document"[512]

10.7. Heathrow's position is untenable, given that the Competition Commission opined at Q5[513] that communicable diseases can be considered a normal business risk and that Heathrow Airport's shareholders are compensated for bearing such risks through the allowed cost of capital, and further that the Q6 licence specifically stated that "the risk that the out-turn is different is borne by the company and its shareholders"[514]

10.8. **Price control re-opening**: In relation to the CAA's powers under section 22 of CAA12, we agree with the CAA that "HAL is wrong to ascribe a meaning to these words that goes beyond a statement of facts about a licence holder's ability to request a licence modification and about the process that the CAA would follow on receipt of such a request"[515]; in particular, we fully agree with the CAA that in

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510 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 78

511 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.29

512 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.29

513 Competition Commission (2007), BAA Ltd: a report on the economic regulation of the London airport companies (Heathrow Airport Ltd and Gatwick Airport Ltd), appendix F, para 137 to 145

514 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.27

515 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.31

any case, it creates "no legitimate expectation of any kind about the outcome that might arise from the CAA's consideration of such matters"[516]

10.9. **Mis-calibration of Q6 framework**: We are concerned that Heathrow has claimed that the Q6 regulatory regime was mis-calibrated as a result of it not being compensated for its pandemic losses; we view this as a severe case of buyer's remorse now the risks that it was compensated to hold have come to pass, and agree with the CAA that "the fact that a pandemic subsequently occurred does not imply that the framework was mis-calibrated given the information that was available at the time"[517]

10.10. As we have consistently observed, were the CAA "to adopt the practice of retrospectively amending forecasts in light of out-turn data, this would constitute rate of return regulation"[518], and agree that this would not be in consumers interests; as a result, we disagree with Heathrow that the "Q6 framework was "mis-calibrated", in that it did not adequately compensate HAL for the possibility of a future pandemic-magnitude event"[519]

10.11. **H7 traffic risk sharing**: We agree with the CAA that it is "legitimate and reasonable for regulators to change approach in response to new information and risks, and provided this is appropriately justified should support investor confidence in the regulatory regime"[520]; Heathrow is therefore unreasonable to suggest that "without a further Q6 RAB adjustment…discriminating between price controls in this way risks signalling to investors that the CAA's commitments to intervene cannot be considered credible"[521], and wrong therefore to consider that "retrospective application of our new framework is necessary to ensure investors' confidence in the operation of the regulatory regime"[522]

10.12. **Financeability**: We agree with the CAA that any analysis of financeability within the context of an ex ante incentive-based price control should be "based on forward-looking metrics and thresholds, which seems most relevant to HAL's ability to finance future investment and the reasonable discharge of our statutory duties"[523];

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[516] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.32
[517] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.39
[518] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.39
[519] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.37
[520] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.42
[521] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.41
[522] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.43
[523] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.46

we observe that such an approach appears to the basis of the CAA's calculation for its own £300m RAB adjustment, therefore believe that on this basis, the CAA must reverse its own RAB adjustment, which was also based upon hindsight

10.13. **Remuneration of historical expenditure**: As we have explained at length in our previous response to the consultation on the RAB adjustment, there is no case for guaranteed recovery of regulatory depreciation over and above any other aspect of the airport charge determined through the single till; in particular, we agree that "HAL is wrong to state that there is a fundamental principle of UK regulation that companies are guaranteed a recovery of regulatory depreciation, unless this has been explicitly set out as part of the regulatory framework"[524]

10.14. In particular, we noted the comments of the Competition Commission that "The convention of using the RAB as an input into the calculation of price caps gives investors the opportunity to recoup their investments, but deliberately puts that return at risk (i.e. it is conditional upon the efficient and competent operation of the assets that are built). As such, it is entirely conceivable (and, indeed, desirable) that the actual return on the RAB will turn out to be higher or lower than the expected return seen in the WACC x RAB calculation"[525]

10.15. **Asset utilisation**: We also continue to disagree with Heathrow that "recognition ought to be given in the H7 price control for depreciation foregone during Q6"[526]; we agree with the CAA that "when applied on a retrospective basis as HAL proposes, these approaches would provide for the recovery of losses incurred in 2020 and 2021"[527], which following our previous comments would be unacceptable in an ex ante incentive based price control

10.16. **Other industries**: The entire premise of incentive based regulation is that it incentivised outperformance of the regulated company in order to drive efficiency over time; we agree with the CAA that "HAL benefitted from passenger forecasts that exceeded forecasts over the Q6 period"[528], which enabled significant dividend payments in excess of those assumed at the Q6 periodic review; we therefore support the CAA's position and "disagree with HAL's suggestion that the fact that its charges are capped warrants a further RAB adjustment or any further retrospective compensation for historical losses"[529]

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[524] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.48
[525] Competition Commission (2008), Stansted Airport Ltd: Q5 price control review, appendix L, paras 7 to 12
[526] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.51
[527] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.52
[528] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.55
[529] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.57

10.17. **European airports**: Both in or experience, and drawing on the expertise of IATA, we agree with the CAA that no other regulators "have provided for an adjustment that is comparable in terms of scale to that HAL is seeking in respect of historical losses"[530], and further that "in most cases, there has not been any compensation provided in respect of historical losses to date"[531]

10.18. The CAA should note that "the Thessaloniki Forum of Airport Charges Regulators is tasked with 1) working on and making recommendations for a better common implementation of the Directive 2009/12/EC on Airport Charges (the ACD) and 2) promoting best practices in economic regulation of airports"[532], and as noted by the CAA "provides a perspective on the options…but is not binding on any regulatory body"[533]

10.19. The paper referred to critically states that "in practice the treatment of financial losses of course will depend on the (legal provisions of) the regulation model in force: (a) in models in which airport operators are assumed to bear the traffic risk, for example in some price cap regulation regimes, there is unlikely to be a policy to recover losses from any crisis"[534], nothing further that "in price cap regulation airports are ideally incentivized to incur efficient cost. The higher risk associated with these regimes is normally compensated with a higher regulatory WACC as compared to a cost-plus regime"[535]

10.20. In particular, the forum observes that "shareholders of price regulated undertakings receive a risk compensation for their price regulated activities in the form a regulatory WACC. For this reason, it is in principle appropriate to transfer the demand side risk to the shareholders. As a result of these general principles demand side risk should according to fundamental economic regulatory principles not be transferred to users by increasing charges"[536]

10.21. We therefore support the CAA's position not to make a further RAB adjustment, where AlixPartners also state "that any further RAB increase, without investment commitment, or to increase the airport capacity or improve the service quality, would likely result in airport charges increases to the detriment of consumers and

530 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.59
531 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.59
532 Thessaloniki Forum of Airport Charges Regulators, "Remedies Available to ISAs to Address Potential Misuse of Significant Market Power by Airports", December 2019
533 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.59
534 Thessaloniki Forum of Airport Charges Regulators, "Airport charges in times of crisis", January 2021, para 4.7
535 Thessaloniki Forum of Airport Charges Regulators, "Airport charges in times of crisis", January 2021, note 27
536 Thessaloniki Forum of Airport Charges Regulators, "Airport charges in times of crisis", January 2021, para 4.10

moreover would raise serious questions about the incentive properties of the regulatory framework"[537]

<u>The CAA's £300m RAB adjustment</u>

10.22. We remain firmly opposed to the £300m RAB adjustment, which the CAA state was made "particularly to support HAL's financeability, the timely re-opening of airport capacity and the quality of service it provides during 2021, ahead of the new H7 price control period starting in 2022"[538].

10.23. This is inaccurate. The CAA previously stated that the RAB adjustment was made where Heathrow had "set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 **<u>and beyond</u>**"[539]

10.24. It is therefore incorrect to state that "the RAB adjustment was made in relation to investment and service levels in 2021 and not in relation to HAL's performance in 2022"[540]; the absence of any additional investment in 2021, failure to open Terminal 4 in advance of demand increases, and failure to support service quality moving into 2022 are key contributors to Heathrow's own operational performance issues, distinct from those related to airlines themselves

10.25. It is imperative therefore that the CAA correct for this error by reference to the investment promises that Heathrow made to the CAA in advocating for the RAB adjustment, which have not been delivered; as we have previously set out in our response to Initial Proposals, that investment has not in fact been delivered, and consumers are now suffering from Heathrow's delays in re-opening capacity and delivery service quality outcomes

10.26. We reiterate the points that we made in our response to Initial Proposals, which we incorporate by reference; whilst we recognise the CAA's response to these points, we remain dissatisfied with the CAA's reasoning particularly in light of Heathrow's failure to deliver investment in capacity ahead of the rise in demand, resulting in the current operational issues that we now see at Heathrow

10.27. These concerns are also reflected in the AlixPartners report, which suggest that "the RAB adjustment needs to be associated with precise and binding conditions regarding future deliverables to provide HAL with appropriate incentives"[541],

537 AlixPartners, Comments on the CAA's Final Proposals, section 11
538 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 74
539 CAA CAP2140, "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", para 4.15
540 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 77
541 AlixPartners, Comments on the CAA's Final Proposals, section 11

however "this 'strong incentive' will be undermined if HAL is allowed to retain this adjustment if the necessary service quality and terminal capacity is not delivered throughout 2022"[542]

10.28. As a result, AlixPartners conclude that "the CAA should make any RAB adjustment contingent on delivering such investment level to set the appropriate incentives. Failure to deliver on this investment level should be reflected on the RAB adjustment. Otherwise, HAL will have a reduced incentive to deliver efficient investments that are beneficial for customers in the future"[543]

11. Asymmetric risk allowance

11.1. We remain concerned with the CAA's approach to asymmetric risk, which in conjunction with the TRS mechanism, shock factor and cost of capital results in significant over-compensation to Heathrow of the risks that it is actually bearing in the CAA's H7 Final Proposals; in particular, we are concerned that the CAA is conflating a fundamental assumption at the heart of the Capital Asset Pricing Model ("CAPM") with one of forecasting passenger volumes within its single till price control model

11.2. We note that the Competition Commission has already opined at Q5[544] that communicable diseases can be considered a normal business risk, that Heathrow's shareholders are compensated for bearing such risks through the allowed cost of capital, and also placed natural disasters, geopolitical upheaval and technological failure of either aircraft or airport systems under the same heading[545]

11.3. AlixPartners note that "it is important to know whether the impact of the individual historical shocks were added back into the historical data (in the individual months or years in which they occurred) before calibration or estimation of the model"[546], and "if this has not been done asymmetric shock factors will have been applied to forecasts that already implicitly include the impact of these shocks, and therefore would be invalid"[547]

11.4. The CAA has developed a calculation, separately from that of the cost of capital that itself already incorporates all known risks "for dealing with future "pandemic risks" through a stand-alone revenue allowance for these low probability but

[542] AlixPartners, Comments on the CAA's Final Proposals, section 11
[543] AlixPartners, Comments on the CAA's Final Proposals, section 11
[544] Competition Commission (2007), BAA Ltd: a report on the economic regulation of the London airport companies (Heathrow Airport Ltd and Gatwick Airport Ltd), appendix F, para 137 to 145
[545] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 10.27
[546] AlixPartners, Comments on the CAA's Final Proposals, section 3
[547] AlixPartners, Comments on the CAA's Final Proposals, section 3

significant events”[548]; in doing so however, the incentives at the heart of regulation has been fundamentally altered

11.5. In addition, this is precisely the risk incorporated in the cost of capital, and just as for the TRS mechanism – which is intrinsically linked to this asymmetric risk allowance along with the shock factor – the cost of capital must be adjusted in exchange for consumers taking on this transfer of risk; it is incontrovertible that a business subject to lower risk exposure has a lower cost of capital, as previously stated by the CAA itself at the Q6 periodic review

11.6. It is for this reason that we continue to criticise the asymmetric risk allowance as unnecessary and duplicative, particularly when combined with the CAA’s approach to the TRS, cost of capital and the shock factor adjustment to the passenger forecast; as a result we continue to believe that the CAA is in error through its failure to recognise the degree of wholesale risk transfer in the cost of capital

Allowance is unevidenced

11.7. CAPM is a model that is used pervasively in cost of capital calculations both in UK regulatory practice and in wider applications across finance and business decision-making; its intellectual underpinnings are well-established, as are its drawbacks and limitations; given significant other protections for UK regulated companies, such as the ability of regulators to aim up or aim down within the cost of capital parameters, it is unclear to us why the CAA seeks to solve a CAPM issue outside the cost of capital calculation

11.8. The assumption therefore that, without such an additional revenue allowance, that Heathrow is subject to asymmetric risks as a result of the calculation of the CAPM[549] is therefore unfounded, and the CAA has provided no evidence that this is the case; indeed it has itself previously provided evidence at the Q6 periodic review that no adjustment was necessary to compensate for alleged asymmetry in the cost of equity, concluding that “it was not persuaded to make such an adjustment, and among other things, placed weight on PwC finding no conclusive proof of asymmetric risk”[550]

11.9. PwC further stated in that report that “it was not appropriate to make a specific additional allowance for skewed equity returns”[551], particularly as capacity constraints were not as stark as suggested by airports, and “that the interaction of capacity and excess demand would affect beta and skewness. In particular,

[548] CAA CAP2365A, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary”, para 84
[549] CAA CAP2365D, “Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues”, para 11.23
[550] CAA CAP1115, “Estimating the cost of capital: a technical appendix to the CAA’s Final Proposal for economic regulation of Heathrow and Gatwick after April 2014”, para 3.11
[551] CAA CAP1115, “Estimating the cost of capital: a technical appendix to the CAA’s Final Proposal for economic regulation of Heathrow and Gatwick after April 2014”, para 3.28

tightening capacity reduced demand risk (i.e. reduced the beta) and also increased negative co-skewness"[552]; it also noted the long-run incentives that would allow airports to expand capacity that were also factored into asset beta measurements

11.10. The CAA concluded at that time, that "it would not be appropriate to maintain its current beta estimate and make an adjustment for co-skewness. If the CAA were to include an allowance for co-skewness it would be appropriate to reduce the beta"[553]; further it observed that "other regulators have not made such adjustments and that PwC is not aware that such adjustments are made when the WACC is used in other practical situations such as business valuations"[554]

11.11. As a result, the CAA continues to be in error by asserting without evidence that any asymmetric risk allowance is required, and it is imperative that it corrects this error in its Final Proposals; the CAA has provided no evidence to support such an assertion that forms the basis of this allowance, and simply by repeatedly asserting that this is the case, this does not form the basis of an evidenced proposal, particularly where its own previous analysis and conclusions refuted such an approach

Shock factor

11.12. We are concerned that the CAA appear to believe that "all parties also accepted that the inclusion of a shock factor within a traffic forecast was likely to produce a more accurate traffic forecast than the use of 'unshocked' forecasting models"[555] when we have repeatedly and consistently refuted such an approach; indeed, the CAA noted that "there is concern that the risk faced by the airport operator through such shocks has previously been accounted for in the WACC"[556]

11.13. We have repeatedly asserted that "as the demand risk was included in the asset beta, to include it in the passenger forecast without offsetting the risk accounted for elsewhere would be double-counting"[557], dealing with such shocks through a shock factor to passenger forecasts would be incorrect; whilst therefore it is right to consider the effect of the pandemic, the CAA is incorrect to ascribe views to BA and airlines that are not in fact the case

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[552] CAA CAP1115, "Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014", para 3.32
[553] CAA CAP1115, "Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014", para 3.39
[554] CAA CAP1115, "Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014", para 3.42
[555] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.25
[556] CAA CAP1103, "Q6 Final Proposals", para 3.10
[557] CAA CAP1103, "Q6 Final Proposals", para 3.12

11.14. Where the CAA stated that "we do not consider that the downside risks facing HAL are matched by equal and offsetting upside opportunities"[558], we reiterate the view of PwC in its report issued to the CAA at the Q6 periodic review, and highlight the incentive effect in its price control for Heathrow to develop capacity whilst airlines also increase aircraft size and load factors as constraints are reached; in particular, we highlight the fact that Heathrow were until recently embarking upon a major expansion project, which would have increased ATMs from a cap of 480,000 to 720,000, supported by the ANPS

TRS mechanism

11.15. We are also concerned about the CAA's assertions about the TRS mechanism, which it states "does not fully protect HAL from traffic risk or remove the inherent skew in the distribution of risks"[559]; the CAA has presented no evidence that this is indeed the case, and where PwC has previously commented on co-skewedness in its earlier report, we are not convinced that this is a problem

11.16. As a result, it is imperative that the CAA correct its error in this regard by either presenting new evidence that asymmetric risks are now problematic, or removing the asymmetric risk allowance in its entirely; we are gravely concerned that the CAA has introduced such an allowance in direct contradiction to its decision at previous periodic review in order to provide justification for its approach to the TRS mechanism, which itself has not been properly justified

Calculation

11.17. **Non-pandemic shocks**: we are concerned that the CAA has simply used Heathrow's updated, proposed numbers without additional challenge; this is a similar situation to that identified by AlixPartners in operating expenditure, where this resulted in reliance "on selective information provided by HAL to justify certain cost increases"[560]

11.18. Since we have not been given the opportunity to validate this calculation, the CAA must properly consult on this proposal and allow airlines to challenge the numbers presented by Heathrow; if this is not permitted, the CAA must remove the shock factor, being unevidenced and in error as a result

11.19. **Pandemic shocks**: the CAA's calculations of the likelihood of a pandemic is described as taking "the potential frequency of such an event and weighting the estimated losses by the probability of such an event occurring during the period"[561];

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558 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.27

559 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.28

560 AlixPartners, Comments on the CAA's Final Proposals, section 5

561 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 84

however, these calculations are not based upon robust epidemiological analysis, and overstate the effect of potential such future events as a result

11.20. The CAA observe that "the experience of the pandemic provides us with very recent data on the way in which a pandemic-magnitude event can cause a near shutdown of domestic and international travel"[562], however we do not believe it is appropriate to infer this effect will transpire for future pandemics; we reiterate our view that governmental restrictions are unlikely to be repeated as future events – such as monkeypox at present – will be transmitted in different ways and result in different responses at that time

11.21. The CAA has provided no evidence that the current pandemic will be a template for future pandemics, and the CAA is in error to dismiss our views merely as "we do not consider that the airlines have presented us with a better evidenced, alternative benchmark for how a future pandemic-magnitude might unfold than the experience of the last three years"[563]

11.22. Furthermore, this approach is highly unscientific, since the CAA's assertions are not falsifiable[564] in any way; as a result, since its approach cannot be contradicted by any empirical test, it is not therefore a sound or robust approach to use as the basis for a regulatory price control

11.23. The CAA is in error to implement its unevidenced assertions, then to dismiss our valid criticism on the basis that we are unable to provide evidence for something that has not yet occurred; this is not robust and logical reasoning and the CAA must correct this by removing its proposals for an asymmetric risk allowance for pandemic-related shocks

Calibration

11.24. **Traffic loss**: considering that Heathrow themselves have not experienced a similar such event in over fifty years, as evidenced by information from Heathrow's investor relations, it is clear that the basis of the CAA's calculation is inaccurate; certain assumptions that pandemics will last for three years and have a similar impact profile to the recent pandemic are highly specific and nor borne out by the historical facts of passenger flow at Heathrow

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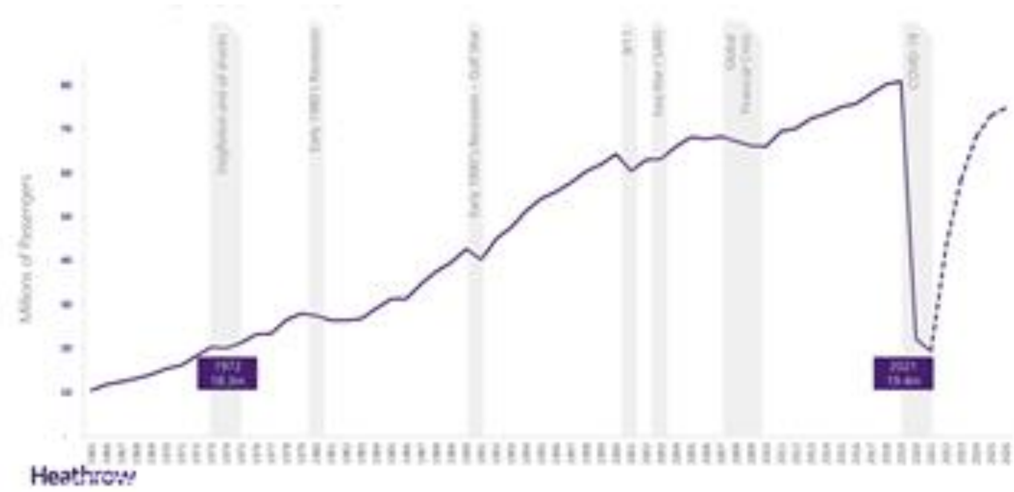
562 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.33

563 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 11.33

564 Falsifiability is a standard of evaluation of scientific theories and hypotheses that was introduced by the philosopher of science Karl Popper in his book The Logic of Scientific Discovery (1934)

<u>Table 11.1: Effect of pandemic on Heathrow passenger numbers[565]</u>



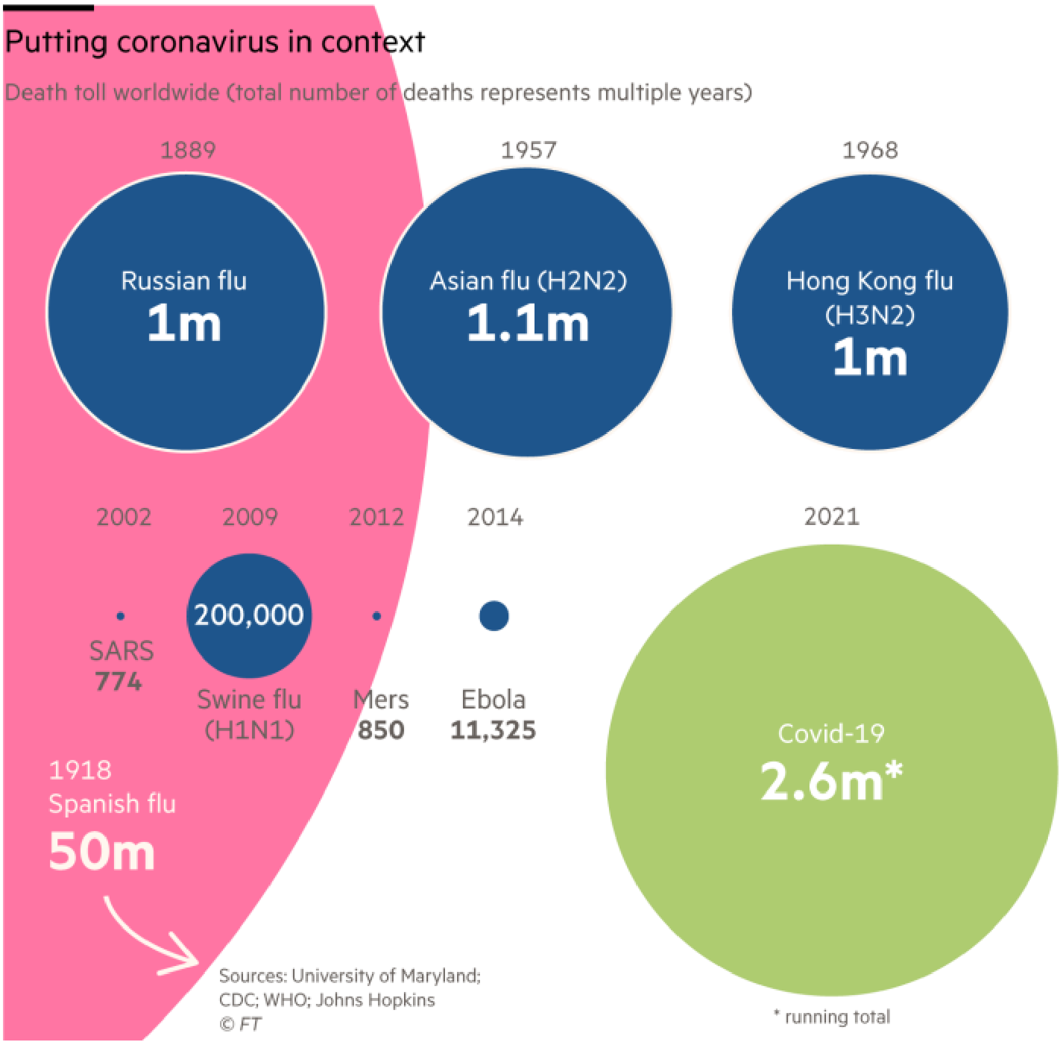
11.25. There is no evidence that such extensive and costly travel bans will be imposed again in future, especially where The Economist has noted that "humanity has learned a lot about the coronavirus in the past two years. Masks, social distancing and, most of all, vaccines have proved effective in curbing its spread. Yet…long-lasting travel restrictions are mostly futile"[566]

11.26. This is supported by abundant and credible evidence, with researchers stating that "travel restrictions would make an extremely limited contribution to any policy for rapid containment of influenza at source during the first emergence of a pandemic virus"[567]; it is therefore highly unlikely that we would ever see a similar pattern of travel restrictions as a result of a new pandemic

11.27. In addition, whilst the CDC has listed out pandemics that have affected humanity in recent history, it is clear that – with the exception of Covid-19 – that none of these have had any effect on passenger numbers at Heathrow; it therefore remains our view that Covid-19 is anomalous, and its effect on Heathrow's passenger numbers a direct result of government action rather than an indicator of the future profile of any pandemic

565 Heathrow Investor Update, 11th May 2022, p12
566 The Economist, "Why travel bans are usually the wrong way to curb Omicron", 1st Jan 2022
567 WHO Bullentin, Effectiveness of travel restrictions in the rapid containment of human influenza: a systematic review, 2014 Dec 1; 92(12): 868–880D

Figure 11.2, Putting coronavirus into context[568]



11.28. The CAA are incorrect to estimate a traffic shock that would have a similar profile and impact on passenger numbers extended over a three year period when such an event has been unprecedented in the history of Heathrow's existence; furthermore, it is not clear that pandemics referred to in the 1960s and 1990s had any impact whatsoever of Heathrow's passenger numbers, therefore the CAA is wrong to assume such an impact might ever again occur

11.29. **Annual losses**: since the basis of Heathrow's price control is volumes, we are not clear what relevance Heathrow's profits have to the calibration of the calculation; protecting profits undermines the basis of Heathrow's regulatory price control what is based upon average revenue per passenger

11.30. **Frequency**: we disagree with the CAA's 3.5% calculation, being based upon a probability that sits between 1-in-20 and 1-in-50; there is no evidence that such a frequency of event will have any impact on Heathrow's passenger volumes, and the

568 Financial Times, "From plague to polio: how do pandemics end?", 12th March 2021

CAA makes the implicit assumption by doing so that such events will have a similar magnitude to that of the current pandemic

11.31. This is fundamentally incorrect, and the CAA must correct this calculation to account for the fact that pandemics do not have the same, or indeed any impact on passenger numbers; this is evidenced by Table 11.1 above, which shows the absence of any impact on Heathrow's passenger volumes until the arrival of the present pandemic

11.32. Furthermore, by not following CEPA's recommendation to "exclude pandemics of lesser severity than the covid-19 pandemic from consideration", this significantly over-weights the effect of the current pandemic; we reiterate the fact that where it is now known that travel restrictions are ineffective at slowing or preventing infection, we do not expect to see such restrictions imposed again in future

12. Financial framework

12.1. It is important that the CAA sets appropriate incentives through the financial framework, ensuring that consumers are not exposed to the risks of Heathrow's financial engineering, but can benefit from the lowest available cost of capital to finance necessary and efficient investment in facilities; we therefore support the continued application of the notional company, where "assessing the price control on the basis of a notional company means that consumers fund an estimate of efficient financing arrangements"[569]

Regulatory depreciation

12.2. However, we are concerned that the CAA has continued to use estimates of depreciation that have been provided by Heathrow through its RBP Update 2 rather than developing a policy of its own for depreciation and using its own calculations as the basis of the price control; regulatory depreciation is not the same as accounting depreciation, and where the RAB is greater than accounting assets, the use of accounting depreciation will tend to leave the RAB at elevated levels in future years

12.3. Our concern is not that the CAA should follow an alternative approach to regulatory depreciation, but that it must have its own approach that does not simply used Heathrow's own proposed numbers; the CAA must therefore correct its error by calculating its own proposals for regulatory depreciation, which could continue existing regulatory practice by being based upon 1/20th of the RAB in each year of the price control, being be a straightforward and proportionate approach that would ensure that the CAA has its own independent forecasts

569 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.14

12.4. We agree with the CAA that Heathrow's proposal to defer regulatory deprecation "could put financial metrics that are important to debt financeability under significant strain and this would have the potential to make financeability more difficult"[570]; furthermore we agree that there are several drawbacks to "linking depreciation to the usage of certain assets"[571], not least the deviation from accounting rules that we have previously highlighted in response to the consultation on Heathrow's proposed RAB adjustment

12.5. We are concerned that through the CAA aiming to "produce a relatively stable RAB balance in the H7 period as shown"[572], in combination with an additional, unsubstantiated £1.2bn of capital expenditure allowances, the CAA is not acting in the best interests of consumers; it is neither appropriate nor an objective of regulation to ensure that the RAB – the prime determinant of Heathrow's business valuation – remains at a stable level throughout the price control period

12.6. The CAA must therefore correct for this significant error by taking its own view on Heathrow' regulatory depreciation profile that is appropriate based upon the regulatory assets that are efficiently incorporated into the RAB; by not producing its own calculation, it might otherwise incentivise Heathrow to propose figures for regulatory depreciation that support its own corporate finance objectives

Inflation indexation

12.7. We agree with the CAA that inflation has become problematic since its Initial Proposals were published, resulting in a situation where "large, rapid and mainly unanticipated rise in inflation creates challenges that regulators have not previously had to confront when setting price controls"[573]

12.8. The CAA's proposal to use CPI appears reasonable, particularly where "CPI is the inflation measure used by the government in its price inflation target"[574], and also where there have been previous difficulties in the calculation of CPIH; given the fact that RPI is now no longer deemed accurate, and has been de-designated as a national statistic as a result of HM Treasury consultation[575], it is wholly appropriate for the CAA to end its use of RPI and move to a CPI-X model

570 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.20
571 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.19
572 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.25
573 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.26
574 Government Actuaries Department, Measuring price inflation, March 2017
575 HM Treasury, A consultation on the Reform to Retail Prices Index ("RPI") Methodology, March 2020

12.9. However, we disagree with the CAA that it remains "appropriate to continue indexing the RAB in line with RPI"[576]; given the new information that has arisen since the "decision that we made in December 2017 to continue with RPI indexation"[577], including the HM Treasury consultation in 2020, we believe that the CAA would be committing a significant error by not indexing the RAB also by CPI

12.10. Whilst the CAA characterises such a choice as relatively immaterial, suggesting that "for a RAB of £17bn and a gap between RPI and CPI of one percentage point, this policy choice leads to a difference in the RAB of £170m in a single year"[578], this ignores the compound effect of this decision and the actions of other regulators, who have phased out RPI in response to abundant evidence of its inaccuracy[579]

12.11. In particular, the compound effect of the significantly elevated wedge between RPI and CPI, which amounted to 3.6%[580], means the CAA understate the effect of using an incorrect inflation index in its example above; it is imperative that the CAA correct for this error by using CPI as the only appropriate indexation method for the RAB, alluding only to its materiality in their subsequent justification not to move from their position from Initial Proposals to Final Proposals

12.12. However, that is the purpose of the consultation process, and we therefore refute the CAA's explanation for not doing so where the "materiality of the issue and the weight that investors attach to the indexation of the RAB we are mindful that to change approach between initial and final proposals would risk harming the CAA's reputation for stable and predictable regulation"[581]; this again and in error places financeability issues over those of consumers, and results in a significant transfer of wealth to Heathrow's investors as a result of its substantial error

12.13. In the absence of any calculation to evidence that consumers interests are not harmed by not changing the basis of the index, we cannot support the CAA's assertion that "a switch to CPI indexation of the RAB and a CPI-stripped cost of capital would require us to give HAL a significantly higher allowed return. Conversely, retaining the RPI linkage of the RAB avoids the need for this higher cost of capital"[582]

12.14. In any event, as we set out above, it is our view that the cost of capital remains significantly elevated compared to the independent views of our advisors, and as a

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[576] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.33

[577] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.34

[578] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.34

[579] Oxera, Indexation of price controls in the water industry, 31st March 2016, section 4

[580] 11.8% (RPI) vs 8.2% (CPI), Office for National Statistics, Inflation and price indices

[581] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.35

[582] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.37

result, we are not satisfied that the CAA's assertions hold true when the cost of capital is recalculated based upon our assumptions

Revenue calculations

12.15. We note the CAA's difficulties where "indexing charges and the RAB by reference to different inflation indices creates certain complexities in the price control calculations"[583]; as a result of these numerous and signification translation adjustments for different measures of inflation, we are unable to independently verify the veracity of the CAA's calculations

12.16. Nevertheless, the CAA has identified an important issue where "there would be a potentially sizeable mismatch between lagged April-to-April inflation and the contemporaneous calendar year inflation forecasts that are used in our building block calculations"[584], particularly where "this could result in HAL recovering more revenue than we have determined it requires"[585]

12.17. As a result, we support the CAA's proposal "to eliminate any scope for mismatch by setting the reference dates in the price control licence condition to calendar year inflation"[586]; in particular, we support the CAA's approach that where the rate card consultation requires the use of an inflation forecast, that the "K-factor term in the price control provides for any over- or under-forecasting of inflation"[587]

Corporation tax

12.18. We support the CAA's view that "maintaining the pre-tax approach, would be a transparent, proportionate and reasonable approach to calibrating tax allowances for HAL"[588] along with "the introduction of a tax uncertainty mechanism will be in consumers' interests as the existing pre-tax approach does not consider the impact on the allowance of any differences arising from changes to the statutory rate of corporation tax"[589]

12.19. We note the CAA's assessment of a RAB adjustment compared to a revenue adjustment, and agree that "a revenue adjustment avoids adding or deducting

583 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.38
584 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.50
585 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.50
586 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.51
587 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.53
588 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.70
589 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.72

additional items to the RAB which is simple and aids transparency"[590], and support blending "between 19% and 25% to account for the change in tax rate at the start of the tax year"[591], thought this must remain subject to further new information from the Government depending upon the stance of the new UK Prime Minister

12.20. For the tax clawback mechanism, we support the CAA's revised calculation as set out in its Final Proposals[592], with the exception that we believe the actual gearing should be assessed on the basis of the level at FGP TopCo Ltd rather than Heathrow (SP) Ltd; the WBS benefits the entire buyout group, and where significant levels of debt sit outside the Heathrow (SP) Ltd Group along with numerous tax credits and allowances that are only applied at higher entities, it would be a significant error for the CAA to only consider the Heathrow (SP) Ltd Group

12.21. Given the levels of debt in FGP TopCo Group exceed 90%, the CAA's calculation of materiality, which itself is based upon a notional figure rather than actual levels of debt, understates the consumer benefit that might result from its proposal; we therefore believe that the CAA is in error to conclude that it "would not be an appropriately targeted or proportionate approach to the regulation of HAL"[593]

13. Price cap and financeability

13.1. It is important for consumers that investments funded by airport charges are financed at the lowest possible cost; as a result, Heathrow must be financed efficiently, ensuring that the cost of capital is at the lowest possible level consistent with this objective; whilst we recognise that financeability is an important consideration, we stress that this can never be placed above the CAA's general duty to consumers, particularly where Heathrow's actual corporate structure has such high levels of leverage that were these to take precedence over the consumer interest, charges would become significantly more elevated than necessary

Overall level and profile of price control

13.2. We agree with the CAA that "a smoothed profile of charges over a five-year period"[594] is appropriate and in consumers' interests, since this allows longer-term investment and network planning to support the available route network; given the 2022 charge has been in place for seven months already, we agree with the CAA

[590] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.73
[591] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.74
[592] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.76
[593] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 12.80
[594] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.87

that there are "advantages to consumers of HAL signalling price changes in advance and acting consistently with the obligations created by the Airport Charges Regulation"[595]

13.3. Whilst it does not appear unreasonable to make "no further changes to the level of the price cap for 2022, and instead are assuming that it is the level of charges for 2023 to 2026 that flex in order to ensure that HAL recovers revenue over the period 2022 to 2026 that is consistent with our building block calculations"[596], we note that to support the 2022 charge implies an extraordinary P0 adjustment of £6.66 from £23.53 in 2021 to £30.19 in 2022, which has ultimately provided unnecessary support for Heathrow's financeability in year one of the price control

13.4. We agree with the CAA that "regular real reductions in charges would also tend to offset some of the impacts of inflation"[597] though where any choice of price path "can be reasonably said to be in the interests of consumers as they are equivalent in present value terms over the five-year period of the price control"[598], it is important that the CAA does not introduce undue complexity; as a result, it appears preferable to introduce "a fixed percentage, real terms reduction in the level of the price cap over the period 2023 to 2026"[599]

13.5. Where this has a secondary function that "better supports financeability in 2023 and 2024"[600], we support the CAA's approach that demonstrates that "the declining profile results in stronger credit metrics in 2023 and 2024 following the pandemic-affected years of 2020 to 2022"[601]

Affordability

13.6. We welcome the CAA's statement that "setting an appropriate level and price profile for airport charges remains a key objective for this price control review and we are not persuaded by HAL's argument that fares and the availability of routes would be unaffected by the airport charge"[602]; however we refute the notion that scarcity rents are present at Heathrow given the lack of robust evidence

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595 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.88
596 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.88
597 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.90
598 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.90
599 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.88
600 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.93
601 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.92
602 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.65

Credit ratings

13.7. We agree with the CAA's assessment that "that achieving an "A-" credit rating during the course of H7 is not a priority for the notional company"[603], particular where this would result in a significant cost for consumers to generate the significant headroom required against targets for credit rating thresholds; we further agree with the CAA's assessment that "the notional company would very likely be able to issue all the debt it needs to at a BBB+ or BBB rating"[604]

13.8. However, we cannot agree with the CAA's assertion that at a BBB- rating, "UK debt markets are more expensive and have significantly reduced liquidity"[605]; whilst debt generally becomes more expensive as the credit rating decreases, simply to assert this is the case without measuring the cost of issuing a lower-rated bond against the cost to the consumer of supporting a higher level of financeability is an error

13.9. In addition, research[606] shows that BBB rated bonds do not trade with *significantly* reduced liquidity, but instead show a more marginal liquidity decline within investment grade rated bonds; indeed financial engineering conducted by private equity investment groups relies upon replacing equity with relatively lower cost debt, often at non-investment grades, which contradicts the CAA's assertion that "if the notional company were to be in this position, it would likely need to rely more on equity finance to ensure that it could finance investment and reduce gearing, until it was able to regain a stronger investment grade rating"[607]

13.10. As a result, we do not agree with the CAA that there is "limited depth and liquidity within the debt market for debt issued at the lowest investment-grade credit rating"[608]; in contrast, the BBB market (including BBB- and BBB+) is in fact the largest market for corporate debt, and by "market value, BBBs account for ~50% of the market"[609]

Figure 13.1: Issuance by credit rating, 1997 to 2021[610]

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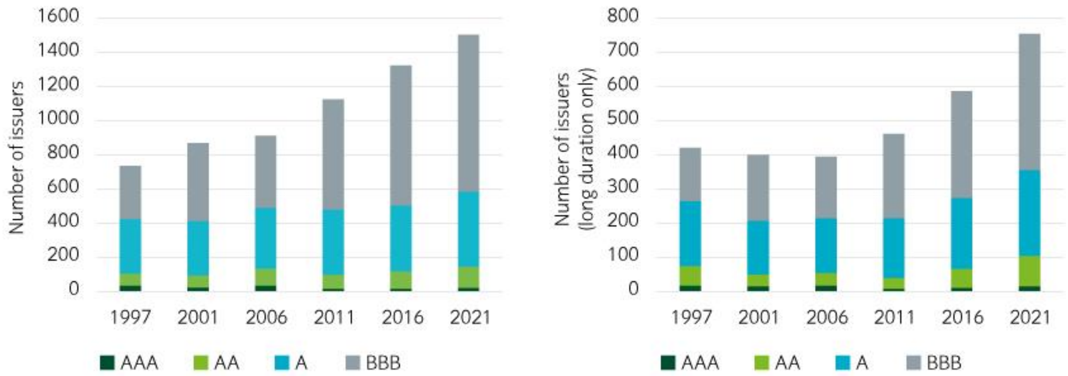
[603] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.28
[604] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.29
[605] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 72
[606] Financial Conduct Authority, Occasional Paper 14, Liquidity in the UK corporate bond market: evidence from trade data, p15
[607] CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 72
[608] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.31
[609] Insight Investment, Credit Insights: Embracing the great BBB convergence, 21st March 2021
[610] Insight Investment, Credit Insights: Embracing the great BBB convergence, 21st March 2021



13.11. This is particularly important, since where bonds within the BBB family now represent the lowest cost issuance on a weighted average basis, it is important to ensure that the notional company is funded at the lowest cost notch within BBB; we disagree with the CAA that the "notional company would be more vulnerable to the loss of its investment grade status in the "stress" cases"[611] were BBB- to be the target instead of BBB since the CAA is providing significant additional protections through the TRS mechanism and other aspects of the price control

Figures 13.2: WACC associated with BBB family ratings[612]

13.12. Even if the CAA were not to target BBB-, it is therefore still possible to target BBB throughout H7, ensuring that the notional company has sufficient protection against falling into non-investment grade ratings in stress scenarios; given that the CAA's "analysis suggests a one notch downgrade to the notional company (from BBB+ to BBB) would only have a limited impact on the cost of debt, of approximately 15 to 30 basis points", there appears to be no reason to target a BBB+ rating at the end of H7 at additional cost to consumers

13.13. It is therefore incorrect as evidenced by the capital structure of the wider Heathrow group below FGP Topco Ltd to suggest that such a BBB+ credit rating is necessary, and an error to assert so without explicitly calculating the trade-off between a higher and lower credit rating; Heathrow has repeatedly demonstrated

[611] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.32

[612] Insight Investment, Credit Insights: Embracing the great BBB convergence, 21st March 2021

its robust financeability, and the CAA must not transfer value away from consumers by doing so

13.14. As a result, we disagree with the CAA's assessment of "the credit metrics of the notional company against the threshold required for a BBB+ credit rating"[613], where this represents a higher credit rating than necessary, and which therefore results in a greater cost to consumers to support Heathrow's financeability, where the CAA's general duty in the Act is to consumers

13.15. However, we agree with the CAA that "the evidence indicates that, even at BBB, the notional company would be able to issue sufficient debt to finance its activities"[614]; as a result, there is no need for the notional company to achieve a credit rating of A- in order to be rated at BBB+ in the absence of a WBS structure

Debt Financeability

13.16. We are concerned that the CAA has redesigned the TRS with the specific intent to ensure it would "provide timely cash flow support to HAL in the event of it being triggered"[615]; given the CAA's earlier statements that "S&P has provided indication to the time period and threshold level to which a rating action would be necessary for HFL"[616] that reference a three-year period, from a consumer perspective, it is not clear why the CAA now propose a mechanism that delivers an increased cashflow to Heathrow just 13 months after a deviation from forecast

13.17. We also note that in the case of the Post Maintenance Interest Cover Ratio ("PMICR") that "for final proposals our assessment of the efficient level of baseline capex for H7 has increased materially (over £1.1bn higher) from Initial Proposals. This brings our "mid case" estimates to similar levels to actual total capex during Q6"[617]; we are concerned that the CAA may have therefore added additional capital expenditure to support this ratio unnecessary, given "that periods of low PMICR that coincide with periods of low capex do not necessarily pose a financeability issue"[618]

13.18. Where Standard and Poors ("S&P") have highlighted concerns in the actual company surrounding "key credit metric funds from operations ("FFO"), which is a measure of cash flow) to debt falling below an average of 7% for the period 2022

[613] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.98
[614] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.38
[615] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.60
[616] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.51
[617] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.61
[618] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.61

to 2024"[619], we note that Heathrow generated £755m in cashflow from operations during the first six months of 2022; this might plausibly be doubled by year end to £1.51bn versus net debt at Heathrow (SP) Ltd of £14.5bn[620], and suggests a run-rate that could lead to a figure of 10.4% on this key metric in 2022 alone

13.19. In addition, we agree with the CAA's view that S&P is unduly pessimistic for Heathrow insofar as "airports that depend more on long-haul traffic "are likely to be at the lower end"[621] of the ranges for recovery of passenger traffic; in contrast, we have seen strong passenger volumes on key long haul routes, and evidenced in our recent financial results

13.20. We therefore agree with the CAA's view that their Final Proposals "reasonably support debt financeability"[622], and based upon both actual performance, as are of the view that a substantially lower price control is also comfortably financeable; we have demonstrated this in our response to Initial Proposals, alongside a report commission by Houlihan Lokey at that time

13.21. This supports the CAA's stress testing, where we agree that it is "reasonable to assume that shareholders in the notional company would be willing and able to provide the additional liquidity required in the stress test scenario"[623]; as a result, we agree with the CAA that "even in the difficult circumstances of a stress test situation and multi-notch downgrade, our Final Proposals would enable the notional company to finance its activities"[624]

Equity financeability

13.22. We support the CAA's view that "an injection of shareholder cash may be useful in terms of providing liquidity and transitioning to a lower of gearing, which would be credit positive"[625]; we also note that the CAA's "analysis of financeability in the base case shows that our Final Proposals would allow gearing to be reduced to 60% in 2022 and then to remain at 60% for the rest of the price control period"[626] and suggest therefore that this is further evidence that a £300m RAB adjustment was unnecessary where the level of gearing has been recovered so rapidly

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619 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 69
620 Heathrow (SP) Ltd, H1 2022 results release
621 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 71
622 CAA CAP2365A, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary", para 70
623 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.138
624 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.140
625 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.79
626 CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.81

13.23. We further agree with the CAA that its approach to returns on regulated equity ("RORE") results in "a significant difference between our calculation of RORE and the approach to these matters taken by other economic regulators, as it is more usual to base RORE on an economic rather than accounting measure of profit/return"[627]; we therefore agree that "the use of RORE calculated on the basis of accounting profits does not add significantly to our understanding of equity financeability as our financial modelling already includes measures of accounting profit"[628]

13.24. We support the CAA's assessment that its "IRR analysis demonstrates that the notional company is capable of generating cash returns equal to the allowed cost of equity"[629], particularly where equity financeability is supported to such a degree by an "average annual dividend payment in H7 is projected to be £373m (CPI-real 2020) while the average nominal yield is projected to be 5.9%"[630]; given that Heathrow also benefits from RAB indexation that increases its capital value, this is extremely generous compared to "the average yield of FTSE100 companies over the period 2015-2021 [that was] 3.88%"[631]

14. Licence implementation

14.1. We note the CAA's proposal to "introduce an additional correction factor to deal with the over-recovery of airport charge revenues in 2020 and 2021 compared with the maximum yield described in the price control formula. We are introducing a bespoke arrangement so that this unusually large correction can be spread over several years during the remainder of H7. The new mechanism provides flexibility for HAL to determine how the adjustment is spread over the period from 2023 to 2026. In view of the size of the adjustment and the longer time delay, we propose that the adjustments in each year are uplifted by RPI inflation and the RPI-real WACC (rather than the Treasury Bill discount rate used in the Q6 correction factor)"[632]

14.2. Whilst we support the incentive using RPI indexation and RPI-real WACC, we are clearly disappointed that the CAA proposed to disapply the typical k-factor

[627] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.112
[628] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.113
[629] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.120
[630] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.124
[631] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 13.124
[632] CAA CAP2365D, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues", para 14.17

recovery in favour of Heathrow's financeability concerns, to the detriment of consumers

15. General comments

[Not used]

16. Q6 capex review (CAP2365 Appendix D)

16.1. Capital expenditure undertaken by Heathrow must be efficient in order to be incorporated into airport charges; as noted above in our response to the CAA's H7 capital and subsequently in the capital efficiency incentives section, it is not acceptable for inefficient capital expenditure to be incorporated into the RAB

16.2. We therefore agree with the CAA that "efficient and timely investment by HAL is key to the delivery of an appropriate level of service in the interests of consumers and to allow for the safe and secure operation of the airport"[633]; however, whilst we recognise the challenges of the ex post review process, it is our view that the CAA's conclusion on the Q6 capex review has been irrational on the basis of the evidence presented

16.3. On the basis of charges alone, the disconnect between charges at Heathrow and comparable airports is suggestive that significant, material inefficiencies have been incorporated into the RAB over time; furthermore, it is clear that capital projects at Heathrow cost substantially more than those at comparable airports, and these two factors should be suggestive of potential inefficiency in its own right, and warrant further investigation without requiring any additional evidence

<u>Presentation of additional evidence</u>

16.4. We note that the CAA states that they have "not received any new evidence from HAL or airlines on our efficiency assessment of the Cargo Tunnel"[634], yet we have consistently asked the CAA to review the project documentation submitted through the capital governance process; it is not clear to us that this project documentation has been assessed in full, which should be the minimum basis of any assessment of capital efficiency

16.5. To avoid any doubt, we incorporate by reference all project documentation and emails issued by Heathrow during the capital governance process related to the projects in question that have been subject to this Q6 capital efficient review, and

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633 CAA CAP2365E3, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Appendices D-K", para D.1
634 Ibid., para D.13

specifically ask the CAA whether all these documents have in fact been reviewed when reaching its conclusions

16.6. Furthermore, the CAA must recognise the vast information asymmetry between Heathrow and airlines, where the supporting information and procurement information are held solely by Heathrow; it by requiring airlines to provide evidence that we do not have whilst simultaneously only proposing to act where evidence is presented, the CAA in effect creates regulatory protection for Heathrow's clear inefficient practices

16.7. To be clear, the tunnel projects have consumed vast resources to date for no consumer gain whatsoever, with embarrassing hoardings surrounding the side tunnels that remain inaccessible; furthermore, the cargo tunnel remains a critical access point to the Central Terminal Area ("CTA"), yet few tangible achievements have occurred since inception of the project

16.8. It does not appear rational that expenditure that is so demonstrably inefficient could not trigger greater penalties for inefficiency, particularly where a commercial entity that had not delivered such projects would find such inefficiency penalised by write-offs and inability to earn revenues; it is irrational for the CAA to use the regulatory regime to protect Heathrow from gross inefficiencies, with just a minimal reduction in Heathrow's RAB of "£12.7 million to reflect inefficiencies identified for the Cargo Tunnel project"[635]

Q6 extension and rollover projects

16.9. It is our understanding that the ex post review conducted to date has considered only those projects in the core years of Q6, that is those from April 2014 to December 2018; since the Q6 framework was extended by one year by the Q6+1 extension, then a further two years by the iH7 extension, we are not clear whether the CAA's proposal does in fact cover capital projects during these extensions

16.10. We note the CAA's position that "further ex post reviews will take place at the end of the H7 price control"[636] within the section referring to iH7 capital projects, yet this alludes to these being rollover projects in the H7 price control; we therefore seek clarification that this does in fact cover all projects in the extension periods, whether rollover projects or not, where evidence of inefficiency may have arisen

16.11. If this were not the case, the CAA may be at risk of error by solely reviewing "capital projects that were ongoing during iH7 at the end of H7 if there is evidence that these may have been delivered inefficiently"[637] by failing to consider efficiency in the Q6+1 extension period in particular; we remain of the view that there are ongoing and systematic inefficiencies in Heathrow's procurement of capital projects, which require deep scrutiny

635 Ibid., para D.26
636 Ibid., para D.25
637 Ibid., para D.26

Final proposals

16.12. As a result, it is our view that the CAA's Final Proposals are irrational on the basis that it proposed only to "reduce HAL's opening RAB by £12.7 million to reflect inefficiencies identified for the Cargo Tunnel project"[638]; as mentioned above, we believe this inefficiency to be materially greater given the overwhelming evidence in this regards

16.13. We support the CAA's intention to "reserve the option of conducting a further review of efficiency of the Main and Cargo Tunnel projects once those projects are complete (or at the end of the H7 price control period if this is earlier)"[639]; however, it is our view that the CAA would be obligated to conduct such a review on the basis of the evidence of inefficiency to date, given the CAA's duties in CAA12 to ensure that charges are not inefficient

16.14. We consider the CAA's position not to "make any further adjustments in relation to the remaining eight capital projects we have reviewed" irrational[640]; this is particularly the case where the level of expenditure has clearly exceeded that at comparable airports, and Heathrow's charges are therefore demonstrably inefficient as a result

16.15. We support the requirement that Heathrow "is required to update its capex governance documents"[641], and remain particularly keen to see the CAA engage thoroughly in this update process, participating fully in the development of new arrangements; we are particularly concerned that the CAA has not been sufficiently familiar with the current governance arrangements during this periodic review to be able to identify poor behaviour, such that Heathrow has not been sufficiently held accountable for its deviation from governance arrangements, which themselves are primarily designed to promote efficiency

16.16. We support the CAA's position that it "may review capital projects that were ongoing during iH7 at the end of H7 if there is evidence that these may have been delivered inefficiently"[642]; however, as above, we query the validity of this without reference to the Q6+1 extension period, and given the demonstrable inefficiencies we identify across Heathrow's capital expenditure portfolio

17. Early expansion costs (CAP2365 Appendix E)

17.1. We remain disappointed by the CAA's approach to expansion costs, which remains fundamentally at odds with the promises made to the Department for Transport

638 Ibid., para D.26
639 Ibid., para D.26
640 Ibid., para D.26
641 Ibid., para D.26
642 Ibid., para D.26

("DfT") , as set out in our response to Initial Proposals; ultimately, the selection of this particular project delivered by Heathrow without introducing any competitive procurement, without constraints on funding, and without a bespoke regulatory regime similar to the Thames Tideway Tunnel has led to substantial regulatory protection for Heathrow which is not only irrational but also detrimental to consumers and airlines

17.2. This is an unacceptable state of affairs, compounded by Heathrow's unwillingness to declare that it is either unable or unwilling to deliver expansion by the 2030 deadline required under the Airports National Policy Statement ("ANPS"); the truth is that expansion is the only prospect Heathrow has for continued growth of the RAB, where the prospect of substantial RAB growth elevates the value of the business

17.3. As a result, whilst Heathrow's current owners are not prepared to declare that they have unilaterally withdrawn, it is clear that Heathrow has consciously chosen not to proceed evidenced both by the lack of activity and the wind-up of personnel, contracts and projects; it is clear to any independent observer that expansion is impossible to deliver before the 2030 requirement of the ANPS

17.4. Consumers and airlines should not be responsible for bailing out Heathrow's investors from their poor investment decisions, and the CAA cannot be complicit in elevating the RAB to unsustainable levels by incorporating inefficient investment; it would be an error for the CAA not to recognise the current situation that Heathrow has engineered to allow it to simultaneously recover all inefficient costs incurred to date whilst maintaining an option of expansion to artificially elevate its prospective RAB, a project it has no current intentions, concrete plans or organisational ability to deliver

Policy for recovery of costs

17.5. We remain particularly concerned by the CAA's approach to Heathrow's recovery of early expansion costs, where "Category B and Category C costs incurred by HAL before March 2020 can be added to the RAB at the beginning of 2022"[643]; it is an error for the CAA to apply previous policy related to Category B costs retroactively to Category C costs, which were not only incurred at Heathrow's own sole risk in the absence of regulatory policy, but were not subject to any governance arrangements at the time they were incurred

17.6. In particular, this lack of governance resulted in a state of affairs whereby there was no oversight by either airlines or the CAA of the expenditure incurred, with £130m[644] of expenditure now estimated, a number that continues to rise with each consultation; where Heathrow had previously been judged to have insufficient records to support its claims, we question how the CAA can possibly consider this expenditure to have been efficiently incurred, and doing so must be in error

643 Ibid., para E.11
644 Ibid., table E.1

17.7. In addition, the disapplication of consumer protections promised to the DfT are an error, where the CAA confirms that "risk sharing arrangements, recovery caps for costs incurred in 2020 and 2021, enhanced reporting requirements and a new licence condition on governance arrangements are no longer necessary or appropriate due to the pausing of expansion"[645]; these protections were promised by the CAA to the DfT in order to prevent "a risk that HAL or its investors could unreasonably "hold out" for a better regulatory settlement or Government support before continuing with capacity expansion"[646], a situation that has undeniably come to pass

Wind down and appeal costs

17.8. Similar to our position related to Category C costs, we remained concerned that wind down and appeal costs have not been subject to any governance arrangements; in particular we highlight the logical disconnect between Heathrow's success in appealing the judgement that had initially deemed the ANPS to be illegal, yet has continued to wind up the expansion project, which suggests the CAA's position – that Heathrow has not unilaterally withdrawn from the expansion project – is not correct

17.9. As set out above, Heathrow has been permitted to achieve near full incorporation of expansion costs in the RAB without being held accountable for either the risk sharing percentages or action that the CAA promised to the DfT in such circumstances

17.10. It is for this reason that we are primarily opposed to the CAA's position that "HAL should be allowed to add wind down costs to the RAB in full"[647]; these remain costs that have not been subject to any detailed airline assessment, and that have been essentially incurred at Heathrow's own sole discretion

17.11. The same position informs our view of appeal costs, where Heathrow appears to benefit from the CAA's position that Heathrow have not unilaterally withdrawn from the project, contrary to the facts on the ground and the clear contradiction with the reality of allowance for wind-up costs above; given the fact the appeal has restored the legality of the ANPS and Government policy remains unchanged in supporting Heathrow expansion

17.12. Ultimately, it is our view that the CAA erred in allowing *simultaneously* all wind up costs, IPHS and appeal costs to be incorporated into the RAB; it is irrational to consider that wind-up is not related to unilateral withdrawal when the ANPS holds

645 Ibid., para E.12
646 CAA letter from CEO Richard Moriarty to Department for Transport Permanent Secretary Bernadette Kelly, "Airport National Policy Statement: the CAA's approach to economic regulation of the expansion of airport capacity at Heathrow", p4, part of a serious published at this link
647 Ibid., para E.45

legal status, or alternatively to allow appeal and IPHS costs whilst at the same time allowing recovery of wind-up costs

Efficiency assessment

17.13. In line with our concerns related to the assessment of efficiency for Q6 capital expenditure, we remained concerned with the degree of information asymmetry inherent in this assessment of Heathrow's expansion costs, particularly as airlines have not been present when the CAA "raised questions with HAL and held "deep dive" sessions with a range of relevant HAL subject matter experts, to form a view on the evidence submitted"[648]

17.14. Similar to many other areas across this periodic review, this appears to give Heathrow a significant advantage, whereas airlines are limited in what they are able to challenge and given little opportunity to engage in substantive discussion of Heathrow's positions; this does therefore appear to be an approach that is one-sided, unfair and biased

17.15. In particular, we are concerned that the budgets originally devised were ultimately ineffective, suggesting that financial incentives put in place to hold the project team accountable were not in fact enforced; in relation to Category B costs, the £1m proposed disallowance at Initial Proposals that has now been reduced to zero[649] has been on the basis of "additional information in relation to the complexity of the work involved"[650] where "exact requirements became known after the development of the budget"[651]

17.16. This is indicative of a rushed and ineffective approach to financial planning and control, and suggestive itself of further inefficiencies across Heathrow's expansion expenditure; there appears to have been little accountability for the expansion team in respect of budgets and at odds with the capital efficiency intentions of the CAA and requirements of CAA12

17.17. Furthermore, airlines have to date seen no detailed analytical review of the expansion budget compared to actual expenditure, with no communication on expansion expenditure following the wind-up of the project at the start of the pandemic, at an expansion board meeting attended by airlines and the CAA; governance arrangements have therefore been wholly ineffective at allowing airlines to challenge Heathrow's budget and expenditure in this area

17.18. In addition, the CAA's justification for reducing its assessment of inefficiency appears to lack substance, where for example it states that "it appears that the

[648] CAA CAP2365E3, "Economic regulation of Heathrow Airport Limited: H7 Final Proposals Appendices D-K", para E.37
[649] Ibid., table E.6
[650] Ibid., table E.6
[651] Ibid., table E.6

additional spend helped reduce risk at the DCO"[652]; the information provided by Heathrow should definitively answer such questions, and if it does not, is suggestive of inefficient expenditure

17.19. As a result, the CAA's conclusions that reduces its disallowances of Category B costs from Initial Proposals, and indeed the level of disallowances that it proposes appear irrational based upon the lack of concrete evidence provided by Heathrow; further, was wrong to not apply not applying the risk sharing arrangements as a result of Heathrow's clear, unilateral withdrawal from the expansion project

17.20. In relation to Category C costs, we support the CAA's conclusions that result in disallowances in relation to major commercial acquisitions, colleague costs, programme leadership, terminals and motorways as a result of insufficient evidence to address previous CAA concerns; we note that the additional expenditure for ground investigations was "related to the resolution of final contract costs with the suppliers"[653] and split between Category B and Category C expenditure

17.21. It is not clear whether these ground investigation costs relate to close out of the contracts as a result of Heathrow's withdrawal from the expansion project, and therefore remain concerned that allowance of these particular costs endorses Heathrow's unilateral withdrawal without formal recognition of this clear reality; in addition, where costs have inflated beyond budget, we reiterate our view that risk sharing percentages should be applied per previous regulatory policy

Implementation

17.22. We agree with the CAA that "any future sale proceeds from properties acquired under the Interim Property Hardship Scheme, or any other properties acquired for the purpose of airport expansion, will be deducted from the RAB as "proceeds from disposals"[654]; this is the correct application of existing RAB rules under the single till, however, we do not have sufficient visibility of the assets held by Heathrow either under its expansion plans or elsewhere on or near the airfield to assess whether Heathrow is or is not holding onto assets longer than necessary

17.23. As a result, we are concerned that Heathrow may hold on to assets that are not economically productive or provide sufficient rental yield to justify their continued inclusion in the RAB; we agree that Heathrow should "sell properties acquired under this scheme at market value in accordance with the ordinary rules of disposing of properties"[655], though they should clearly only be sold if they are not required under any expansion plan

[652] Ibid., table E.6
[653] Ibid., table E.7
[654] Ibid., para E.57
[655] Ibid., para E.58

17.24. Finally, we welcome the CAA's statement that "if capacity expansion were to restart, we should have an established policy on the treatment of costs"[656] and that "in the circumstances of the capacity expansion programme restarting, we would consult stakeholders on these matters"[657]; it is clear that this second, failed expansion project has once again landed consumers and airlines with the invoice for Heathrow's expenditure designed to meets its aspirations of RAB growth rather than deliver any tangible consumer outcomes

Conclusion

17.25. In summary, we remain opposed to the CAA's treatment of expansion costs, which we believe are subject to inconsistent regulatory policy, and have been applied in an illogical manner; the most material error is the conclusion that Heathrow has not unilaterally withdrawn from the expansion project despite all evidence to the contrary, and stemming from this allowing Heathrow to recover wind-down costs, an act that is inconsistent with the statement that Heathrow has not unilaterally withdrawn from the project

17.26. Further to this, in allowing Heathrow to retroactively recover Category C early construction costs – being costs related to early construction that Heathrow had incurred at its own sole risk and the in the absence of regulatory policy of governance being in place – under the same policy at Category B costs; in addition, the disapplication of risk sharing arrangements that might apply were the expansion project to have failed undermines the purpose of those arrangements that were to ensure Heathrow did not spend inefficiently

17.27. Finally, we are deeply concerned by the efficiency assessment performed on the Category B and Category C costs, particularly as a result of the vast information asymmetry and lack of governance arrangements that surrounded the expansion project; we have no visibility of the information that Heathrow has provided to the CAA nor any reasonable means of challenging its assessment, which ultimately undermines the important role that airlines play under CAA12 in the economic regulation of Heathrow

18. Capex incentives (CAP2365 Appendix F)

18.1. Further to our comments above, we note that the "capex allowance set by us is based on the most recent business plan proposal by HAL, as part of the RBP Update 2"[658]; we reiterate that there has been no formal mechanism for us to provide feedback to the CAA of this particularly business plan, a fundamental weakness in the process that is contrary to the intent of CAA12 and likely to result in errors of judgement arising

656 Ibid., para E.59
657 Ibid., para E.59
658 Ibid., para F.5

18.2. We are therefore concerned that where "Arcadis have advised that the capex categories contained in HAL's RBP Update 2 (using the 10 sub-capex categories in the Asset Management and Compliance programme proposed by HAL) are compliant with the CAA definition"[659] that these have not been robustly assessed by airlines through any process of engagement

18.3. Nevertheless, we agree with the CAA that "for the ten Asset Management and Compliance ("AM&C") capex categories, HAL proposed using OBR measures as delivery objectives"[660] this would be inappropriate; in particular, we agree with the CAA that "we do not agree that performance against the OBR framework should be the primary means of assessing effective capex delivery"[661]

18.4. In addition, we agree with the view of Arcadis, the CAA's advisors, that "most of the delivery objectives…do not meet the SMART test"[662], though are alarmed that Heathrow have been permitted an increased capital expenditure envelope since Initial Proposals despite a "level of granularity of information available at this stage about the H7 capex plan means that Arcadis has not been able to finalise the delivery objectives"[663]

18.5. Given the abundant information available to Heathrow on its operations and the capital investment requirements for a two runway airfield, it should be particularly straightforward to provide the required information to the CAA in order to define the capital expenditure envelope; to allow Heathrow an increased allowance from Initial Proposals despite a "lack of specific quantified metrics which are to be developed by HAL at a later stage of the programme development process"[664] is fundamentally flawed

18.6. We note the CAA's request that they "expect HAL to work with airlines to continue defining the outcomes, outputs and timescales for the H7 capex categories over the next few months, into well-defined delivery objectives"[665], though are concerned that this is not specified in any particular licence obligation; it would be an error of judgement to expect Heathrow to genuinely engage without any incentive mechanism that would oblige this engagement to take place

Reconciliation process

18.7. We note that the example of the reconciliation process suggests that it should "calculate the NPV of the overspending or underspending, reflecting the financing costs during H7"[666], though later states that the example "does not consider

659 Ibid., para F.6
660 Ibid., para F.8
661 Ibid., para F.8
662 Ibid., para F.9
663 Ibid., para F.10
664 Ibid., para F.10
665 Ibid., para F.12
666 Ibid., para F.25

inflation"[667] albeit under a simplified assumption; for clarity we would seek to understand whether inflation is included, which would be the correct and consistent approach to calculating the present value of any figures

18.8. Nevertheless, we agree with the CAA that the "objective of the reconciliation calculations is to ensure that an adjustment is made at H7 so that any overspending (or underspending) by HAL during the H7 period is subject to the same incentive strength regardless of the year in which it occurs"[668]; it important that no party unduly benefits from anomalies in the calculation of the time value of money

Jacobs report

18.9. We welcome the CAA's view that the Heathrow-commissioned "Jacobs report does not offer a balanced view and we do not agree with its main conclusions in terms of the HAL programmes that are suitable for ex ante incentives"[669]; in particular, the report's conclusions did not follow from the evidence that it had assessed, and many of the examples used were inappropriate

18.10. The CAA therefore draws the correct conclusions in its assessment of ex ante capital incentives, both that "Jacobs did not take into account the CAA proposed approach of holding HAL to account against baselines and delivery obligations set at G3"[670], and that Jacobs overlooked a number of key issues such as relatively lack of complexity, lower age and governance arrangements in place in other sectors[671]

18.11. Furthermore, we also disagree with the Jacobs ex ante criteria, and in particular agree with the CAA that "we do not consider that these criteria are the right ones to use in determining which projects should be in the scope of ex ante incentives"[672], noting in particular the successful application of ex ante capital incentives in other sectors of greater complexity (e.g. complex tunnelling operations at the Thames Tideway Tunnel project)

19. Capex incentive framework assessment (CAP2365 Appendix G)

19.1. We agree with the CAA's assessment of ex ante capital incentives against its duties, as mapped in its assessment[673]; these are both balanced and in keeping with the CAA's duties under CAA12, in particular "targeting an intervention at a case where action is needed"[674], as is the case with capital expenditure, where governance arrangements need reinforcing to control capital expenditure, and prevent an

667 Ibid., para F.27
668 Ibid., para F.28
669 Ibid., para F.33
670 Ibid., para F.36
671 Ibid., para F.37
672 Ibid., para F.38
673 Ibid., table G.1
674 Ibid., para G.6

excessive RAB from resulting in charges that are at significant divergence from those at comparable hub airports

19.2. We therefore agree with the CAA on the key issues, being that the "Q6 approach does not provide sufficiently strong commercial incentives on HAL to ensure projects are delivered on or below budget"[675], and in particular that "it is not always clear to airlines whether the benefits/outputs from projects have been delivered"[676]

Ex post reviews

19.3. Whilst we agree that "ex post assessments can be challenging and are likely to require expert judgement and a broad evidence base to identify inefficiencies"[677], we have been disappointed by the execution the ex post reviews in the Q6 period, where what we view as clear inefficiencies supported by strong evidence have not been recognised as such by the CAA, perhaps as a result of the limitations described by the CAA in conducting such reviews[678]

19.4. Nevertheless, it is our view that there remains a place for limited ex post assessments in addition to ex ante incentives, and whilst we note a desire to "eliminate the need for ex post efficiency reviews by the CAA"[679] it is incumbent on the CAA to ensure it has access to ex post reviews as a regulatory tool where necessary should its new incentives be less effective than it intends at this periodic review, ensuring a consistent regulatory incentive can be achieved as a result

19.5. For example, when assessing Heathrow's performance against baseline across the capital portfolio, were these found to be "systemically inflated against historical averages"[680], the CAA would need to apply a mechanism to correct for such gaming of the incentive; this is particularly relevant as Heathrow has said it might increase risk allowances to projects as a direct result of capital incentives, and only an ex post review could claw back such inefficiency

Rationale for approach

19.6. We agree with the CAA that Heathrow's inability to recover financing costs associated with any over-spending "is not targeted at encouraging cost efficiency and could create perverse incentives on HAL to delay spending"[681], and

[675] Ibid., para G.11
[676] Ibid., para G.11
[677] Ibid., para G.11
[678] Ibid., para G.12
[679] Ibid., para G.14
[680] Ibid., table G.2
[681] Ibid., para G.11

furthermore that "incentives to ensure that projects are delivered on time are not strong enough under the existing approach"[682]

19.7. The CAA is correct to seek to "create appropriate incentives for HAL to make capital investments efficiently"[683] at this periodic review and agree that "as a result of the impact of the covid-19 pandemic mean that efficiency and value for money will be particularly important"[684], although we caveat that it has always been important to ensure the charge is efficient

19.8. Furthermore, we agree this remains appropriate given the above observations of drawbacks in the Q5 and Q6 capital expenditure regime, and support the CAA's view that the lack of any expansion project in the H7 price control (and ultimately Heathrow's apparent unilateral withdrawal) is not a relevant determinant of whether to introduce these incentives

Assessment against duties

19.9. We expect that the development phase of projects will indeed become more detailed, such that "the quality of this work should help to lower costs by optimising designs and minimise the prospect of cost overruns"[685] as planning work allows projects to be costed at G3 on the basis of robust P50 cost estimate; doing otherwise would result in continued cost inflation seen today as poorly-planned and delivered projects cause additional cost over-runs

19.10. It is our view that the CAA's proposals include more than sufficient flexibility for Heathrow to be able to managed should greater capital be required during H7; in particular, "will have two opportunities to request CAA to increase the value of the envelope"[686] should it find airline support, supported by continued and significant "airline involvement in the development to core process"[687]

19.11. However, we do not agree that removal of any existing asymmetry is necessary to ensure that "these arrangements should represent a "fair bet" for Heathrow"[688]; we note numerous other capital efficiency incentive arrangements in other UK regulated sectors that do not use symmetrical rates in order to drive specific behaviours, and this point was covered in our response to Initial Proposals[689], which we incorporate by reference

682 Ibid., para G.11
683 Ibid., para G.13
684 Ibid., para G.13
685 Ibid., table G.2
686 Ibid., table G.2
687 Ibid., table G.2
688 Ibid., table G.2
689 British Airways response to CAA CAP2265

ANNEX TWO: ALIX PARTNER'S REPORT TITLED "ANALYSIS OF THE CAA'S FINAL PROPOSALS"

ANNEX THREE: CEPA'S REPORT ON THE COST OF CAPITAL