

# Economic regulation of Heathrow airport: H7 Final Issues - CAP2980 Heathrow Airport Ltd response

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## Introduction and Summary:

- 1 This document sets out Heathrow Airport Limited's (Heathrow) response to the CAA's (Civil Aviation Authority) consultation on H7 final issues, CAP2980. Heathrow is supportive of finalising key decisions related to the implementation of H7 in this consultation as soon as possible. The CAA's final proposals that will follow industry responses to this consultation, must be implemented swiftly, clearly, and ahead of Heathrow's 2025 charges consultation.
- 2 Finalisation of these issues is also important to provide certainty to all stakeholders, as Heathrow continues to make positive progress on delivering against our plans for our customers, under the H7 settlement. Over 450 capital investment projects are underway across six programmes, with over £1bn invested in the first two years of the H7 period alone (2022 and 2023). This includes our next-generation Security Programme which continues to progress towards completion of 146 lanes in total, and our T2 baggage system replacement – both delivered amongst a period of high passenger demand.
- 3 These investments have also come against a backdrop of continuing passenger satisfaction. In the first three months of 2024 alone, Heathrow achieved the highest overall passenger satisfaction score since Q1 2022, despite passenger numbers up by 11% compared to 2023. This has been driven by strong security performance - with the vast majority of direct passengers passing through security within 5 minutes - and improved operational performance across the airfield - resulting in departure punctuality outperforming arrivals.
- 4 Heathrow is also proactively playing a role in the price control lessons learned exercise (delivered via CAP2618, "Setting Future Price Controls") and is committed to being a constructive and engaging partner to the CAA as we look towards the next price control review, H8.
- 5 Whilst Heathrow is disappointed in the delays to the publication of this consultation – finalising the issues outlined and providing clarity on CAA positioning ahead of the upcoming H8 process, is vital. Heathrow has proceeded with its business planning over the last year at considerable risk (given the financial impact any changes to many of these issues will have in the final two/ three years of the H7 period), and the CAA must use this as a catalyst for change on establishing clear, transparent, and realistic set timelines during the H8 process.
- 6 Heathrow has provided a detailed response to those of the most importance, below, however a summary of our overall response to CAP2980 is as follows:
  - **Maintain** the CAA's revised AK factor proposal (but **review and remove** the passenger mix element to align more closely with CMA final determination) and Shock Factor level;
  - **Reinstate** the CAA's original H7 proposals on Pension Deficit Repair Costs (PDRCs) and premiums on index linked debt, to deliver against clear historical CAA positions and CMA expectations;
  - **Recommend** a new approach to mitigating the risk of a significant rise in Business Rates from 2026;
  - **Amend** the current licence to "tidy up" issues surrounding Control Post MTIs, TDOC under recovery, and resource certification;
  - **Commit** to providing clarity and certainty to how the CAA will treat and approach all CAP2980 issues outlined, during the H8 process.
- 7 Alongside the response to each individual element, it should be noted that Heathrow does support the approach taken by the CAA in CAP2980 regarding implementation – making the adjustments within H7 itself through the price cap and splitting the adjustments between the AK factor (the most significant) and the other licence adjustments (H7t).

## The AKt Adjustment Factor

- 8 Heathrow welcomes the initial changes proposed by the CAA on the AK factor in CAP2980, as a result of the CMA's final determination in October 2023. The CMA was clear in its findings that the approach the CAA took towards calculating the AK factor was wrong, and that it required a detailed analysis. However, Heathrow is concerned as to whether the CAA has undertaken the analysis required, particularly on key elements of the AK factor, such as the passenger mix.
- 9 Heathrow's position during the H7 process and during the CMA appeal was that there was no over-recovery, given the significant impact of Covid-19 on both operations and revenues. Revenues were down 70% below target, with £3.8bn of losses during the two-year period 2021-2022. Heathrow strongly disagreed with the original AK factor adjustment value as this equated to more than 25% of our aeronautical revenues over the relevant period.
- 10 Heathrow agrees that the correct interpretation by the CAA of the CMA's decision, results in a significant reduction in the AK factor applied in respect of 2020 and 2021. The CMA's decision stated clearly that a recalculation would inevitably lead to a reduction, which has now been delivered. Heathrow welcomes the CAA confirming this in their final proposals, and as a result, that this proposal now sits as the baseline maximum level that any AK factor can and should sit - meaning there should be no further upwards adjustment.
- 11 The importance of confirming that is that Heathrow's business plan for 2024-26, which it is currently seeking to implement, is predicated on this correct interpretation of the CMA's decision and that any adjustment upwards counter to this would likely lead to consumer harm by reducing available revenues.
- 12 Heathrow also agrees with the CAA decision to deal with the AK factor during the current H7 price control, rather than roll into H8 – and agree with the CAA that failing to do this “*would increase the costs for future consumers and would not be in their interests*”. However, Heathrow considers that the CAA's approach does not align with the CMA's final determination requiring further detailed analysis, in respect of the passenger mix calculation.
- 13 Whilst the CMA did not point to a specific alternative means of assessing the appropriate level of the passenger mix element of the AK adjustment in its judgment, it was clear in its judgment that:
- the CAA did not have the evidence to show that the differences between Heathrow's actual yield per passenger, and the amounts allowed under its price control, were because of any 'failure' on the part of Heathrow;<sup>1</sup>
  - Heathrow's submissions regarding airlines' decisions to fly planes with fewer passengers on board are relevant to the calculation; and<sup>2</sup>
  - the CAA was wrong not to have considered whether it was more appropriate to calibrate each component of the AK factor adjustment more closely to Heathrow's actual over-recovery;<sup>3</sup>
- 14 The CAA's proposed response in CAP2980 to these points from the CMA was to apply a seemingly arbitrary 50% sharing of the amount with the consumer – however, Heathrow has not seen full justification for how the new passenger mix value was properly considered and evaluated by the CAA.

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<sup>1</sup> CMA H7 FD para 10.114

<sup>2</sup> CMA H7 FD para 10.120

<sup>3</sup> *ibid*

- 15 This is particularly the case when the CMA's ruling note that the airlines' decisions to fly aircraft with fewer passengers "*should have attracted further assessment and due consideration by the CAA, as it represented a clear risk that the correction factor arrangements might generate perverse outcomes*"<sup>4</sup>.
- 16 As such, and to ensure the CAA's approach to analysis surrounding the AK factor is both consistent to the other elements of that make up the AK factor calculation, and has direct regard for the airlines decisions to fly plans with fewer passengers, Heathrow proposes that the CAA **revisit and remove the over recovery element of the passenger mix linked to airlines low load factors, and consistently apply the same 'scaling' approach as implemented on the Development capex and business rates elements, for the remaining passenger mix contributions.** This would reduce the overall AK factor to £52m, from the CAA's £75m proposal in CAP2980<sup>5</sup>.

### The H7t Factor

#### The Shock Factor:

- 17 Heathrow supports the CAA in their position outlined in both the H7 Final Decision from March 2023 (FD) and CAP2980, that "*the shock factor is an appropriate tool for producing a risk-weighted forecast for the purpose of a price control*"<sup>6</sup>. As further outlined in Appendix C of CAP2980, a number of "shock" events have taken place over the past 30 years where the application of a shock factor is entirely right and proper.
- 18 Heathrow also notes that in response to CAP2618, Virgin Atlantic noted their opposition to the CAA's inclusion of the "Shock Factor" in the H7 FD, despite the clear ruling from the CMA to the contrary. This is clearly not accurate given the CMA's ruling, and the CAA must ensure they include shock factor provisions ahead of H8 despite calls from airlines to the contrary.
- 19 In its Final Determination, the CMA outlined that whilst the CAA was wrong in its approach to calculating the "shock factor" for the FD, it was clear that the CMA were not in a position to conclude that the 0.87% Shock Factor level calculated and outlined by Heathrow itself, was wrong.
- 20 Heathrow is therefore **supportive of the analysis undertaken by the CAA as a result of this appealed issue, and the affirmation of Heathrow's shock factor** calculation for 2023-2026, at 0.87%.
- 21 Despite the forecasting challenges seen and acknowledged by the CMA throughout the years of the Covid-19 pandemic for all stakeholders, Heathrow's approach to this element was right and proper, with 0.87% being appropriate for the remaining H7 period. The underlying approach to calculating shock factors has now been scrutinised significantly over the past few years (both the principle, the approach and the methodology) and found to be correct. Going forward, the CAA should also commit to an approach which takes as its

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<sup>4</sup> [CMA H7 FD, para 10.116](#)

<sup>5</sup> **Airline Load Factors:** Full remove of airline low load factor element of pax mix = £8m in 2020; £16m in 2021 = £24m (CPI, 2020) (To note, half of impact already removed as per 50% proposal from CAA in CAP2980).

**Rest of Pax mix:** Alignment of rest of pax mix to CMA scaled approach for development capex and business rates = -£1m in 2020; £0m in 2021 = Total -£1m (CPI, 2021)

**Final AK Factor:** -£21m in 2020; -£31m in 2021 = total -£52m (CPI, 2020)

<sup>6</sup> CAP2980, paragraph 3.3, page 31, March 2024

starting point Heathrow's methodology for calculating future shock values and engage with Heathrow on that basis.

#### **Premium applied to index-linked debt:**

- 22 The CAA in its initial proposals for H7 in 2021, stated that *"it would be inappropriate to penalise HAL unduly by preventing it from recovering costs associated with issuing index-linked debt"*<sup>7</sup>. Heathrow agrees with this statement.
- 23 Heathrow's business plan submissions as part of the H7 process provided our view and evidence of the premiums associated and note that the CAA's initial proposals which accepted Heathrow's calculation and included the above statement, were not challenged by any other stakeholders before the FD was released in March 2023.
- 24 Alongside this, the CMA decision that this issue be reconsidered was only due to view on the sample size outlined and added in their statement that *"under proper scrutiny, this additional evidence is useful in forming a view on the appropriate index-linked premium"*<sup>8</sup>.
- 25 Given the above information throughout both the H7 process and from the CMA's final determination, it is important that the above principles and positions are used as the basis for future CAA decision making on this issue.
- 26 As such, Heathrow believes **the dismissal of the additional evidence provided by the CAA's advisers Centrus, is not correct** and does not align with views of the CAA in 2021 and the views of the CMA in 2023.
- 27 At each stage where further analysis of this issue has been conducted, it has proven that there is a premium, and that this premium sits at the level Heathrow initially proposed at the early stages of H7. This is reflected within the Centrus analysis which demonstrates an inflation linked premium at every iteration of its assessment of comparables. If the evidence gathered demonstrates the premium exists, and if the CAA's original 2021 position that Heathrow should not be penalised for premium this remains – it would be seem remiss of the CAA to not use whatever evidence it has at its disposal (which at each stage has been developed further and added to, but reinforced the same level) to ensure Heathrow is not penalised.
- 28 Whilst Heathrow welcome the consistent reinforcement of the existence of the premium itself in the analysis undertaken, the reason for the rejection of the premium in CAP2980, is inconsistent.
- 29 There has also been no clarification from the CAA on what a correct sample size should be following the CMA appeal. The CAA states that *"there is an evidentiary threshold needed to conclude on the existence of an index-linked premium"* – however this threshold has not been explained or outlined in the proposals in CAP2980.
- 30 Specifically, Heathrow believes the CAA should consider the following when re-evaluating their position:
- The original FD decision was based on five bonds, but the new CAA analysis on 17 comparisons. This is a clear step up in the evidence base – which the CMA stated would be useful in forming a view on the appropriate index-linked premium.

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<sup>7</sup> [CAA H7 Initial Proposals, Section 2: Financial Issues, para 9.218](#)

<sup>8</sup> [CMA Final Determination, October 2023, para 7.299](#)

- Whilst the data set is not large, this is a reflection of the lack of liquidity which results in an illiquidity premium. Further there is scope for more bonds to be explored, as a simple search of non-financial GBP linker issuances in Bloomberg resulted in more than 250 bonds which included entities seemingly not considered by Centrus, for instance Wessex Water and Thames Tideway.

31 In the comparables considered by Centrus, a negative premium was found in 5 of the 17 peer sets, showing inflation linked debt to price inside of nominal fixed debt – suggesting a negative premium does not feel credible or substantial. As has been demonstrated through the pricing construct previously provided and would be confirmed through any expert witness testimony, the mechanism for pricing an inflation linked corporate bond starts with taking the most appropriate nominal secondary spread and adjusting it for illiquidity and tenor, where appropriate. As a result, the nominal spread is an input into the inflation linked spread which has a further spread applied, refuting the ability for there to be a negative premium.

32 Furthermore, when exploring the bonds which were deemed to have a negative linker premium, errors in calculation were found. For example:

- Centrus have cited Yorkshire water to have spreads of 131bps and 160bps for the linker and nominal bonds respectively. However, Heathrow found the linker issuance of with a coupon of 3.31% which issued at par, to be c.2.37% over the Linker Gilt which was trading at c.0.93% on the date of issuance, whilst the nominal spread for this paired bond is cited in Bloomberg at 125bps. The Yorkshire bonds were issued 10 years apart which provides difficulty in comparing them as idiosyncratic Yorkshire Water considerations would drive significant shifts in their spread relative to the iBoxx, irrespective of whether the bond is nominal or linker.
- Centrus do not state their method of adjusting for issuance date using the iBoxx, however Heathrow found that the average iBoxx A&BBB yield to be 6.77% at the issuance date for the linker bond. Heathrow can adjust the yield of the bond of c.3.31% to deduce the yield an equivalent nominal bond using the Fisher formula for inflation assumptions, which sees the yield to be c.6.74%, and therefore 3bps inside the iBoxx. Given the yield of the nominal paired bond was 2.81% at issuance against an iBoxx of 3.07%, 26bps inside of the iBoxx, therefore a 23bps linker premium can be found.
- Heathrow believes that the National Grid trade is a better reflection of the premium as both the linker and nominal bond were executed within months of each other and therefore idiosyncratic moves in the corporate credit relative to the iBoxx will be of lesser impact. The nominal National Grid bond was issued at 5% when the 01/03/2005 Gilt was trading at 4.573%, implying a spread of 43bps. The linker issuance yield of 2.28% was a premium of c.80bps over the linker Gilt of 1.49%. This implies a c. 37bp Linker premium. However, as the iBoxx to have decreased from 5.63% to 5.44% between nominal and linker issuance, Heathrow can adjust lower the spread by 19bps and find a linker premium of 18bps.
- As Cadent suffers from the 2 bonds being issued 9 years apart and National Rail benefits from the government guarantee as cited by Centrus, Heathrow does not see any credible negative linker spreads from the analysis.
- Finally, even with negative spreads, Centrus stated that the data implies that there is an average premium in the range of 10-20bps, indicating that some spreads were sufficiently larger than 20bps to offset the negative spurious anomalies. Whilst Heathrow questions the existence of negative linker spreads, Heathrow expects that the average of a data set is a sensible point to be reflected in future issuances and applied through the

regulation, as Heathrow has previously evidenced, and do not believe that confidence has been undermined in the existence of a spread.

- 33 In addition, whilst Heathrow acknowledges the CAA's commentary on the use of fixed debt and inflation linked swaps to achieve inflation linked exposure, we do not understand how the CAA can conclude that this leads to no premium for IL debt. These trades are executed with bank charged spreads and are not at zero cost. Any such cost is on top of the cost of the fixed debt, and therefore it is a clear error for the CAA to conclude that the availability of this approach supports a view that the premium for IL debt is zero. This conclusion can only be correct if banks provide IL swaps at zero cost which is clearly not correct. The use of such approaches, despite the additional cost of the swaps, demonstrates that IL debt has a higher cost, otherwise the IL swap approach would not be cost effective and would not occur.
- 34 As a result of the above, **Heathrow believes that the CAA should revisit this decision** – recognising that the sample size has continued to increase, and proven the initial analysis correct, and delivers against the CAA's original positioning in 2021 and the CMA's views in 2023.
- 35 It is also important that the CAA clarify whether they intend to do similar analysis of this issue for H8 and that they commit to further work on the required evidence base, or whether they believe there is no further sample size that is relevant to consider. Heathrow would propose the former.

#### **Pension Deficit Recovery Contributions (PDRCs):**

- 36 Heathrow's overall pension scheme includes sections for Heathrow (referred to as "regulatory fraction" in Q6) and for pensioners at Stansted, Gatwick and Edinburgh at the time these airports were separated from BAA. For the previous regulatory period Q6, the CAA made it clear that the relevant pension scheme for regulation of Heathrow was the Heathrow section only, and that the performance of the other section was a shareholder risk.
- 37 Heathrow consistently flagged the Q6 approach as relevant precedent and provided information to the CAA on this basis throughout the H7 process, to help assess an appropriate PDRC allowance. Heathrow has also been clear in its position and engagement with the CAA surrounding PDRCs – most notably, that there is a risk PDRCs will be required to recommence from 2026 onwards (that is, following the upcoming 2024 valuation). Given a key tenant of the CAA's opex allowance development is ensuring efficient costs are covered (with pension costs of employees aligned to delivery of that operation being an evitable element of this) Heathrow does not support the CAA's decision to remove the opex allowance in this consultation.
- 38 As such Heathrow believes the CAA's conclusion on **PDRC allowance is not correct and PDRC should be reinstated**. At a minimum, the CAA must use this lack of clarity against other price control determinations, as a further catalyst for change ahead of H8, and set clear expectations for the purpose of PDRC estimation going forward.
- 39 The Government Actuary's Department (GAD) report that the CAA commissioned to conduct further analysis in PDRC costs, also clearly states that there is "*uncertainty surrounding what the position will be following the 2024 valuation...therefore, a degree of flexibility within the regulatory framework may be needed*". Heathrow believes the CAA decision does not provide this flexibility required.
- 40 In addition, Heathrow believes that there remains a risk its funding levels would drop below a specified threshold and as a result, the Trustees may request Heathrow to recommence PDRCs before the 2024 valuation is concluded. As such, Heathrow's position is that it is an

error to not include an allowance based on the perceived risk, regardless of recent volatility in funding levels. Heathrow proposed a way forward, which the CAA acknowledges in the proposals for CAP2980, but does not take up.

- 41 Consistent with previous submissions during H7, Heathrow considers it is facing a risk of at least £20mpa should PDRCs recommence considering the Heathrow portion of the pension portfolio.
- 42 If the CAA choose not to reinstate the allowance based on the evidence, information and rationale provided above, then Heathrow supports at a very minimum, the principle of a run through of recovery in H8. Whilst this has been set out in the consultation CAP2980, Heathrow would request that the **CAA unequivocally commit to this approach in its response to this consultation, in order to allow Heathrow to plan ahead of H8.**
- 43 In addition, in the event that the H8 process leads to delay, it is important that any substantial increase is reflected in the maximum allowable yield for 2027 and beyond and not also deferred into later years.

#### **Business Rates:**

- 44 Heathrow supports the CAA in its CAP2980 proposal where it notes that the Valuation Office Agency (VOA) revaluation of business rates may increase for 2026 *“in excess of the allowance made”*. **Heathrow therefore welcomes the CAA’s proposals to maintain at the very minimum, the £85m opex allowance in the FD** in order to help mitigate some of this risk.
- 45 Despite Heathrow continuing to engage with the VOA to ensure any revaluation of Heathrow’s business rates bill is accurately reflective, Heathrow believe there is a very inherent risk that the value from 2026 will be substantial, potentially significantly more than the CAA’s opex proposal.
- 46 The VOA’s proposal to use the receipts and expenditure method, instead of the contractor’s basis method, could see Heathrow’s Rateable Value almost quadruple from £210m to £822m - based on the VOA’s calculations. This is an unprecedented increase and we will be challenging the VOA vigorously.
- 47 As an alternative, Heathrow and other UK airports have requested a more balanced assessment by the VOA which considers the valuation of both methodologies and aligns with the agency’s own guidelines to reach a fair decision. Despite this ongoing work and continued engagement, Heathrow believe the risk of significant increase in 2026, before the H8 process is formally underway (and where the CAA intend to “true up” any increase), represents a financing risk.
- 48 Heathrow proposes that instead of the dual approach of the opex allowance outlined in CAP2980 and a proposed H8 process true up, **the CAA should outline that should a material increase over and above a certain level, (to be discussed between Heathrow and the CAA based on current discussions with the VOA) the amount of the rates bill to be recovered in H8 is reflected in the RAB during 2026 to help ensure additional amounts can be financed.**

- 49 This follows the clear direction and positioning from the CAA that Heathrow “*neither loses nor gains from matters that are largely beyond its control*”<sup>9</sup>.
- 50 In the event that the H8 process leads to delay, it is important that any substantial increase in rates is reflected in the maximum allowable yield for 2027 and beyond and not also deferred into later years.
- 51 As an aside to the CAA’s consideration of the above issue and proposal, it remains vital that the CAA to set out clearly and commit firmly directly in their response to this consultation, that any additional business rates bill will pass through and be covered in the next price control period, H8.

#### **Pod Parking:**

- 52 Whilst Heathrow disagrees with the CAA view that the premium applied to the pod parking estimation is 50% (versus our original proposal of 73% and corresponding evidence), **Heathrow broadly support the analysis undertaken that provides for a net reduction in the commercial revenue forecast of just under £4 million**. This supports the overall CAA regulatory principle on how to treat pod parking.
- 53 Heathrow suggest however that going forward, there is a new approach to how the evidence shared with the CAA is engaged with. During 2023, there was significant correspondence and evidence shared on the CAA’s request. – particularly on not comparing the T5 business parking with the premium set for pod parking.
- 54 However, in CAP2980, the CAA state that there was no “new evidence” provided. The last correspondence Heathrow received from the CAA on this issue, in September 2023, indicated that the CAA was satisfied with all the information provided so far, and therefore implying the 'pre-consultation process' for gathering and clarifying evidence was concluded. That letter did not request new information and stated that these issues would be dealt with in this current consultation. Heathrow original evidence supporting our assumption, remains our position.
- 55 For future price control reviews, Heathrow would therefore suggest a new approach to engagement, evidence sharing and analysis of this evidence to better understand what evidence was not supported and where new evidence (aside from that provided) was required.

#### **Other Issues – Proposed in CAP2980:**

##### **Formula error in condition C1.6 (Maximum Allowable Yield formula)**

- 56 Heathrow agrees with the airlines that this appears to be a manifest error as outlined by the CAA. Heathrow supports a proposed an “erratum notice” to correct this.

##### **Calculation of charges for 2025 and 2026:**

- 57 Heathrow believes that the stated £31.57 from the Licence is correct, noting the  $X_{2024}$  value in the price control already accounted for bonuses and capital triggers. Heathrow supports the CAA position in CAP2980 and agree that no further action is required.

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<sup>9</sup> [CAP2980, H7 Final Issues, Para 18](#)

### Other issues - not included in CAP2980 but that require addressing in H7 period):

- 58 Whilst the CAA have outlined in CAP2980 that the consultation will only consider matters that have been outlined and proposed within the document, Heathrow requests that the CAA review a number of key issues which require evaluation and a licence change during H7, to ensure certainty and clarity forward.
- 59 It should also be noted that Heathrow has written separately to the airline community outlining the background, rationale and our proposals on these issues – both in the spirit of collaboration and transparency and to ensure the airline community has time to consider and respond to our proposals in their own consultation responses to CAP2980 (see appendix for copy of letter).
- 60 A summary of each issue and proposed licence change is outlined below:

### Queuing Times for Vehicles (security):

- 61 Starting in 2017, Heathrow and the Airline Community have engaged extensively on the definition of the service quality framework for H7, including discussions on performance targets for vehicles queuing times in control posts.
- 62 As a result of this long engagement, Heathrow and the Airline Community have agreed that moving the target to a per-vehicle measure was likely to be the best way forward for H7. Heathrow and the Airline Community have also agreed on retaining the Q6 methodology for measuring the performance concerning this indicator.
- 63 This is, by measuring the average percentage of vehicles at each control post group which have a waiting time of less than 15 minutes in every 15-minute period (i.e., retaining the Q6 '15-minute time slice methodology', also consistent with other performance targets in the framework).
- 64 While Heathrow and Airline Community have communicated this agreement to the CAA (update provided by email in August 2021), such measurement methodology is not reflected in Heathrow's economic licence effective May 2023 (Licence). The actual wording used in the Licence is ambiguous as it refers to the 'Percentage of vehicles at each control post group which have a waiting time of less than 15 minutes'.
- 65 There is a risk that this may be incorrectly interpreted as the average across the month as opposed to every 15-minute period, which is not the intent of the measure. Heathrow raised this inconsistency with the CAA in March 2024. The CAA has confirmed the metric is based on the average wait time every 15-minute period rather than the average across the month.
- 66 Accordingly, Heathrow proposes the Licence (both paragraph 3.20 and item F8 of Table 2, in Schedule 1) is amended to include the following wording, which is consistent with other Licence measures:

*'Percentage of vehicles at each control post group **measured once every 15 minutes** which have a waiting time of less than 15 minutes.'*

### Application of the Terminal Drop-off Charge recovery mechanism for 2022 and 2023:

- 67 The H7 FD is clear in relation to the TDOC recovery mechanism): the differential between the total TDOC revenue forecast by the CAA and Heathrow's actuals/forecast TDOC revenue is subject to a risk sharing factor, with 65% of any profit or loss being shared with the airline

community through the aeronautical charges.<sup>10</sup> The policy takes effect from the regulatory year 2022.

- 68 However, the Licence implementation only starts from 2024 and does not include a mechanism for addressing differences in 2022 and 2023. This creates an inconsistency between the policy set in H7 Final Decision and the Licence that implements it, as there is no formal mechanism to recover this through the charging process.
- 69 In addition, the formula to calculate the yearly TDOC amounts as set in the Licence considers 2020 prices as a baseline (as per CAA’s Final Decision) but does not include a respective mechanism for inflation adjustment.
- 70 To resolve these issues, Heathrow propose that (i) the equivalent of the amounts for 2022 and 2023 should be included in the K factor calculation for 2024 and (ii) to clarify that the calculation of the TDOC needs to consider the necessary adjustment by CPI. Heathrow recommends an amendment to Table C.5 in the Licence as below:

For TDOC in Regulatory Year	Adjustment for revenue requirement in Regulatory Year (t)		
	2024	2025	2026
2022	$L_t \times (OTDO_{2022} - FTDO_{2022}) \times (1 + CPI_{2022} + CPI_{2023})$	0	0
2023	$L_t \times (OTDO_{2023} - FTDO_{2023}) \times (1 + CPI_{2023})$	0	0
2024	$L_t \times (OTDO_{2024} - FTDO_{2024})$	0	0
2025	0	$L_t \times (OTDO_{2025} - FTDO_{2025})$	0
2026	0	0	$L_t \times (OTDO_{2026} - FTDO_{2026})$
$TDO_t$	Sum Rows	Sum Rows	Sum Rows

where:

- (a)  $L_t = -1.00$  if a change to legislation comes into force in Regulatory Year t that prevents the Licensee from recovering the full amount of the Forecast, and  
 $L_t = -0.65$  otherwise;
- (b)  $OTDO_t$  is the outturn revenue collected by the Licensee from Terminal drop-off charges in Regulatory Year t uplifted by CPI inflation from the CAA price base (2020) to regulatory year t; and
- (c)  $FTDO_t$  is CAA’s forecast of the revenue that the Licensee is expected to collect from Terminal drop-off charges in Regulatory Year t, uplifted by CPI inflation from the CAA price base (2020) to regulatory year t, and is set out in the CAA’s final decision setting the price control applicable to the Licensee for H7.

<sup>10</sup> CMA H7 FD Chapter 5 in ‘Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks’, CAP2524C.

## Operational certificate of adequate resources:

- 71 Heathrow's Licence contains a specific obligation that requires an annual Certificate of Adequacy of Resources in relation to financial resources (CAR-F) and Certificate of Adequacy of Resources in relation to operational resources (CAR-O) to be produced, approved by a resolution of the Board, and submitted to the CAA by the end of April each year. The CAR-F and CAR-O were a single certificate in Q6, but the CAA has now separated this into two certificates for H7.
- 72 Both certificates must be accompanied by a report from Heathrow's statutory auditors, PwC, which states whether the auditors are aware of any inconsistencies between the certificate and any information they obtained during their audit of the year end accounts. While PwC's report on the CAR-F has not highlighted any inconsistencies, they have set out that they cannot provide assurance on the CAR-O certificate. This is due to the CAR-O now being a standalone certificate, and providing an opinion on Heathrow's operational resources and day to day management would lie outside the scope of their audit.
- 73 The CAA has been informed of this situation and has accepted that a certificate from PwC would not be possible. As such, they have agreed that they would not take any action as a result of non-provision. In substitute of this, Heathrow has agreed for 2024 to provide further assurance signed by our Chief Operating Officer and a nominated Board member confirming that Heathrow has reviewed the requirement and confirm Heathrow has available sufficient operational resources to provide airport operations in accordance with the Licence for the next two years.
- 74 As such the current wording of the Licence needs to be modified. Heathrow has proposed alternative wording to Condition E2.5 of the Licence to clarify the mechanism agreed with the CAA in 2024:

*E2.5. The Licensee shall obtain and submit to the CAA with ~~each~~ **the** certificate provided under Condition E2.2 ~~and Condition E2.3~~ a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, those certificates and the statement submitted with them and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee. **In relation to the certificate provided under Condition E2.3, the Licensee will provide assurance by producing a signed declaration from the Chief Operating Officer and a nominated Board member confirming that they have reviewed the Licence requirement, and that the Licensee has available sufficient operational resources to provide airport operations.***

## APPENDIX

Letter from Heathrow Airport to Joint Steering Board (JSB), 19<sup>th</sup> April 2024

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JSB members

[shared via email]

19 April 2024

### **CAA consultation on H7 Final Issues (CAP2980): Other Outstanding Issues**

Dear JSB colleagues,

I am writing to you regarding Heathrow Airport's response to the Civil Aviation Authority's (CAA) consultation on 'H7 Final Issues' (CAP2980).

In the spirit of transparency and collaboration as we work together to improve the delivery and implementation of price controls, this letter is to inform you that, in addition to the issues included by the CAA in CAP2980, we have identified three other outstanding elements connected to the H7 Final Decision that we believe require addressing (as further detailed below).

Heathrow is seeking resolve all H7 pending matters under CAP2980 and considering that these elements will require adjustments to our licence, we wanted to ensure you and the airline community had both the background to them and enough time to consider and respond to them as part of this process.

Please do not hesitate to contact us should you have questions or wish to discuss these issues in further detail.

Yours sincerely,

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## Background and Heathrow Position - other H7 outstanding issues:

### 1. *Queuing times for vehicles (security):*

Starting in 2017, Heathrow and the Airline Community have engaged extensively on the definition of the service quality framework for H7, including discussions on performance targets for vehicles queuing times in control posts.

As a result of this long engagement, Heathrow and the Airline Community have agreed that moving the target to a per-vehicle measure was likely to be the best way forward for H7. Heathrow and the Airline Community have also agreed on retaining the Q6 methodology for measuring the performance concerning this indicator. This is, by measuring the average percentage of vehicles at each control post group which have a waiting time of less than 15 minutes in every 15-minute period (i.e., retaining the Q6 '15-minute time slice methodology', also consistent with other performance targets in the framework).

While Heathrow and Airline Community have communicated this agreement to the CAA (update provided by email in August 2021), such measurement methodology is not reflected in Heathrow's economic licence effective May 2023 (Licence). The actual wording used in the Licence is ambiguous as it refers to the '*Percentage of vehicles at each control post group which have a waiting time of less than 15 minutes*'. There is a risk that this may be incorrectly interpreted as the average across the month as opposed to every 15-minute period, which is not the intent of the measure.

We raised this inconsistency with the CAA in March 2024. The CAA has confirmed the metric is based on the average wait time every 15-minute period rather than the average across the month. Accordingly, Heathrow's response to CAP2980 will address this issue and propose the Licence (both paragraph 3.20 and item F8 of Table 2, in Schedule 1) is amended to include the following wording, which is consistent with other Licence measures:

*'Percentage of vehicles at each control post group **measured once every 15 minutes** which have a waiting time of less than 15 minutes.'*

### 2. *Application of the Terminal Drop-off Charge (TDOC) recovery mechanism:*

The H7 settlement related to the TDOC (Table C.5 in Heathrow's Licence) is clear. The differential between the total TDOC revenue forecast by the CAA and Heathrow's actuals/forecast TDOC revenue is subject to a risk sharing factor, with 65% of any profit or loss being shared with the airline community through the aeronautical charges. The policy takes effect from the regulatory year 2022.

However, the Licence implementation only starts from 2024 and does not include a mechanism for addressing differences in 2022 and 2023. This creates an inconsistency between the policy set in H7 Final Decision and the Licence that implements it, as there is no formal mechanism to recover this through the charging process.

In addition, the formula to calculate the yearly TDOC amounts as set in the Licence considers 2020 prices as a baseline (as per CAA's Final Decision) but does not include a respective mechanism for inflation adjustment.

To resolve these issues, we propose that (i) the equivalent of the amounts for 2022 and 2023 should be included in the K factor calculation for 2024 and (ii) to clarify that the calculation of the TDOC needs to consider the necessary adjustment by CPI. We will recommend to the CAA to amend Table C.5 in the Licence as below:

**Table C.5: Calculation of the Terminal drop-off charge**

For TDOC in Regulatory Year	Adjustment for revenue requirement in Regulatory Year (t)		
	2024	2025	2026
2022	$L_t \times (OTDO_{2022} - FTDO_{2022}) \times (1 + CPI_{2022} + CPI_{2023})$	0	0
2023	$L_t \times (OTDO_{2023} - FTDO_{2023}) \times (1 + CPI_{2023})$	0	0
2024	$L_t \times (OTDO_{2024} - FTDO_{2024})$	0	0
2025	0	$L_t \times (OTDO_{2025} - FTDO_{2025})$	0
2026	0	0	$L_t \times (OTDO_{2026} - FTDO_{2026})$
$TDO_t$	Sum Rows	Sum Rows	Sum Rows

where:

- (a)  $L_t = -1.00$  if a change to legislation comes into force in Regulatory Year t that prevents the Licensee from recovering the full amount of the Forecast, and

$L_t = -0.65$  otherwise;

- (b)  $OTDO_t$  is the outturn revenue collected by the Licensee from Terminal drop-off charges in Regulatory Year t **uplifted by CPI inflation from the CAA price base (2020) to regulatory year t**; and
- (c)  $FTDO_t$  is CAA's forecast of the revenue that the Licensee is expected to collect from Terminal drop-off charges in Regulatory Year t, **uplifted by CPI inflation from the CAA price base (2020) to regulatory year t**, and is set out in the CAA's final decision setting the price control applicable to the Licensee for H7.

#### 74.1.1

##### 3. Operational certificate of adequate resources:

Heathrow's Licence contains a specific obligation that requires an annual Certificate of Adequacy of Resources in relation to financial resources (CAR-F) and Certificate of Adequacy of Resources in relation to operational resources (CAR-O) to be produced, approved by a resolution of the Board, and submitted to the CAA by the end of April each year. The CAR-F and CAR-O have historically been a single certificate, but the CAA has now separated this into two certificates as part of the H7 Licence.

Both certificates must be accompanied by a report from Heathrow's statutory auditors, which states whether the auditors are aware of any inconsistencies between the certificate and any information they obtained during their audit of the year end accounts. While the auditors' report on the CAR-F has not highlighted any inconsistencies, they have set out that they cannot provide a report for the CAR-O certificate. This is due to the CAR-O now being a standalone certificate, and

providing an opinion on Heathrow's operational resources and day to day management would lie outside the scope of their audit.

The CAA has been informed of this situation and has accepted that a certificate from PwC would not be possible. As such, they have agreed that they would not take any action as a result of non-provision. In substitute of this, Heathrow has agreed for 2024 to provide further assurance signed by our Chief Operating Officer and a nominated Board member confirming that we have reviewed the requirement and confirm Heathrow has available sufficient operational resources to provide airport operations in accordance with the Licence for the next two years.

As such the current wording of the Licence needs to be modified. We will propose alternative wording to be included in Condition E2.5 of the Licence to clarify the mechanism agreed with the CAA in 2024:

*E2.5. The Licensee shall obtain and submit to the CAA with ~~each~~the certificate provided under Condition E2.2 ~~and Condition E2.3~~ a report prepared by its Auditors stating whether or not the Auditors are aware of any inconsistencies between, on the one hand, those certificates and the statement submitted with them and, on the other hand, any information which they obtained during their audit of the relevant year end accounts of the Licensee. In relation to the certificate provided under Condition E2.3, the Licensee will provide assurance by producing a signed declaration from the Chief Operating Officer and a nominated Board member confirming that they have reviewed the Licence requirement, and that the Licensee has available sufficient operational resources to provide airport operations.*