

# Setting future price controls – lessons learnt from the review of approach

CAP 3000

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Civil Aviation Authority  
Aviation House  
Beehive Ring Road  
Crawley  
West Sussex  
RH6 0YR

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Enquiries regarding the content of this publication should be addressed to: [stewart.carter@caa.co.uk](mailto:stewart.carter@caa.co.uk)

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# Introduction and Summary

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## Purpose of the review and approach

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- 1.1 In 2023 we completed the price control reviews for Heathrow Airport Limited (“HAL”, the “H7” review) and for NATS (En Route) plc (“NERL”, the “NR23” review). Following appeals by both HAL and airlines, the Competition and Markets Authority (“CMA”) concluded that the price control for HAL had struck “broadly the right balance” between protecting consumers and encouraging investment.<sup>1</sup>
- 1.2 In July 2023, the DfT published its review of the CAA as part of the Cabinet Office Public Bodies review programme (the 2023 Public Body Review of the CAA).<sup>2</sup> Recommendation 5.6 of the review said that we should review the process for economic regulation including the ‘process, governance and mechanics’ and the ‘lessons learned’ from all the CAA’s economic regulation activity, on the basis agreed between the CAA and DfT. It also said that the DfT should consider whether a wider review of the basis, scale and scope of all the CAA’s economic regulatory activity is required.
- 1.3 Consistent with best practice and the recommendations of Public Body Review of the CAA, we have reviewed our approach to setting price controls to identify opportunities to improve the efficiency, timeliness and effectiveness of the processes and outcomes. This document sets out the findings from our review of our approach to setting price controls (including the lessons learnt from H7 and NR23), which will inform our overall approach to future price controls.
- 1.4 While this review has been led by the CAA, we have agreed the basis of the review with DfT and sought views from stakeholders and independent sources to inform the lessons and provide a robust basis for this review, including:
  - consulting on the scope of the review and key issues in February 2024 (“the February 2024 Consultation”).<sup>3</sup> We received 15 written responses from stakeholders, including HAL, NERL, airlines, airport and airline representatives and the Heathrow community. These responses are summarised in the relevant chapters and published on our website alongside the February 2024 Consultation. Nonetheless, where stakeholders have raised detailed policy issues around how we set the

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<sup>1</sup> [CMA issues final determination in Heathrow Airport appeals - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/news/cma-issues-final-determination-in-heathrow-airport-appeals)

<sup>2</sup> [Civil Aviation Authority review - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/news/civil-aviation-authority-review)

<sup>3</sup> Setting future price controls – review of approach, CAP 2618, February 2024. See: [www.caa.co.uk/Cap2618](https://www.caa.co.uk/Cap2618)

price controls in H7 and NR23 and the changes we should make (rather than broader lessons learnt), we plan to address these as part of the next HAL and NERL price control reviews;

- holding eight workshops with HAL, NERL and airlines to seek feedback on the February 2024 Consultation. The notes from these workshops are summarised in Appendix C;
- seeking views from an Advisory Panel that is independent from the CAA on the lessons learnt findings. The Panel is comprised of three experts on regulatory and consumer matters. Its independent views are summarised in this document and the Panel has confirmed that this summary is a reasonable and fair representation of their views. The input was provided by the Panel independently from the CAA's assessment and has been an important consideration in formulating our views on the lessons learnt; and
- commissioning two independent studies, which look at international and cross-sector approaches to regulation: Grant Thornton ("GT") – lessons for the future approach to cost assessment; and MKmetric – lessons from international case studies. The high-level findings of these reports have been taken into account in formulating our views on the lessons learnt and the more detailed points and considerations will be considered in future price control reviews. We have published these reports with this document on the CAA website.<sup>4</sup>

1.5 Understanding consumers' views will be an important part of making sure that the price controls further the interests of consumers. We set out our views on consumer engagement during the price control review in chapter 3.

1.6 This document sets out our views on the lessons learnt from the H7 and NR23 price control reviews and summarises areas where we hope to do better and strengthen our approach for H8 and NR28. It will also be important for licensees and airline stakeholders to consider how best they can enhance their contributions to the price control review process. This should involve improving the quality and robustness of business plan and other information submissions, providing this information and responses to consultations in a timely way and seeking to engage with each other in an open, practical and measured way. Taken together, this should allow for a Constructive Engagement<sup>5</sup> process between stakeholders that provides a meaningful contribution to the price control

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<sup>4</sup> Grant Thornton, Future regulatory approach – cost assessment, 10 July 2024; and MKmetric, International approaches to airport and air traffic control regulation, 19 July 2024.

<sup>5</sup> Constructive Engagement is a CAA-mandated process that requires the regulated entity to discuss its business plan with airlines before the CAA develops its proposals for the relevant price control.

review process, seeks out and highlights areas of broad agreement, and helps to deliver an approach to economic regulation that properly protects consumers.

## Context for the lessons learnt review

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- 1.7 To make sure the lessons learnt are relevant to future reviews, we need to take account of the unusual circumstances of the H7 and NR23 reviews, which we would not expect to be repeated for the next price control reviews.
- 1.8 The H7 price control review took place over more than seven years, between 2016 to 2024. The original focus of the H7 review was the planned expansion and development of third runway at Heathrow airport. In response to the challenges of the capacity expansion programme and subsequent delays to HAL's plans to submit its application for a Development Consent Order ("DCO") as part of the planning process, the original Q6 price was extended for first one year (to cover 2019) and then for a further two years (to cover 2020 and 2021). Legal challenges to the Government's approach to the Airports National Policy Statement and the impact of covid-19 in 2020 then caused HAL to suspend its work on capacity expansion and we changed the focus of the price control review to a two-runway airport and to deal with the impacts of covid-19 on the airport, its airline customers and consumers.
- 1.9 During the H7 and NR23 reviews, we saw the severe impact of covid-19 on traffic levels and uncertainty about the speed of recovery. This uncertainty was combined with a changing macroeconomic environment of higher interest rates and inflation, and together these factors meant that HAL and NERL both faced real difficulties in producing business plan information.
- 1.10 We also needed to carry out additional work on the H7 price control, to review HAL's request for a covid-19 related RAB adjustment and consider new traffic risk sharing arrangements. For the NR23 price control, we needed to determine the appropriate treatment of existing traffic risk sharing arrangements for NERL and reconcile the previous price control period (RP3), which had been shortened to no more than three years (2020 to 2022) in the CMA's redetermination. These were high profile and contentious issues, with very different views between stakeholders and the CAA on the best way to protect the interests of consumers. Some of these issues formed parts of the H7 appeals to the CMA.
- 1.11 The above issues and challenges caused very significant difficulties for stakeholders, including both HAL and NERL, but also for airlines and other stakeholders in the aviation sector. While the sort of disruption that was associated with covid-19 (very significant reductions in passenger numbers extending over a period great than a year) is unlikely to be a feature of H8 or NR28, we now have better regulatory mechanisms to respond to such shocks. These included traffic-risk sharing, the shock factor and flexibility to re-open the price control (provided that this would be consistent with our statutory duties).

We would also work proactively with stakeholders in future to avoid significant delays to our price control review processes and fully recognise the difficulties and disadvantages created by such delays, but if a major shock occurs during a price control review we cannot guarantee the completion of the review to a 'business as usual' timetable.

- 1.12 There will be challenging and important issues to deal with at the H8 and NR28 reviews. These include ensuring that the price controls support appropriately high quality and resilient services while delivering value for money, and dealing with important wider issues in a targeted and focused way, such as supporting the transition to net zero and airspace modernisation.
- 1.13 The delays and challenges associated with the H7 and NR23 reviews also mean that the new regulatory arrangements that were introduced during these reviews have only been operating for a short period of time. Therefore, we have little evidence in terms of track record to judge the effectiveness of these arrangements and so it has not been practicable to carry out an extensive review of historical performance to inform this lessons learnt review. We will consider new information as it becomes available.
- 1.14 It will also be appropriate to take account of the different statutory frameworks for HAL and NERL and ensure that our approach to each of H8 and NR28 is consistent with our statutory duties as set out in the Civil Aviation Act 2012 ("CAA12"), which apply to H8, and Transport Act 2000 ("TA00"), which apply to NR28. These frameworks are summarised in Appendix B.

## Summary of key findings

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- 1.15 In the February 2024 Consultation, we set out our initial views on the scope of this lessons learnt review and on the key issues we would need to consider for the next price control reviews for HAL and NERL. These were organised around four main topics:
- the process for setting price controls. This should cover all the steps of the process in how we set price controls and where we can make improvements;
  - the governance of price controls. This should encompass the responsibilities of CAA and other stakeholders, detailing how we ensure CAA and stakeholders documents are complete and timely, and ensuring that the price control review achieves its objectives in a timely and efficient manner;
  - the issues around our approach to estimating the price control building blocks (including operating costs, capital expenditure and returns) that we use to determine the price control revenue that the licensee should recover over the period of the new price controls; and

- broader strategic issues, which we considered might be most relevant to subsequent price controls after H8 and NR28.

1.16 We present our views on the main strategic issues for each topic below, with further detail provided in the relevant chapters.

### **The process for setting price controls**

1.17 We plan to maintain our existing timetables for H8 and NR28, which include overlapping reviews during the second half of 2025 and 2026. We are taking steps to meet this challenging timetable and stakeholders will also have a key role in providing high quality business plans (by high quality we mean including all the information requested provided on time, with properly supported views, compelling evidence including benchmarking and appropriate assurance, rather than a glossy document with a 'lightweight' supporting narrative). A successful process relies on all parties stepping up to the mark.

1.18 Consistent with a transparent and proportionate approach to regulation we will consider and consult on potential areas of simplification for the next NERL price control review.

1.19 Constructive Engagement should be carried out at an earlier stage and in multiple rounds to provide a greater opportunity for airlines to influence HAL's and NERL's business plans, and to comment on our initial proposals. We will consult on further guidance on Constructive Engagement later in the summer.

### **Governance around price controls**

1.20 We will always seek to establish effective and efficient governance and will consider how best to do this for the H8 and NR28 reviews. We will establish a price control review advisory panel, such that our work benefits from suitable external expertise and insight.

1.21 It is important that our work on price control reviews is properly informed by consumer engagement and research. HAL and NERL will need to carry out their own research and we will consider what guidance we should provide in relation to these matters and how best to engage with licensees to ensure that consumer research is appropriate and fit for purpose. We will also consider whether to carry out our own research to supplement that carried out by licensees.

1.22 We will seek to improve our approach to engagement with non-airline stakeholders and consider how we can best encourage high-quality engagement between licensees and wider stakeholders.

1.23 Further consideration will be given to strengthening our business plan guidance and the incentives on licensees to provide timely and high quality business plan information.

## Price control building blocks and cross-cutting issues

### Traffic forecasting

- 1.24 We expect to commission an external independent traffic forecast for H8 and to retain the use of the STATFOR forecast for NR28.

### Traffic risk sharing (TRS)

- 1.25 Given the importance of appropriate risk sharing arrangements to HAL's and NERL's financeability and cost of capital, we expect to retain TRS arrangements, but will consider the form and calibration of these arrangements.

### Service quality

- 1.26 We will consider the balance of incentives, alignment with consumer priorities and importance of incentives for resilience. HAL and NERL should engage with consumers. We will review how consumer research is used, how we engage with groups representing passengers and the scope for research commissioned by the CAA or an independent body to supplement engagement by HAL, NERL and airlines.
- 1.27 Following the publication of the NATS Independent Review, we will review the recommendations and consider appropriate changes to the service quality incentives and targets (including in relation to resilience) for NERL. This review of the lessons learnt has been conducted independently from the NATS Independent Review.

### Opex and capex incentives

- 1.28 Bearing in mind that HAL's capital efficiency incentives have only been recently introduced our focus will be on understanding how they are working in practice and making any evolutionary improvements that appear appropriate, either at the H8 review or subsequently.
- 1.29 We will prioritise reviewing the way NERL's capex is incentivised as part of the NR28 review, given Egis's recommendation to the CAA and the findings of the NATS Independent Review.

### Cost assessment

- 1.30 There are three key areas that we intend to prioritise to strengthen our approach to the assessments of costs and efficiency for HAL and NERL:
- i. develop our approach to information gathering and business planning guidance;
  - ii. work to widen the evidence base including further consideration of international benchmarking and targeted bottom-up analysis; and

- iii. develop further our approach to the assessment of NERL's capex and its incentives for capital efficiency and delivery.

### **Environmental sustainability**

- 1.31 We will continue to support and incentivise NERL and HAL to transition to and reasonably support net zero during H8 and NR28.
- 1.32 We will also continue to support airspace modernisation, which has the potential to generate environmental benefits.

### **RAB and financeability**

- 1.33 We expect to retain a RAB-based approach to regulation at future price control reviews, bearing in mind the advantages of regulatory consistency and providing reasonable stability for investors (which in turn will avoid any unnecessary increases in the costs of financing investment). Consistent with the approach adopted by other economic regulators we expect to move from the RPI to CPI or CPIH indexation of the RAB at the next round of price reviews.
- 1.34 A number of airlines have expressed concerns about the size of HAL's RAB. We will consider these issues at H8. There are interventions that could be made to reduce the size of the RAB while continuing to act consistently with the reasonable expectations of investors, but these measures would need to be considered carefully as they might lead to higher charges at H8.
- 1.35 For the NERL price control we are looking at how the underlying calculation of the price control can be simplified.

### **Cost of capital**

- 1.36 The approach we adopted to calculate the cost of capital at H7 and NR23 should provide a reasonable starting point for our work at H8 and NR28, but we will also consider new precedent from other regulatory reviews, the UK Regulators Network ("UKRN") guidance, the comparators for beta estimation, new market evidence and further evidence from stakeholders.

### **Broader strategic issues**

- 1.37 For most of the broader strategic issues covered in this document, we do not consider there is a strong case for considering these in detail for H8 and NR28. However, there are some areas we plan to consider and consult on further:
  - the case for any additional flexibility, guidance or mechanisms for addressing the opex-capex trade-off, particularly in relation to NR28;
  - the case for a six-year regulatory period for NERL, to enhance incentives for efficiency and reduce the overlap between future HAL and NERL price control reviews after H8 and NR28; and



- airspace modernisation and the efficient and effective integration of new users into the arrangements for managing airspace remain important objectives for the CAA, and these issues will be considered as part of the work on NR28 and (where appropriate) H8.

## Update on timetable for the H8 and NR28 price control reviews

- 1.38 In the February 2024 Consultation, we provided indicative timetables for the next price control reviews for HAL and NERL.
- 1.39 We received a relatively large number of responses from stakeholders on the timetable and the approach to Constructive Engagement. These noted that the timetable for the next price controls was tight and set out different views on whether we should retain the current timetable or plan to allow more time for the next price control reviews. Nonetheless, a common theme in responses was the need for a clear and stable timetable.
- 1.40 Following a review of different timetable options, we consider the current timetables for H8 and NR28 provide the clearest protections for the interests of consumers and discharge of our statutory duties.
- 1.41 We recognise this is a relatively tight timetable and experience from H7 and NR23 showed that overlap between price controls requires careful management. To meet the overlapping timetables for H8 and NR28, we would need to have in place effective and streamlined governance, recruit sufficient resources in the CAA economic regulation team, appoint external advisors to provide assurance and technical support or delivery partner roles, and receive timely and complete submissions from HAL, NERL and stakeholders.
- 1.42 This timetable will only be possible with these measures and there remains other risks, including in relation to unforeseen circumstances and the natural stretch that will be created by running price control reviews in parallel. We will, therefore, need to be flexible in our approach and work with stakeholders to explore alternative options at an early stage if the timetable no longer seems to be deliverable.
- 1.43 Our updated view on draft timetable for H8 would include:
- the following CAA publications relatively early in the process
    - a letter on the approach to Constructive Engagement at the end of August 2024 for consultation and discussion with stakeholders in September 2024,
    - draft method statement for H8 in October 2024. This would provide guidance for business planning, though any detailed guidance and templates may need to be developed separately. This would be for consultation over four weeks, and



- final method statement in February 2025;
- multiple rounds of Constructive Engagement between HAL and airlines, including:
  - round 1 between October and December 2024 on high level issues of service quality and investment,
  - round 2 between January and March 2025 on more detailed building block issues, but excluding areas such as cost of capital and cost efficiency,
  - round 3 between June and August 2025 on HAL's business plan submission, and
  - round 4 between January and February 2026 on the CAA's Initial Proposals;
- a single business plan submission from HAL in June 2025. This should follow the CAA's guidance and provide detail on forecast traffic, costs, investment and prices for the H8 period;
- CAA Initial Proposals in December 2025 for consultation. This would include draft licence modifications;
- CAA Final Proposals and statutory consultation on licence modifications in July 2026;
- CAA Final Decision and statutory notice on licence modifications in October or November 2026; and
- Licence modifications coming into effect in January 2027.

1.44 We anticipate that the timetable for NR28 will follow a year behind the H8 review and there will overlap between these processes. As discussed above and in chapter 9, we will consider the case for a six-year price control to reduce the overlap between the subsequent HAL and NERL price controls.

1.45 We will engage with HAL, NERL, airlines and any other interested stakeholders during August 2024 to seek their views on the draft timetables for H8 and NR28, before we finalise these in the H8 and NR28 method statements.

## Structure of the document

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1.46 The rest of this document is structured as follows:

- chapter 2 sets out lessons on the process for setting price controls;
- chapter 3 sets out lessons on the governance around price control reviews;

- chapter 4 sets out lessons on the approach to traffic forecasts and incentives, including for service quality;
- chapter 5 sets out lessons on the approach to cost assessment;
- chapter 6 sets out lessons on environmental sustainability;
- chapter 7 sets out lessons on RAB and financeability;
- chapter 8 sets out lessons on cost of capital;
- chapter 9 discusses the broader strategic issues;
- appendix A provides a glossary of terms;
- appendix B sets out the CAA's statutory duties; and
- appendix C provides a summary of the notes from the February 2024 stakeholder workshops.

## Chapter 2

# The process for setting price controls

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## Introduction

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- 2.1 This chapter sets out the lessons learnt on the process for setting price controls, including the assessment of market power, objectives for the price controls and how we ensure proportionate and transparent regulation.
- 2.2 It also deals with the timetable for setting future price controls and the approach to Constructive Engagement for H8, recognising the timetable for this review is relatively tight. Finally, we set out a summary of our position on the key lessons learnt in relation to the process for setting price controls and discuss next steps.

## Market power

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### Introduction

- 2.3 In the February 2024 Consultation, we said that our existing approach to dealing with the substantial market power of HAL and NERL, through economic regulation and licences, remains appropriate. We also set out our initial view that there was no compelling case to carry out a further Market Power Determination (“MPD”) for Heathrow airport.

### Summary of stakeholder views

- 2.4 HAL said that we should clarify the basis for our assessment that a change to the 2014 assessment is unlikely given major developments including changes in air traffic and airline market, airport competition and expansion, net zero and covid-19. It stated that regulatory best practice points to regular reviews of market power. ACI Europe also commented that recent industry changes might affect our assessment.
- 2.5 HAL also said we should consider whether the single till still remains appropriate, as a lack of investment in certain peripheral services and activities since 2005 suggests it may not be delivering the best outcome for consumers.
- 2.6 NERL agreed that en route and oceanic are monopoly services but noted that other services it is planning to provide in future could be separately regulated with its own cost base and charges.
- 2.7 A number of airlines agreed there had been no material changes to market conditions and that both HAL and NERL should continue to be regulated.

- 2.8 Arora and Pandox raised HAL's conduct in relation to other regulated charges ("ORCs") and Arora said HAL uses its significant market power to set charges above competitive levels.

## Our views

- 2.9 A new MPD would only be needed if there was a reasonable prospect that HAL might no longer meet the Market Power Test ("MPT"). As noted in our February 2024 Consultation, we consider that this is highly unlikely as:
- demand for Airport Operation Services ("AOS") has risen strongly but there has been no material change in the supply of AOS in the part of the UK served by Heathrow airport since the previous MPD in 2014; and
  - HAL's business plan for H7 included a substantial increase in airport charges. This indicates that, in the absence of economic regulation, HAL would substantially increase its charges.
- 2.10 Nonetheless, we will consider issues around the boundary of the single till and the regulation of ORCs as part of the next price control reviews.

## Objectives

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### Introduction

- 2.11 In the February 2024 Consultation, we said that key policy objectives may help in providing a clear focus for the work of the price control review. We asked stakeholders whether there are particular outcomes or objectives we should focus on as part of the upcoming HAL and NERL price controls.

### Summary of stakeholder views

- 2.12 Several stakeholders noted the need for clarity on the role of environmental factors (including, for NERL, the balance between delays/capacity and environmental performance).
- 2.13 NERL suggested that NR28 objectives should focus on airspace modernisation, new users/services, and NERL's contribution to net zero.
- 2.14 HAL suggested H8 should focus on an improved regulatory process, consumer priorities and a balanced approach to prices and outcomes, investment and growth incentives (including scaling the airport to meet demand), and net zero.
- 2.15 Some airlines referred to affordability (for both HAL and NERL price controls) and stated that the CAA should consider the role and size of HAL's regulatory asset base ("RAB").
- 2.16 The interim report from the NATS Independent Review was published in March 2024 and we will review carefully the recommendations in the final report when

published.<sup>6</sup> The interim report highlighted issues around the measurement of cancellations and knock-on delays, as well as setting stronger incentives for a resilient and safe service. This review of the lessons learnt has been conducted independently from the NATS Independent Review.

## Our views

- 2.17 We remain of the view that establishing objectives for a price review (that is, objectives that highlight the importance of specific issues rather than simply stating our statutory duties) may be helpful in providing context and focus for a price control review. We will consider further what specific objectives may be appropriate for the H8 and NR28 reviews in developing our draft method statements for these reviews and consult stakeholders further on the best approach.

## Proportionate and transparent regulation

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### Introduction

- 2.18 In the February 2024 Consultation, we said that we would consider opportunities to make our approach and framework more proportionate and transparent. This included looking at areas of the framework that could be simplified where the frameworks have become increasingly complex over time.

### Summary of stakeholder views

- 2.19 In broad terms, stakeholders did not seem to support significant simplification of the current frameworks. We did receive a range of comments that we should prioritise our work in future, focusing on key issues and spending less time on smaller details.
- 2.20 HAL said we should be clear about the problems our regulation is trying to solve, how the changes will achieve these aims, and provide supporting evidence and impact assessments. It said that the approaches to capex efficiency incentives and ORCs should be reviewed and revised, as they do not reflect better regulation principles.
- 2.21 A number of airlines did not support any simplification of regulation for the HAL price control. There was some support for proportionate recalibration for the NERL price control. Airlines would also like to see greater CAA engagement during the price control reviews and greater ongoing monitoring/engagement. They said the CAA should address the lack of transparency due to the asymmetry of information held by HAL and NERL.

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<sup>6</sup> Independent Review of NATS (En Route) Plc's Flight Planning System Failure on 28 August 2023, Interim report, March 2024

- 2.22 NERL highlighted the very large number of follow-up questions on its business plan. It also said that we should not simplify the framework where it could increase NERL's financial risk without delivering customer benefits, and the current framework does not prevent NERL from delivering and developing safe and resilient services for customers.
- 2.23 Arora said that the approach to setting ORCs was not proportionate or transparent and it would like to see greater engagement and consultation with non-airline stakeholders during the next HAL price control review.

### Advisory Panel views

- 2.24 The Advisory Panel observed that there can be significant advantages from simplifying price controls. However, simplification should only be pursued when it does not result in adverse outcomes or higher risks for consumers.

### Our views

- 2.25 The current price control framework for HAL appears to be broadly appropriate and we have not seen a strong case for significant simplification. Nonetheless, we will seek to refine and improve the approach to capital efficiency incentives as we gain more experience of what is a relatively new set of incentive arrangements.
- 2.26 MKmetric's report suggests that the regulatory process could be simplified and improved by focusing on a small number of regulatory building blocks, such as traffic forecasts and major opex and capex allowances.<sup>7</sup> However, in the context of UK regulation, market power and appeals, we consider there is a strong case to continue to scrutinise the full range of building blocks for HAL.
- 2.27 For NERL, we consider that NERL's price control framework is unduly complex in places, where the regulatory process could be improved. We will consult further with stakeholders on areas where we consider simplification would make the framework more proportionate and transparent. We set out further detail in chapter 7.
- 2.28 In general, the comments received suggests that our approach to H7 and NR23 was seen as transparent. Nonetheless, we will continue to engage with stakeholders on the best and most reasonable approach to transparency, including in relation to ORCs.
- 2.29 We will also review our approach to ongoing monitoring and enforcement, and how we engage with smaller stakeholders as part of the next price control reviews.

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<sup>7</sup> MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024

## Timetable

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### Introduction

- 2.30 In the February 2024 Consultation, we set out an indicative timetable for the next price control reviews for HAL and NERL. This showed the H8 review starting in 2024 and our final decision in late 2026. The NR28 price control would follow a year behind, so would overlap with H8 in 2025 and 2026.
- 2.31 We said that running the H7 and NR23 price control reviews in parallel put a significant strain on CAA resources, which could contribute to the delays to the price control reviews. We asked for stakeholders' views on the indicative timetable and alternative options that would reduce the amount of parallel running of the price control reviews.

### Summary of stakeholder views

- 2.32 A number of stakeholders recognised that the indicative timetable for the H8 price control review is tight and said there is a need for a clear and realistic timetable to avoid delays later in the process.
- 2.33 HAL said the CAA should demonstrate deliverability of the timetable and was concerned that the indicative timetable reduced time for important stages of the price control review, such as Constructive Engagement. It also said that important capacity and infrastructure decisions risk being squeezed and diluted if HAL needs to deliver an initial business plan in early 2025, especially as there is no certainty when CAA will deliver the business plan guidance.
- 2.34 HAL said the CAA should make improvements, including: providing precise dates; developing comprehensive plans for resourcing; making improvements to internal governance and informing stakeholders as soon as possible about any delays or changes to the timetables.
- 2.35 NERL said we should develop a robust plan to deliver the Final Decision for NR28 by Q4 2027 at the latest. It said we should allow sufficient time for development of the business plan and Constructive Engagement, with more considered use of external resources, focus on the most material issues and agile decision-making.
- 2.36 A number of airlines noted the H8 timetable appears tight and high-level. They said we should set out clearer business planning guidance, timescales, milestones, resource levels and dependencies, with sufficient time for Constructive Engagement. They also said we will need higher quality information from the regulated companies to meet these tight timetables. Some airlines and other stakeholders were concerned that we were already, at this early stage, signalling potential delays and slippages to the timetable.

## Advisory Panel views

- 2.37 The Advisory Panel noted the significant pressures on timetabling at H7 and NR23. It said the CAA should consider delaying the next NERL price control review by 1 year, to reduce the amount of parallel running with H8.

## Our views

- 2.38 We have considered the comments on the timetables and evaluated different options for the next HAL and NERL price control reviews. All of the alternative options we have considered, including delaying the NERL price review by one year (as per the suggestion from the Advisory Panel), have potential disadvantages. Bearing this in mind our current preferred view is to maintain the current timetables for the H8 and NR28 price controls, which is consistent with protecting consumers and the appropriate discharge of our statutory duties.
- 2.39 A key lesson learnt is the need for clear and detailed timetables for the upcoming price control reviews. We provide an update in chapter 1 on our current view of the timetable for the H8 review, with further detail on stages of the review. We will discuss this updated draft timetable with stakeholders before finalising it in the H8 method statement.
- 2.40 The need for a start to H8 in 2024 and the overlap with the NR28 review means that there are a number of risks to meeting this timetable. We are taking steps to mitigate these risks including:
- starting a phased recruitment campaign designed to ensure we have fully resourced price control teams;
  - setting out more detail on the draft price control timetable at this stage for discussion with stakeholders; and
  - considering how to make the best use of our external advisors, including delivery partner models as has been used by other economic regulators.
- 2.41 We recognise that there will remain risks to the timetable, in particular the availability of CAA resources. Nonetheless, we will seek to avoid undue delays and inform stakeholders as early as practicable if delays occur. Stakeholders will also have an important role to play providing high quality business plan information (as discussed in paragraph 1.17 above).

## Constructive Engagement

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### Introduction

- 2.42 Constructive Engagement between HAL, NERL and their airline customers continues to be an important part of the price control reviews.



- 2.43 We recognise that improvements can be made to the process for Constructive Engagement and we have asked stakeholders for views on the lessons from H7 and NR23.

### Summary of stakeholder views

- 2.44 A number of stakeholders said the CAA should play a more active role in Constructive Engagement and provide clear direction and oversight. This includes clarifying expectations on the purpose, timing, scope and conduct ahead of Constructive Engagement, and then providing direction and moderating on challenging issues where parties disagree during Constructive Engagement.
- 2.45 Some airlines said HAL and NERL should be required to make more information available on options and how information reconciles to previous periods, and we should penalise HAL and NERL where this is not provided. They would also like independent experts to provide input during the engagement.
- 2.46 A number of stakeholders noted that, due to the timing of Constructive Engagement, only limited changes could be made to business plans as a result of Constructive Engagement. NERL said we should allow more time for Constructive Engagement to inform the initial business plan and use three phases for engagement: (1) early high-level and senior bilateral engagement with airlines on priorities; (2) multilateral Constructive Engagement with CAA participation; and (3) scrutiny of the submitted business plan.
- 2.47 HAL, NERL and some airlines suggested there could be an earlier start to other types of engagement (such as on capex plans, strategic direction and optioneering) while business plans are being developed. A number of stakeholders said that Constructive Engagement should focus on particular issues such as capex, traffic forecasts and service quality targets.

### Advisory Panel views

- 2.48 The Advisory Panel said there should be an early start to the Constructive Engagement process, the CAA should consider how to take account of the views of the wider set of stakeholders as well as airlines and that the CAA's role should not focus on resolving disputes during Constructive Engagement.

### Our views

- 2.49 Constructive Engagement is an important part of the price review process and a key lesson from H7 and NR23 is that this process was not as effective as it could have been in finding common areas of agreement between parties.
- 2.50 We agree with stakeholders that we should consider early and multiple phases of Constructive Engagement so airlines can influence HAL's and NERL's business plans and find common areas in response to our initial proposals. We would expect HAL and NERL to provide materials to airlines on the benefits and costs

of different options to enable this. We set out our initial views on stages of Constructive Engagement in chapter 1. We will set out more detail on our expectations and approach to enforcement in guidance on Constructive Engagement to be published later this summer.

- 2.51 There will be advantages in focusing Constructive Engagement on areas where dialogue is likely to be most productive, for instance in relation to investment programmes, service quality and resilience. We will also consider how to take account of the views of other stakeholders in addition to the Constructive Engagement with airlines.
- 2.52 This is supported by MKmetric's report, which says that the example of Constructive Engagement and collaboration on investment decisions at Dublin Airport could provide a useful model for delivery of large-scale projects at Heathrow airport.<sup>8</sup>
- 2.53 On the role of the CAA, we consider that we could more actively participate during the Constructive Engagement, providing input where appropriate. However, it will remain appropriate that stakeholders attempt to resolve or narrow differences during the Constructive Engagement process. We will set out our views on key issues and areas of difference in public consultations and proposals documents.

## Summary and next steps

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- 2.54 We do not intend to carry out a new MPD for HAL. We consider that a change in our assessment would be highly unlikely, so it is not necessary or proportionate.
- 2.55 There are potential advantages of setting objectives for the price control reviews, and we will consider and consult further on these matters as we develop draft and final method statements for the H8 and NR28 reviews.
- 2.56 Consistent with a transparent and proportionate approach to regulation we will consider and consult on potential areas of simplification for the next NERL price control review. These matters are discussed further in chapter 7.
- 2.57 We plan to maintain our existing timetables for H8 and NR28, which include overlapping reviews during the second half of 2025 and 2026. We are taking steps to meet this challenging timetable and stakeholders will also have a role in providing high quality business plans and timely submissions. A successful process relies on all parties stepping up to the mark.
- 2.58 There are advantages in a clear timetable for H8 and NR28 and we set out for further consultation a more detailed timetable for the H8 review in chapter 1.

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<sup>8</sup> MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024

- 2.59 Constructive Engagement should be carried out at an earlier stage and in multiple rounds to provide a greater opportunity for airlines to influence HAL's and NERL's business plans, and to comment on our initial proposals. We will consult on further guidance on Constructive Engagement later in the summer.

## Chapter 3

# Governance around price controls

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## Introduction

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- 3.1 This chapter sets out the lessons on governance of the H7 and NR23 price controls process, including management of process, consumer and customer engagement, guidance and information gathering, and expert advice and assurance. It then sets out a summary of our position on the key lessons learnt and discusses next steps.

## Management of process

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### Introduction

- 3.2 In the February 2024 Consultation, we said we should have a focused decision making process and stronger expectations around the timely provision of information by licensees and stakeholders.

### Summary of stakeholder views

- 3.3 A number of stakeholders said that we should plan external resourcing and have detailed and stable timetables that allow sufficient time for CAA internal governance, analysis and preparation of documents. Delays should be avoided, but where they do occur, they should not shorten important stages of the process, such as Constructive Engagement.
- 3.4 NERL said we should allow a more interactive exchange of information and greater organisation of questions, to expedite the flow of information in future.
- 3.5 HAL and a number of airlines supported the CAA using a sub-committee and/or an expert panel to provide economic regulation expertise and ensure there is sufficient Board-level engagement in the price control process.

### Advisory Panel views

- 3.6 The Advisory Panel said a regulatory sub-committee might be helpful in guiding the Board through key issues and this approach had been used by Ofgem.

### Our views

- 3.7 We recognise the need for clear and deliverable timetables for price reviews, avoiding undue delays as far as practicable. These matters are addressed further in chapters 1 and 2.

- 3.8 There are advantages in effective and efficient Board governance and we will seek to ensure such arrangements are in place for the H8 and NR28 reviews. We will also look to establish a price control review advisory panel, such that our work benefits from suitable external expertise and insight, and we will consider the views from the Advisory Panel on a regulatory sub-committee.

## Engagement with stakeholders and consumers

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### Introduction

- 3.9 We asked stakeholders for their views on how consumer views should be reflected in the price control process, and how stakeholder and consumer engagement for H7 and NR23 could be improved.

### Summary of stakeholder views

- 3.10 HAL said that the CAA should carry out its own consumer research, alongside HAL and airlines' own research, to understand consumer priorities and ensure these inform the development of service outcomes, prices and investment. HAL stated that outcomes must be informed by direct consumer input and not take airlines as the only voice of consumer interests. ACI Europe noted that consumers are willing to pay for higher service quality.
- 3.11 Airlines also supported the CAA carrying out its own consumer research with VAA proposing that consumer feedback should be gathered by CAA and used to inform HAL's business plan. AOC/LACC said that the CAA's H7 approach of encouraging HAL to commission consumer research and insights has resulted in the CAA being overly reliant on HAL's view of what consumers want.
- 3.12 Airlines valued engagement with CAA during the H7 and NR23 processes, including Board-to-Board exchanges. They would like to see more structure around the engagement for the next price control reviews.
- 3.13 NERL said that its engagement ahead of NR23 with consumers had helped provide evidence in support the key priorities in its business plan. It also said the CAA should draw on resources like the Consumer Panel and UK Aviation Consumer Survey and set out what evidence NERL should provide. On service quality, NERL highlighted the importance of setting its historical performance in context and using other air navigation service provider benchmarks to provide a clear view of its overall performance.
- 3.14 A number of stakeholders raised specific issues that they considered were not considered fully by CAA for H7 and NR23.
- 3.15 Prospect, CISHA, and Padox stated that the CAA should consider engaging with other stakeholders during the price control reviews, in addition to the regulated entities and airlines. They provided suggestions for how this could be

achieved. The Heathrow Passenger Forum said that they represent Heathrow's consumers and could provide an independent input to the next price control.

### **Advisory Panel views**

- 3.16 The Advisory Panel said that gathering consumer views and engaging with consumers to understand their needs should be the responsibility of HAL and NERL. The CAA should provide clear guidance and set out its expectations on how consumer research and engagement is used to inform HAL's and NERL's business plans, and should provide oversight of this research and engagement.

### **Our views**

- 3.17 Understanding consumers' views is an important part of making sure that the price controls further the interests of consumers. The H7 and NR23 reviews showed that high quality consumer engagement and research is not straightforward. Consumer research should be set in the appropriate context and carried out at a stage when it can influence HAL's and NERL's business plans.
- 3.18 A number of stakeholders have said that we should lead on carrying out consumer research. Our current view, supported by the views from the Advisory Panel, is that HAL and NERL should continue to lead on consumer engagement and provide a clear line of sight as to how consumer priorities are reflected in their business plans. We will consider further what guidance we should provide licensees on these matters and whether we should carry out our own research to supplement that carried out by HAL and NERL.
- 3.19 We will seek to improve our approach to engagement with non-airline stakeholders and consider how we can best encourage high-quality engagement between licensees and wider stakeholders. It will remain important that HAL continues to lead on engagement with its local community and we welcome views being submitted from all stakeholders, including the Heathrow Passenger Forum.

## **Guidance and information gathering**

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### **Introduction**

- 3.20 We asked stakeholders how we should secure the provision of timely and high quality information to support the next HAL and NERL price control reviews.

### **Summary of stakeholder views**

- 3.21 A number of stakeholders said we should provide more detailed business plan guidance, to ensure stakeholders know what is expected, reduce follow-ups and make non-compliance easier to identify. It was also suggested that this guidance should be developed in consultation with stakeholders.

- 3.22 HAL and NERL said that they provided all available information for H7 and NR23. They indicate that issues arose where our guidance was unclear and we had unrealistic expectations about the information available in challenging times.
- 3.23 A number of other stakeholders said we should use our information gathering powers during the price control process. Some airlines said we should take enforcement action and apply penalties where information is late or incomplete, and we should reduce our reliance on information provided by HAL. Arora also said that information should be signed off by the HAL Board.

### Advisory Panel views

- 3.24 The Advisory Panel said the process could be improved by the CAA using its information gathering powers. It said the CAA should consider applying stronger incentives for HAL and NERL to comply with its guidance, which has been done in other regulated sectors.

### Our views

- 3.25 We remain of the view that there were significant shortcomings in the quality of some of the information provided by HAL and NERL during the last set of price control reviews. While we accept that the circumstances created by the pandemic were difficult this does not fully explain these issues with the information provided by licensees. We will consider further whether we can strengthen our business plan guidance and the incentives on licensees to provide timely and high quality business plan information.
- 3.26 We did not use our formal information gathering powers during H7 and NR23 and it is unclear whether doing so would have resolved the issues above. We will consider our approach for the next price controls, though we consider there is a risk that applying a formal approach widely could distract attention from underlying goal of providing all relevant information in a timely way.
- 3.27 For H7 and NR23, we relied heavily on information from business plans and there could be opportunities to improve our approach to cost assessment and traffic forecasts, for example, from using wider information and benchmarks. We provide further detail on this in chapters 4 and 5.

## Expert advice and quality assurance

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### Introduction

- 3.28 The February 2024 Consultation asked stakeholders for any views on the quality of the reports that we published by our external consultants during H7 and NR23 and for any suggestions for how we should best use external consultants and advisors in the future.



## Summary of stakeholder views

- 3.29 HAL and NERL both stated that we should have earlier planning of external work by consultants. HAL also suggested we should allow for prompt engagement between HAL and consultants, and HAL should have an opportunity to comment on the terms of reference for the CAA's consultants.
- 3.30 Airlines supported our use of consultants, stating we should rely on their work rather than information from HAL. Some airlines supported greater engagement with our consultants.
- 3.31 Prospect said time and resources had been wasted on a pay benchmarking study for NERL.

## Advisory Panel views

- 3.32 The Advisory Panel did not consider it to be normal regulatory practice for HAL or NERL to comment on the terms of reference.

## Our views

- 3.33 External advisors for H7 and NR23 provided important quality assurance on parts of the price review that require specific technical expertise, including assessing efficiency and estimating the cost of capital. At times, support was also needed to provide sufficient resources to meet publication deadlines.
- 3.34 We will consider whether to engage consultants at an earlier stage, but this will depend on the scope of their work and the appropriate timing to make sure their work is based on the latest available information. We will be transparent in our approach to use of external support, although we will only seek views and stakeholder input on terms of reference where this is appropriate.

## Summary and next steps

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- 3.35 We will always seek to establish effective and efficient governance and will consider how best to do this for the H8 and NR28 reviews. As part of this we will establish a price control review advisory panel, such that our work benefits from suitable external expertise and insight.
- 3.36 It is important that our work on price control reviews is properly informed by consumer engagement and research. HAL and NERL will need to carry out their own research and we will consider what guidance we should provide in relation to these matters and how best to engage with licensees to ensure that consumer research is appropriate and fit for purpose. We will also consider whether to carry out our own research to supplement that carried out by licensees.
- 3.37 We will seek to improve our approach to engagement with non-airline stakeholders and consider how we can best encourage high-quality engagement between licensees and wider stakeholders.



- 3.38 Further consideration will be given to strengthening our business plan guidance and the incentives on licensees to provide timely and high quality business plan information.
- 3.39 The use of external advisors will remain important in terms of providing additional analytical and other support to the price review process. We will adopt a transparent approach to our work with external consultants but will only seek stakeholder views on the terms of reference where this is appropriate to do so.

## Chapter 4

# Traffic forecasting, incentives and service quality

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## Introduction

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- 4.1 This chapter sets out our findings in relation to traffic and passenger forecasting, and the regulatory incentive mechanisms, including service quality schemes, across the HAL and NERL price controls.<sup>9</sup>
- 4.2 These policy areas are significant in the process of setting a price control because:
- traffic forecasts underpin the revenue and cost forecasts; and
  - regulatory incentive mechanisms support us in creating a framework where the company delivers the desired outcomes for consumers, including efficient costs and appropriate levels of service quality.
- 4.3 We aim to create a balanced set of incentives and appropriately allocate risk across service quality, cost efficiency (including costs beyond airport charges), commercial revenues and passenger traffic. The regulated companies should be incentivised to:
- produce a robust and high-quality business plan;
  - meet the needs of their airline customers and consumers;
  - deliver appropriate levels of service, resilience and environmental performance; and
  - achieve these outcomes in an efficient way, including taking account of the costs of financing investment.
- 4.4 These objectives are also supported by other policy areas, including our approach to cost assessment (chapter 5), the financial framework (chapter 7), and environmental sustainability (chapter 6).

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<sup>9</sup> Mechanisms for HAL and NERL include Traffic Risk Sharing (TRS), service quality incentives, and opex and commercial revenue cost efficiency incentives. HAL-specific mechanisms include *ex ante* capital expenditure incentives, and Other Regulated Charges. NERL-specific mechanisms include Airspace Modernisation (ACOG reporting requirements), and the new user cost recording and recovery mechanism.

## Overall package of incentives

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- 4.5 The February 2024 Consultation noted the importance of a balanced overall package of incentives and said that we should consider how best to increase the focus and transparency of our work on the overall package of incentives.

### Summary of stakeholder views: HAL's incentives

- 4.6 HAL expressed general concerns about the overall balance of incentives and about how costs are estimated for individual building blocks. It said the CAA should consider the balance between long-term service improvement versus short-term costs.
- 4.7 It also expressed concerns about how some mechanisms (for example the *ex ante* capex efficiency incentive) have been implemented in practice, and also stated that newly introduced or changed incentive mechanisms should be allowed to operate before major changes are considered.
- 4.8 Airlines said that the incentive mechanisms in place as part of the HAL framework are generally well understood and have clear objectives (individually). They highlighted that the key issue from their perspective is the information asymmetry during the Constructive Engagement process, and the risk of gaming by HAL, and suggested enhanced incentives for business plans.
- 4.9 In addition, airlines noted the importance of effective enforcement by the CAA and BA suggested that, ahead of Constructive Engagement for H8, the CAA should present analysis showing the impact of different approaches to risk allocation on the WACC.

### Our views: HAL's incentives

- 4.10 We note the points raised on costs and information asymmetry. These are matters that will be addressed during the H8 process, including by strengthening Constructive Engagement.
- 4.11 There is also a case for considering further whether we can strengthen incentives on HAL in relation to resilience and the quality of its business plan.
- 4.12 We agree that effective implementation of incentive mechanisms is an important part of a price control review, and that a proportional and reasonable approach needs to be taken to modifying incentives, particularly those that are relatively new. There are links between the incentive package and the cost of capital and we will explore and calibrate these to the extent this is reasonably practicable.
- 4.13 We remain of the view that a greater focus on creating a balanced package of incentives is an important objective for H8.

## Summary of stakeholder views: NERL's incentives

- 4.14 NERL highlighted the stability of the regulatory framework as having a positive effect in itself and warned that change without clear justification can often come with costs.
- 4.15 It also provided feedback during the stakeholder workshops that there is an imbalance between the capex engagement incentive, where there are potentially high penalties for NERL, and the service quality incentives, where penalties are quite low.

## Advisory Panel views

- 4.16 The Advisory Panel said that, in line with the NATS Independent Review interim report, the CAA should revise the service quality measures so that they cover all the appropriate areas, providing sufficient incentives and give enough emphasis to resilience.

## Our views: NERL's incentives

- 4.17 In addition to the broad observations noted above in relation to HAL we will look at the balance between service quality incentives and the capex engagement incentive at the next NERL price control review. When the final report from the NATS Independent Review is published, we will review the recommendations carefully, including in relation to service quality and resilience.

## Passenger and traffic forecasting

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- 4.18 In the February 2024 Consultation we set out our high-level view that the passenger/traffic forecasts remain an important part of the price control reviews and have a significant impact on cost allowances. We highlighted that the process for setting passenger forecasts had been a contentious issue for the H7 review, and that we should consider how we could improve this process for H8. For NR23, forecasts from external sources were more readily available and their use had been broadly supported by stakeholders during the price control review.

## Summary of stakeholder views: the Heathrow passenger forecast

### HAL theme 1: use of an independent forecast as the basis of the price control forecast

- 4.19 HAL said the passenger forecast should be Heathrow-specific, particularly as, in its view, the airport is likely to be capacity constrained during the H8 period. For that reason, HAL did not consider that there are any suitable external forecasts which could be used. HAL also noted that generating a Heathrow-specific external forecast would be time consuming and costly.
- 4.20 Airlines said that the H7 forecasting approach needs fundamental change and a new, balanced forecast needs to be developed. They suggested that the current

forecast is skewed in HAL's favour and overly pessimistic. Airlines supported the CAA commissioning an independent forecast for H8.

### HAL theme 2: process and transparency around traffic forecasting

- 4.21 HAL said that the CAA's approach to deriving its H7 passenger forecast was not transparent and highlighted its inability to fact-check the adjustments the CAA had applied to HAL's forecast in order to reach its final figures.
- 4.22 Airlines highlighted the deficiencies they saw in relation to the H7 forecasting process, including the failure of HAL to properly share its traffic forecasting model with airlines.

### Advisory Panel views

- 4.23 The Advisory Panel noted that, rather than generating multiple traffic forecasts, the CAA could focus on understanding the impacts on costs where traffic growth is above or below the forecast level. The Advisory Panel suggested that the CAA may be able to learn lessons from the approach to uncertainty mechanisms adopted by Ofgem for the electricity distribution price review in relation to expenditure on low carbon technology. It also suggested CAA should consider further whether there is scope for greater use of *ex post* adjustment factors to reduce reliance on the accuracy of particular forecasts.

### Our views: the Heathrow passenger forecast

- 4.24 We remain of the view that there would be advantages in commissioning an external traffic forecast for the H8 review.
- 4.25 There would also be advantages in HAL and the airlines working together to reach a joint view on a reasonable range of forecasts. Doing so will require transparency and engagement and, therefore, we consider it would be sensible for HAL and airlines to explore how best to achieve this during Constructive Engagement at the start of the H8 process.
- 4.26 The TRS arrangements for HAL (discussed further below) already provide for *ex post* adjustments to take account of unexpected variances in passenger numbers. We will consider whether the calibration of these arrangements should be adjusted, taking account of the Panel's suggestions and the overall level of confidence we have in the traffic forecasts that are developed as part of the price review process.

### Summary of stakeholder views: the NERL traffic forecast

#### NERL theme 1: use of STATFOR forecast and other sources of forecasts

- 4.27 NERL and airlines (easyJet and BA) supported using the STATFOR traffic forecast in NR28, as it has an established track record for accuracy.

## NERL theme 2: specific issues to be considered at NR28

- 4.28 NERL said that climate policies should be explicitly taken into account in the traffic forecast as these policies could dampen demand going forward. NERL also explained that new user traffic is not currently included in the forecast and that for NR28, a bespoke forecast for new users should be produced.
- 4.29 BA requested that an independent Oceanic forecast should be produced for NR28.

## Our views: the NERL traffic forecast

- 4.30 There is general support for the continued use of the STATFOR forecast and we propose to continue with this approach for NR28. Matters relating to Oceanic and new users will be dealt with as part of the next NERL price control review.
- 4.31 We would expect the forecast produced by STATFOR to factor in the impact of known climate policies on traffic.

## Traffic risk sharing

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- 4.32 In the February 2024 Consultation, we explained that traffic risk sharing arrangements, currently in place for both HAL and NERL, are designed to protect the regulated business from undue risk and prevent unnecessary increases in its cost of capital that would lead to higher charges for customers.

## Summary of stakeholder views: traffic risk sharing for HAL

- 4.33 HAL said that the TRS is an important part of the regulatory framework, but stressed that its current design is not suitable for H8 given the likely capacity constrained nature of the airport in the next regulatory period and the asymmetries that this creates.
- 4.34 Airlines and the AOC/LACC generally supported the principle of the TRS, but suggested the current design is either not suitable for H8 (when airport will likely be at capacity) or does not result in symmetric outcomes because there is a capacity cap in place for Heathrow on the upside but no floor on the downside. VAA also stated that under the current design, HAL are protected in a downside scenario, whereas consumers and airlines have little ability to be rewarded in an upside scenario.

## Our views: traffic risk sharing for HAL

- 4.35 We expect to retain TRS arrangements for H8 (given their beneficial impact on managing risk and reducing the cost of capital) but will consider points from stakeholders on the design and calibration of these arrangements as part of the H8 review.

## Summary of stakeholder views: traffic risk sharing for NERL

- 4.36 BA and easyJet said that the current NERL TRS mechanism is not balanced and needs to be re-evaluated for NR28. easyJet stated that the TRS needs to be re-considered in the context of a possible extreme event like the covid-19 pandemic occurring again, to avoid a prolonged increase in charges to airlines.
- 4.37 NERL supported the CAA's NR23 decision, and the lessons learnt in relation to TRS. It emphasised the importance of TRS in allowing NERL to remain financeable during the pandemic, asking for regulatory stability in this area as change is not needed. Prospect also supported the TRS arrangements for NERL.

## Our views: traffic risk sharing for NERL

- 4.38 Consistent with the approach discussed above in relation to HAL, we expect to retain TRS arrangements for NERL at NR28. We will consider points around design and calibration as part of the NR28 review, but note that the NR23 process considered in detail how best to adapt the arrangements to deal with pandemic type events.

## Service quality

- 4.39 H7 saw a transition to outcome-based regulation ("OBR") allowing for a greater focus on outcomes and the overall satisfaction of consumers at Heathrow airport. For NR23, we broadly retained the same approach from previous price controls to service quality measures and incentives, informed by EU air navigation service provider metrics and targets. In the February 2024 Consultation, we said that we will review the service quality incentives on both HAL and NERL at H8 and NR28 respectively.

## Summary of stakeholder views: regulation of HAL's service quality

### HAL theme 1: Consumer research and engagement

- 4.40 HAL, airlines and other respondents raised a number of points relating to consumer research and engagement. These matters are discussed and addressed in chapter 3.

### HAL theme 2: Incentives framework and design

- 4.41 HAL said that the measures, targets and incentives forming the OBR framework generally work well as an effective incentive mechanism. Nonetheless, HAL also highlighted the asymmetry between rebate and bonus payments (7% vs 0.36% of airport charges) and argue that rebates should be retained by HAL for investment to benefit the consumer rather than be paid to airlines.

- 4.42 BA supported the move to OBR but expressed concern that the outcomes and measures are insufficient to incentivise improvements. BA and AOC/LACC suggested that bonuses should either be removed or made more stretching.

### **Our views: regulation of HAL's service quality**

- 4.43 In chapter 3 we deal with issues relating to consumer research and engagement. This will be important to take into account as we set measures, targets and incentives within the OBR framework. Consumer research should include samples based on different consumer groups and include appropriate information and context to help participants make informed responses.
- 4.44 More detailed issues on the design and calibration of incentives will be considered as part of the H8 price review.

### **Summary of stakeholder views: regulation of NERL's service quality**

#### **NERL theme 1: Consumer research and engagement**

- 4.45 NERL, airlines and other respondents raised a number of points relating to consumer research and engagement. These matters are discussed and addressed in chapter 3.

#### **NERL theme 2: Environmental incentives**

- 4.46 NERL's views on how environmental objectives are reflected across the wider price control and affect service quality are addressed in Chapter 6. NERL specifically supported a thorough review of wider environmental incentives, including the 3Di metric. Other stakeholders expressed similar views, including easyJet, which called for the CAA to target ambitious improvement in 3Di performance.

#### **NERL theme 3: Incentive design and NATS Independent Review**

- 4.47 NERL considers that service improvements should be made in line with improvements to other aspects of performance such as resilience and states that it will respond to the NATS Independent Review recommendations on service quality.
- 4.48 NERL also noted what it perceives as imbalanced incentives contrasting the example of a £50 million maximum penalty for capex engagement incentive and £65 million for all service quality incentives. Prospect said that service quality performance targets should be set to take account of impacts on staffing levels, training capacity and capex/technology rollout.
- 4.49 BA stated that emerging NATS Independent Review lessons on the effectiveness of service performance incentives should be considered in the round for NR28. Other airlines also said the incentives on NERL to provide a resilient service should be strengthened.



## Our views: regulation of NERL's service quality

- 4.50 As noted above, we deal with matters relating to consumer research and engagement in chapter 3.
- 4.51 We will also consider the recommendations from the NATS Independent Review in relation to service quality and resilience ahead of the NR28 review.
- 4.52 Specific issues in relation to the design and calibration of NERL's incentives will be addressed at the next price control review, including ensuring that we create a balanced package of incentives and have appropriate environmental incentives and targets.

## Cost incentives

- 4.53 In the February 2024 Consultation, we reiterated that a key objective of the price control review is to provide incentives for efficiency in a broad sense (so that the licensee targets both an appropriate quality of service as well as an efficient level of costs for delivering this quality of service).
- 4.54 We explained that, as part of the H7 review, we had introduced a new framework for *ex ante* capex incentives, and that these will need time to bed in before their impact can be properly assessed. For NR23, we continued to assess the efficiency of capex on a backward-looking ("*ex post*") basis and said that we would consider the best approach to capex incentives as part of NR28.
- 4.55 In this section we consider capex and opex incentives, and the approach for recovery of other costs, such as costs relating to specified services and facilities that are collected separately from the charges subject to price control.

## Summary of stakeholder views: HAL's cost incentives

### HAL theme 1: overall design of the H7 *ex ante* capex efficiency incentives

- 4.56 HAL said that the capex efficiency framework put forward by the CAA for H7 is too complex and does not reflect the principles of better regulation, and that it has already resulted in increased complexity without clear benefits. However, HAL also stated that it is premature to consider further changes to the capex efficiency framework for H8, before understanding the impacts of its implementation in H7.
- 4.57 Airlines are also of the view that it is too early in the implementation of the new capex efficiency framework to understand whether it has been successful. Nonetheless, VAA expects the CAA to review how delivery obligations ("DOs")<sup>10</sup>

<sup>10</sup> DOs are agreed by HAL and airlines at Gateway 3 of the capital planning process and capture the fundamental elements of what a project is expected to deliver as well as the budget, and its expected output, quality and timing.

are designed when revising incentives for H8 and BA is also calling on the CAA to review the effectiveness of DOs ahead of H8.

#### HAL theme 2: balance between opex and capex incentives

- 4.58 The AOC/LACC and BA consider that the current approach, whereby HAL is liable for, or can retain, 100% of opex increases or savings respectively during the regulatory period, but earn a return on capital investment, could incentivise solutions and optioneering that prioritise capex. They say that the capital governance process provides some checks on this: however, by the time airlines scrutinise projects, the opex versus capex debate has already been decided.
- 4.59 AOC/LACC also considers that the current approach to opex incentives could be seen to encourage regulatory gaming, with HAL's timing decisions to fall either side of control periods, and new initiatives or savings unlikely to be considered in time for the next period.
- 4.60 BA set out a list of reasons why 100% opex cost sharing (as is currently the case) might not be appropriate for HAL. These reasons included a customer base that differs over time, the limited extent to which savings get reflected in cost allowances for the next period in a framework with a single regulated company, and the possible reclassification of costs during the period, resulting in opex savings for HAL but 'double charging' for the airlines.

#### HAL theme 3: other regulated charges (ORCs)

- 4.61 AOC/LACC and BA did not agree with the CAA's proposed approach to ORCs in the lessons learnt document (namely waiting to see the impact of changes to governance arrangements and results of the ORC independent review). They said that recent challenges in relation to agreeing the ORC protocol with HAL (and subsequent escalation to CAA) demonstrate the need for change in the ORC framework.
- 4.62 Padox raised several concerns regarding the regulation of ORCs, including the way that the single till flows through to charges for airlines (reducing them) and the potential detrimental impact of this on non-airline users. It stated that HAL did not consult with non-airline ORC users during the H7 process and set out a request that CAA ensures that non-airline users are considered for H8. Padox supported the independent review of ORC cost allocations but emphasised that there needs to be an appropriate level of transparency around this review.
- 4.63 Arora was of the view that the CAA was not balancing its duties in terms of promoting competition in the provisions of AOS when setting ORCs. It said that the way ORCs are set is not consistent with a competitive market outcome, because HAL's charges are set above market levels and above the levels at other airport locations, for similar services. Arora also said that the CAA did not

ensure there was sufficient transparency around ORCs and that these charges had not been set in consultation with Arora.

## Our views: HAL's cost incentives

### Capex efficiency incentives (theme 1)

- 4.64 The new capex efficiency incentives need time to bed in before we can effectively assess the scope for further improvements as part of the H8 review.
- 4.65 The MKmetric report sets out some lessons from the StageGate process applied at Dublin airport and sharing of investment risk between the airport and its customers, which we can consider when assessing the scope for any further improvements at H8.<sup>11</sup>
- 4.66 We note that there has been good collaboration between HAL and airlines on the implementation of the new *ex ante* framework, and the CAA has been actively involved in these discussions, providing additional guidance where appropriate. Further issues can be considered as part of the H8 process, including in relation to DOs.

### The balance between opex and capex incentives (theme 2)

- 4.67 We note that there are trade-offs between opex and capex. The new standard information template for capex projects (introduced at H7) asks HAL to explicitly set out what opex solutions it has considered before bringing forward a capex project. We will consider any evidence of a possible capex bias as part of the H8 setting of cost allowances, WACC and cost efficiency incentives. Nonetheless, we would need to find convincing evidence that there was significant difficulty with the present arrangements before considering change.

### Other regulated charges (theme 3)

- 4.68 We remain of the view that we have adopted a reasonable and proportional approach to the regulation of ORCs, consistent with the fact that we have a primary duty to protect the interests of consumers.
- 4.69 The CAA has been involved in the independent review of the ORC cost allocation commissioned by HAL. We will consider the need for further change as part of this process.
- 4.70 At the H8 price review, we will consider whether further changes to the arrangements for ORCs are appropriate. We also encourage HAL to consider how it can better engage with airline and non-airline users on the ORC calculations and overall approach, and how it can increase the transparency of ORCs, to address concerns raised by stakeholders.

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<sup>11</sup> MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024

## Summary of stakeholder views: NERL's cost incentives

- 4.71 NERL said that cost efficiency incentives should be considered in the context of setting a balanced settlement, which incentivises NERL to deliver a set of outputs (safety, resilience, service performance) which are valued by users. It said we should avoid undue and over detailed scrutiny of its cost base and retain a higher level approach to incentivising efficiency, including allowing it to retain efficiency gains until the next period.
- 4.72 BA and easyJet supported the capex engagement incentive (including it continuing into NR28), but with easyJet saying we should assess whether the incentive is meeting its objectives.
- 4.73 BA also supported reforms to the way capex is incentivised and noted the potential to move away from *ex post* assessment of capex efficiency for NERL, to a settlement that more strongly incentivises efficiency, delivery and maximising benefits from capital investment. VAA supported introducing *ex ante* incentives for NERL (similar to the incentive introduced for HAL at H7), and having DOs in place for NERL.

## Our views: NERL's cost incentives

- 4.74 We agree that cost efficiency incentives should be considered in the context of setting a balanced settlement. However, we do not agree with NERL's suggestion that the consumers should only benefit from efficiency gains in the following period. Setting efficient cost allowances is a central element of a price control review, and a key part of the CAA discharging its statutory duties.
- 4.75 We will prioritise reviewing the way NERL's capex is incentivised as part of the NR28 review, given the Egis recommendation to the CAA.<sup>12</sup> The MKmetric report also said international case studies emphasised the need for a robust process of *ex ante* capex scrutiny and strong financial incentives for investment in new, digitised technology.<sup>13</sup>
- 4.76 The first stage our work on these matters will involve establishing what issues enhanced incentives would seek to address, and setting out options to address these issues. These options could include introducing cost efficiency incentives (on an *ex ante* basis) or incentives for the delivery of milestones or the delivery of benefits from capex projects or programmes.

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<sup>12</sup> See [Egis Review of key Capital programmes proposed by NERL for the NR23 period Final Report](#) - October 2023, pages 4 and 38.

<sup>13</sup> MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024

- 4.77 NERL has already outlined some of the changes it has been making to its internal approach to capex governance and stakeholder engagement,<sup>14</sup> which should directly address some of the recommendations made by Egis.
- 4.78 Any new incentive mechanism would have to work alongside the capex engagement incentive and we would need to be conscious of possible interactions and the overall regulatory burden.

## Summary and next steps

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### The regulation of HAL

#### Overall package of incentives.

- 4.79 We remain of the view that a greater focus on creating a balanced package of incentives is an important objective for H8.

#### Passenger forecasts

- 4.80 We expect to commission an external independent traffic forecast for H8.
- 4.81 We will encourage HAL to work with airlines to win greater stakeholder confidence in its forecasting model and the forecasts that it produces.

#### Traffic risk sharing (TRS)

- 4.82 Given the importance of appropriate risk sharing arrangements to HAL's financeability and cost of capital, we expect to retain TRS arrangements, but will consider the form and calibration of these arrangements.

#### Service quality

- 4.83 Matters relating to consumer research and engagement are covered in chapters 1 and 3.
- 4.84 We will consider the balance of incentives, alignment with consumer priorities and importance of incentives for resilience at H8.
- 4.85 The OBR Mid-Term Review<sup>15</sup> is also ongoing and is an important interim step for further work leading into the H8 review.

#### Opex and capex incentives

- 4.86 Bearing in mind that HAL's capital efficiency incentives have only been recently introduced our focus will be on understanding how they are working in practice

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<sup>14</sup> NERL set out these changes as part of a stakeholder workshop run by the CAA on the Egis Review report.

<sup>15</sup> See CAA, [Outcome Based Regulation Mid-Term Review scope consultation](#) letter, 25 April 2024.

and making any evolutionary improvements that appear appropriate, either at the H8 review or subsequently.

- 4.87 As part of the H8 review we will also consider whether improvements can be made to the regulation of ORCs.

## **The regulation of NERL**

### **Overall package of incentives**

- 4.88 We remain of the view that a greater focus on creating a balanced package of incentives is an important objective for NR28.

### **Traffic forecasts**

- 4.89 We expect to retain the use of the STATFOR forecast for NR28.

### **Traffic risk sharing (TRS)**

- 4.90 Given the importance of appropriate risk sharing arrangements to NERL's financeability and cost of capital, we expect to retain TRS arrangements, but will consider the form and calibration of these arrangements.

### **Service quality**

- 4.91 Matters relating to consumer research and engagement are covered in chapters 1 and 3.
- 4.92 Following the publication of the NATS Independent Review we will review the recommendations and consider whether any changes to the service quality incentives and targets (including in relation to resilience) are required for NERL. This review of the lessons learnt has been conducted independently from the NATS Independent Review.
- 4.93 More widely for NR28 we will consider the balance and weighting of service quality incentives within the wider suite of regulatory incentives.

### **Opex and capex incentives**

- 4.94 We will prioritise reviewing the way NERL's capex is incentivised as part of the NR28 review, given Egis's recommendation to the CAA and the findings of the NATS Independent Review.

## Chapter 5

# Cost assessment

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## Introduction

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- 5.1 A key part of our work at a price control review involves assessing the efficient level of costs that the regulated business is expected to incur.
- 5.2 This chapter summarises the views of respondents to the February 2024 Consultation on our approach to cost assessment (including how we set allowances for opex, capex and commercial/non-regulated revenues), as well as through an internal review of our approach to cost assessment and workshops with external stakeholders. It also draws on the findings of reports we commissioned from GT on our approach to cost assessment and MKmetric on international case studies.<sup>16</sup>
- 5.3 We note that respondents made a number of detailed points in their responses, on a range of issues related to cost assessment, but not specifically regarding our broader approach. These included policy points related to inflation and ORCs. We consider that these comments will be best addressed as part of the price control process and they are not addressed in detail in this chapter.
- 5.4 In the 'summary and next steps' section of this chapter, we identify three key priority areas for action.

## Lessons learnt – process

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### Summary of stakeholder views

#### Initial framework

- 5.5 HAL told us that the CAA should be more proactive in setting out its approach to cost assessment in advance. It suggested that the CAA needs to set a regulatory framework as the context for the business plan submissions.

#### Business planning guidance

- 5.6 Consistent with the discussion in chapter 3, a number of stakeholders suggested that the CAA needs to improve the guidance which it provides to companies in relation to the preparation of cost forecasts included in business plans. BA said that the H7 plan provided little insight and there was a lack of detail as to the

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<sup>16</sup> See reports published with this document from Grant Thornton, Future regulatory approach – cost assessment, 10 July 2024; and MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024.

constituent cost elements, while VAA suggested that more generally the CAA should ensure there is genuine 'optioneering' in both HAL's and NERL's plans that demonstrate the "pros and cons" of key aspects of their business plan.

### **Business planning process**

- 5.7 In their responses, some airlines stated that there should be more and earlier involvement by CAA in the development of cost forecasts. BA suggested that early engagement in the inception of business plans would enable CAA to consider how to best deploy a range of cost assessment tools. It was also noted that for the Constructive Engagement process to complement the CAA's approach, airlines rely on the regulator to address information gaps.
- 5.8 AOC/LACC stated that a more timely and iterative assessment on HAL's overall opex and commercial revenue performance would improve the assessment process. They considered that, in future, a focus should be a greater consideration and assessment of the choices being considered within the plan and potential outcomes it is seeking to achieve.
- 5.9 Other respondents said that the CAA should have a role in ongoing engagement and monitoring relative to the business plans, with VAA stating that in respect of NR28, the CAA should embrace a more proactive approach to monitoring of the evolution of costs versus NERL's business plan. easyJet considered that there should be a consistent and ongoing annual review of NERL's cost base.

### **Provision and transparency of information**

- 5.10 Several stakeholders commented on the opportunities for improvements to the CAA's process including in the area of the provision and transparency of information and the organisation of clarification questions.
- 5.11 BA commented that the CAA should not allow the regulated entity to benefit through higher allowances from any failure to provide its regulator and users with the required information, and that the CAA should be using the full suite of its enforcement powers to gather the necessary information.
- 5.12 The AOC/LACC pointed out that fundamental challenges remain in relation to asymmetry and transparency of information; while HAL stated that the CAA should make its assumptions and supporting models transparent to it early in the process.
- 5.13 NERL more generally requested stronger expectations around the timely provision of information by licensees and stakeholders and specifically requested that the CAA ensure greater organisation of clarification questions, and greater specificity in the questions and level of detail expected for the answers.
- 5.14 Although not raised in the consultation responses, it was mentioned by airlines in discussions that the CAA should provide more detail on opex and staff costs,



especially air traffic control staffing plans and productivity, including pay benchmarking, and focus on the drivers of cost growth.

### **Appointment of external consultants**

- 5.15 Several stakeholders requested improvements to the appointment of external consultants. BA commented on CAA having previously appointed consultants at a late stage, while HAL suggested that the CAA must ensure engagement between CAA consultants happens at the initial stage of work.

### **Our views**

- 5.16 We agree that it would be helpful to set out and consult on our broad approach to cost assessment at the start of each price control review. We will also consider how we might best improve the provision and transparency of information and the process of asking clarification questions, including how we ensure their timely provision and that they are well-focused and manageable.
- 5.17 The early appointment of consultants will often be helpful but note that the exact timing of their appointment needs to be aligned with the provision of information and the changing needs and priorities of our work programmes.
- 5.18 A priority for us will be to develop our approach to information gathering, business planning guidance and process including constructive dialogue. Specifically, we intend to provide clear guidance on the form and content of cost information that is required in business plans, to allow for better and more consistent scrutiny of these costs.
- 5.19 We will also reconsider our approach to Constructive Engagement (as set out in chapter 2). We will consider what role we might have in these discussions and in the ongoing monitoring of costs, although this is likely to vary according to the cost category under consideration and might also differ between the regulated companies.

## **Lessons learnt – method**

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### **Summary of stakeholder views**

#### **Less reliance on company views and greater use of benchmarking**

- 5.20 BA stated that the CAA should not be using the licensee's estimates as a starting point in its efficiency assessment to avoid perverse incentives. The AOC/LACC also said that the CAA's analysis (supported by independent expert input), rather than HAL's analysis, should form the starting point for cost assessment. easyJet made a similar point and said that the assessment of NERL's efficient costs should not be restricted to just the initial business plan.
- 5.21 BA said that the CAA had given equal weight to its own studies and those of the licensee and that this approach was not appropriate. It suggested that the CAA

should not adopt positions presented by licensees with little justification, including any findings from company-led studies that conflict with the CAA's own independent advice. The AOC/LACC suggested that the CAA should place stronger reliance on the output of the external consultants' reports, and that these should take precedence over information submitted by HAL.

- 5.22 BA stated that "it considered that the approach adopted at NR23 by the CAA was light-touch, including the lack of a proper assessment of staff costs"<sup>17</sup> while easyJet commented that the CAA should set up cost allowances that reflect an efficient market operator within a competitive landscape. Prospect urged that a focus should be placed on analysis of truly comparable entities, which it suggested were other European ANSPs in the case of NERL.
- 5.23 Some stakeholders requested that the CAA develop bottom-up cost estimates. easyJet said that for the NR28 determination, the CAA should adopt a bottom-up investigation of opex and capex. VAA stated that the regulated parties should be required to demonstrate both a top-down but also bottom-up approach to budgeting.
- 5.24 NERL cautioned that the CAA should only make any change to its approach to cost assessment as a result of a clearer identification of a shortfall in performance or outcome which might be remedied by any proposed new approach. It said the CAA should be fully informed by the latest practice adopted by other UK economic regulators, and any relevant findings from price control appeals to the Competition and Markets Authority.

### **Deep dives, earlier consideration and cross checks**

- 5.25 Some stakeholders considered that we should carry out 'deep-dives' in certain cost areas. For instance, BA cited HAL's 15% addition to capex projects to cover portfolio costs for 'Leadership and Logistics' as a possible example of an area which may benefit from a deeper dive assessment. The AOC/LACC also cited HAL's approach to leadership and logistics costs as well as procurement, risk and cost assurance as possible areas for further review.
- 5.26 Other stakeholders commented on the opportunity for earlier consideration of certain cost areas. The AOC/LACC said that early understanding of new large-scale requirements that may be needed in H8 will allow early consideration of the overall 'affordability' at H8 and would support better decision-making on specific investments in H7.

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<sup>17</sup> See para 14.18 of the BA response to our [February 2024 Consultation](#).

## Advisory Panel views

- 5.27 The Advisory Panel said that as part of the respective price reviews, benchmarking needs to be done earlier for both HAL and NERL, and that the CAA should investigate the scope for greater benchmarking, particularly across other major European airports.
- 5.28 The Advisory Panel also said that HAL should be required to provide more in-depth bottom-up justification of expenditure in particular cost areas.

## Our views

- 5.29 Changes to our approach to cost assessment will need to be carefully considered, so that the costs of any changes to our approach can be balanced against their merits.
- 5.30 The examination of company business plans will continue to form an important part of cost assessment. There will be areas of cost where information provided in the business plans will need to continue to form the starting point of our cost assessment. Furthermore, the weight which we place on our own consultant's advice compared to the companies' submissions will be examined carefully and determined on a case-by-case basis.
- 5.31 Nonetheless, we recognise that it will be important for us to identify options for supplementing the use of company business plan information so that we might broaden and deepen the evidence base which we are drawing upon in reaching our own views on the level of efficient costs. This includes the greater development, and use of, benchmarking information where practicable. It is also important that both HAL and NERL provide evidence of robust benchmarking of their processes, costs and service quality in their business plans to demonstrate efficiency and value for money.
- 5.32 As noted in the introduction to this chapter, in March 2024 we commissioned consultants, GT, to identify ways in which we might strengthen our approach to cost assessment including options which make greater use of external benchmarks. MKmetric also identified case studies with practical applications of cost and service quality benchmarking in Europe for airports and Europe, US and Canada for air traffic control services.
- 5.33 Overall, the work of GT and MKmetric points to supplementing the CAA's current approach to cost assessment with:<sup>18</sup>
- i) International benchmarking. GT advised that: 'Whilst challenging, the benefits – especially over the long term – of international benchmarking could be game-

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<sup>18</sup> Grant Thornton, Future regulatory approach – cost assessment, 10 July 2024, pages 24-25; and MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024, page 4

changing for CAA's cost assessment activities'. MKmetric's report states: 'regular benchmarking exercises would offer the CAA valuable information to enhance operational efficiency and service quality.'

- ii) Targeted bottom-up analysis. GT's report states: 'While a comprehensive analysis of all HAL/NERL costs is unlikely to be proportionate, identifying areas for detailed investigation could yield significant benefits, even in the short term.'
- iii) Gap analysis and triangulation. GT concluded that: 'With multiple cost assessment approaches potentially being brought to bear in future, the opportunity arises to strengthen understanding and increase confidence in findings by triangulating results of different approaches and focussing on the sources of any efficiency gaps found'.

5.34 We recognise that developing, and making greater use of, top-down international benchmarking, is likely to be challenging and will take time to develop. We will seek to make progress on these matters for H8 and NR28, but this work should be seen as complementing other approaches to cost assessment. Furthermore, we understand that reaching a bottom-up view on specific cost areas is likely to be a relatively resource intensive exercise and would require external support. Nonetheless, at future reviews we will look to supplement the bottom analysis we have undertaken at previous reviews (for example, in relation to pension costs), taking a proportionate approach and focusing on areas where there will be greatest benefits to consumers.

## Summary and next steps

- 5.35 There are three key areas that we intend to prioritise to strengthen our approach to the assessments of costs and efficiency for both HAL and NERL:
- i) Develop our approach to information gathering and business planning guidance. We plan to work to improve and enhance our approach to gathering information from the companies to support our development of cost estimates. Specifically, we intend to provide clear guidance on the form and content of cost information that is required in business plans, to allow for better and more consistent scrutiny of these costs.
  - ii) Work to widen the evidence base including further consideration of international benchmarking and targeted bottom-up analysis. We will build on the recommendations of the GT report to develop specific options to supplement the use of company business plan information so that we might broaden and deepen the evidence base which we are drawing upon in reaching our own views on the level of efficient costs. We would expect HAL and NERL to provide evidence of robust benchmarking of their processes, costs and service quality in their business plans to demonstrate efficiency and value for money.

- iii) Develop further our approach to the assessment of NERL's capex and its incentives for capital efficiency and delivery. We will consider what changes to our approach to setting allowances for NERL capex might strengthen the cost estimates which we produce. Our considerations will reflect, and build on, the relevant recommendations of, both the Egis report (referenced in chapter 4) and the NATS independent review report. As part of this, we will consider whether complementary capex governance mechanisms might be required for NERL and we will also explore delivery incentives for NERL capex as set out in chapter 4.

## Chapter 6

# Environmental sustainability

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## Introduction

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- 6.1 Our statutory duties require us:
- in furthering the interests of consumers, to consider the need for HAL to be able to take reasonable measures to reduce, control or mitigate the impact of Heathrow airport on the environment; and
  - in maintaining a high standard of safety in NERL's activities, to take account of any advice on environmental objectives we are given by the Secretary of State.
- 6.2 During the H7 review we made allowances for HAL to deliver a number of projects that will support the airport's transition to net zero. The NR23 price control includes incentives for NERL to provide air traffic services in a way consistent with the provision of efficient flight paths for the airlines that use its services, which directly furthers the interests of airlines and consumers by reducing fuel burn, with consequential reduction in emissions.
- 6.3 In the February 2024 Consultation, we asked whether there are more steps that HAL or NERL could reasonably take during H8 and NR28 to contribute towards achieving net zero and whether there are any changes that we should make to enable this.
- 6.4 This chapter summarises stakeholder responses, explains our latest views on these matters and then sets out a summary of our position on the key lessons learnt and next steps.

## Summary of stakeholder views

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### Introduction

- 6.5 Stakeholders agreed that environmental sustainability is a key issue. Most stakeholders said that the existing price control frameworks provide a reasonable basis for allowing licensees to contribute towards the UK's target to reduce greenhouse gas emissions to net zero, but there were also a number of suggestions as to how the price control frameworks could be developed further to support sustainability.

## Views on HAL's framework

- 6.6 HAL said that the CAA's approach to assessing its H7 sustainability capex programme was well understood but it suggested that the CAA should set a clear direction on the importance of net zero projects. It suggested that future capex governance arrangements should be streamlined so that projects that are important for HAL to meet its sustainability targets are not delayed. It said this would be particularly important as a key driver of investment for H8 will be decarbonising energy as the airport transitions from fossil fuels to electricity. HAL also said that as part of its H8 business planning process, it is considering investment that will be needed to maintain a resilient airport in the context of climate change.
- 6.7 Airlines said that the H7 framework did not preclude HAL's work on sustainability, but they said that HAL did not always provide robust business cases to support investment on sustainability projects. Airlines said HAL could use the net zero agenda to promote future capex spending and said that this investment should be scrutinised for efficiency.
- 6.8 Both HAL and airlines noted that sustainability projects tend to be long term and that the regulatory frameworks should be sufficiently flexible to accommodate the long-term planning of these investments, particularly as future solutions are still being developed.
- 6.9 Heathrow Southern Railway commented that we should consider surface access policy and said the price control framework for HAL should take account of the local environmental benefits that Heathrow Southern Railway could deliver, as well as its benefits in terms of reducing greenhouse gas emissions.

## Views on NERL's framework

- 6.10 NERL suggested that the CAA needs suitable government guidance and/or new duties or there will be a risk that regulation "may hinder the evolution of NERL's regulatory framework so that it can better support transition to net zero in aviation".<sup>19</sup> In contrast, airlines did not suggest such a change.
- 6.11 Airspace modernisation was a key area of NERL's NR23 plans to contribute to environmental sustainability. NERL and a number of airlines agreed that the existing framework does not present barriers to the delivery of this programme.
- 6.12 On the balance of incentives, NERL said that airlines will prioritise capacity over wider environmental considerations and that this balance was not effectively challenged at NR23.

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<sup>19</sup> See page 6 of the NATS response to our [February 2024 Consultation](#).

- 6.13 NERL and a number of airlines supported the review of the 3Di measure. NERL said that it is considering more easily understood measures to complement 3Di and intends to share this work as part of the review. Some airlines also commented on the level of the 3Di targets.
- 6.14 NERL also noted that incentive mechanisms to reduce emissions could be introduced through the modulation of route charges, which is a key element of the reform of the European Union Aviation Safety Agency ("EASA") Single European Sky regulation.

### Advisory Panel views

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- 6.15 The Advisory Panel notes the CAA is considering a reputational measure relating to Heathrow's carbon footprint and said that, for the next HAL price control review, we should consider the case for introducing a financial incentive on this measure.

### Our views

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- 6.16 We do not consider that either new duties or guidance are necessary to allow us to support, through the setting of price control incentives and cost allowances, HAL and NERL working towards and supporting net zero.

#### Incentives to reduce emissions

- 6.17 Our mid-term review of HAL's H7 OBR framework<sup>20</sup> includes consideration of a reputational measure relating to Heathrow's carbon footprint. This measure will be an important addition to HAL's service quality performance, providing an incentive on HAL to reduce its carbon emissions. Consistent with the suggestion from the Advisory Panel we will consider whether this measure should be enhanced and subjected to a financial incentive at the H8 price review.
- 6.18 We will be reviewing the 3Di measure ahead of NR28 and welcome the work that NERL is proposing on developing more easily understood measures to complement the existing performance measure. The appropriate targets for NERL's environmental performance will be considered as part of NR28.
- 6.19 We will monitor the Eurocontrol project on the modulation of en route charges to incentivise airspace users to support improvements in environmental performance and assess any future findings that may be relevant to NR28.

#### Investment in sustainability projects

- 6.20 HAL and NERL will need to make investments to meet their net zero obligations. It is important that these investments are supported by clear and robust business

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<sup>20</sup> [CAA consultation letter – Outcome Based Regulation mid-term review scope](#), April 2024



cases, including long term plans setting out how the investment will deliver net zero targets.

- 6.21 The existing capex incentive framework for H7, including the HAL and airline governance arrangements, will remain appropriate for investment on projects to support HAL's net zero targets. This framework provides appropriate incentives for efficient and timely delivery and should be sufficiently flexible to deal with environmental projects. It is important that these projects are not unduly delayed but are also subject to an appropriate level of scrutiny so that proposed investment is efficient. This process should ensure HAL is incentivised to deliver environmental benefits and consumers are not exposed to unnecessary costs.
- 6.22 It will be important that the existing frameworks for HAL and NERL allow flexibility for new investment plans to be reflected in the price controls, for example through the use of capex governance arrangements and the capex uncertainty envelope mechanism for HAL,<sup>21</sup> and remuneration of efficient capex for NERL. We will consider whether there is scope to improve these arrangements as part of the reviews of the H8 and NR28 price controls.
- 6.23 On the comments from Heathrow Southern Railway, we recognise the importance to the environment of appropriate modal shift in terms of travel to Heathrow airport, and we will consider an appropriate approach for the H8 price control, building on our existing surface access policy.<sup>22</sup>

## Summary and next steps

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- 6.24 We will continue to support and incentivise NERL and HAL to transition to and reasonably support net zero at H8 and NR28.
- 6.25 As part of the H8 and NR28 reviews, we will consider whether the regulatory frameworks are sufficiently flexible to support environmental investment. This will include building on our mid-term review of HAL's OBR framework and the review of NERL's 3Di environmental measure.
- 6.26 It will also be important that HAL and NERL's investment programmes appropriately reflect net zero. As part of our method statements for H8 and NR28, we will set out our expectations on the evidence that HAL and NERL should provide to support environmental investment and performance measures.

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<sup>21</sup> For H7 we said that one of these reasons for the capex envelope might be to support accelerated measures to achieve decarbonisation and the challenges of net zero (see CAA, Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks, June 2022, [CAP2365](#), para 7.123-7.140).

<sup>22</sup> See CAA, Economic regulation of Heathrow Airport Limited: an update on the CAA surface access policy, October 2019, [CAP1847](#)

This will include investment to support resilient services in the context of climate change adaptation.

- 6.27 We will also continue to support airspace modernisation, which has the potential to generate environmental benefits.

## Chapter 7

# RAB and financeability

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## Introduction

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- 7.1 The regulated asset base (“RAB”) represents a record of the amount that investors have invested into a regulated company which has not yet been recouped through charges. The RAB is a fundamental part of our regulatory approach as it is a key driver of charges and the confidence that it affords investors supports the cost effective financing of new investment.
- 7.2 Financeability is the term we use to describe our assessment of whether the price control determination will allow a regulated company to finance its regulated business. Financeability helps to support investment and we have secondary statutory duties to consider financeability for both HAL and NERL.<sup>23</sup>
- 7.3 In this chapter we discuss stakeholders’ and our views in respect of the lessons learnt relating to RAB and financeability. This chapter also includes discussion of our approach to financial modelling (as it is closely related to our assessment of financeability) and whether we should simplify the regulatory arithmetic that we use for calculating NERL’s price control. It then provides a summary of key lessons learnt and next steps.

## Summary of stakeholder views

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### RAB

- 7.4 BA, the AOC/LACC, VAA and easyJet raised concerns about the size of HAL’s RAB, suggesting that it was too large and ought to be reduced. Different airlines made different suggestions in relation to how the RAB could be reduced.
- 7.5 The AOC/LACC suggested moving away from RPI indexation of the RAB and suggested “liquidating” non-core and under-performing assets.
- 7.6 BA said under-performing assets in HAL’s RAB should be reviewed. BA identified £2.2 billion of assets labelled as ‘investment property’ which they described as liquid assets and suggested that by selling them HAL could lower charges.

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<sup>23</sup> See appendix B for further consideration of our statutory duties.

- 7.7 A number of airlines supported indexing the RAB by either CPI or CPIH instead of RPI.<sup>24</sup> BA also suggested introducing a mechanism to limit the scope for inflation-driven returns.
- 7.8 VAA also called for a more fundamental re-examination of the use of the RAB and suggested the CAA should consider amending, changing or breaking up the RAB.
- 7.9 BA suggested that the CAA should consider the merits of not indexing the RAB to general inflation and suggested that the CAA might instead employ a nominal cost of debt.<sup>25</sup> Finally, BA also sought confirmation from the CAA as to whether it will make more RAB adjustments akin to the £300 million RAB adjustment that we had made in response to the covid-19 pandemic.
- 7.10 easyJet suggested that the RAB should not be indexed because inflation risk is remunerated through the regulatory allowance for the cost of capital. Similarly, easyJet opposed the indexation of the TRS debtor in the NERL price control. easyJet also suggested that, to avoid biases in the forecasting of inflation, we should use a notional value for inflation.
- 7.11 HAL and NERL both suggested that any transition from RPI to CPI should be neutral in net present value terms. HAL stated that the approach to RAB and depreciation should be guided by a balanced view of long- and short-term consumer interests. It also said that the CAA should retain the principle of recovery of efficient expenditure through the RAB and depreciation, and there was not enough transparency in the indices used by the CAA.

## Financeability

- 7.12 A common theme in the responses from airlines was concern that the financeability assessments we have made in support of our price control decisions have contributed to charges being higher than necessary. The AOC/LACC suggested that we should review the balance of risk and reward in a post-pandemic world. BA said the CAA should look at market evidence, such as HAL's excess profits, and recognise that the secondary duty of financeability should not override the primary duty to consumers.
- 7.13 easyJet suggested that credit metric analysis was not particularly relevant to NERL due to its monopoly status, ownership and essential infrastructure nature.

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<sup>24</sup> CPIH is a measure of inflation. It is defined as the consumer prices index (CPI) including owner occupiers' housing costs. The Office for National Statistics describes it as the most comprehensive measure of inflation. See here for further details: <https://www.ons.gov.uk/datasets/cpih01/editions/time-series/versions/45>

<sup>25</sup> See chapter 8 for further consideration of a nominal cost of debt.

It also expressed concern that NERL may be earning excess profits and the CAA should look at performance in past price controls.

- 7.14 NERL suggested that our financeability analysis should look at the possible variability in equity returns and focus on the overall package of incentives and balance of risks in the price control. NERL stated that we should examine a wider range of scenarios when stress testing.
- 7.15 HAL stated that the notional company should target at least a BBB+ credit rating and that we should consider obtaining independent advice on the level of credit rating required for the next price control.

### Modelling and simplification of price control calculations for NERL

- 7.16 NERL stated its support for having a better functioning price control model (“PCM”).
- 7.17 VAA supported simplification of the regulatory framework. NERL was open to the possibility of simplification and noted that looking for such opportunities is good regulatory practice. NERL stated that any simplification should be assessed on a case-by-case basis and simplification should not be a guiding principle in setting the next price control. NERL also stated that it would be concerned if simplification led to the removal of any *ex post* true up mechanisms as it could increase financial risk for NERL.

### Advisory Panel views

- 7.18 The Advisory Panel said the CAA could consider how price controls support investability (that is, in the circumstances where additional equity funding is required there are reasonable incentives on investors to provide such funding) in addition to financeability where there is significant additional investment, as Ofgem has proposed in its approach to upcoming electricity transmission price controls.
- 7.19 The Panel also said, in response to airline comments that the RAB is too high, that this should only be the case if there had been an error in calculating the RAB or the allowances for regulatory depreciation had been too low.

### Our views

#### RAB

- 7.20 We remain committed to using the RAB as the basis of our price control decisions. While other forms of regulation exist, such as cost pass through, we recognise the benefits of maintaining a predictable and rational approach to regulation, which supports the efficient financing of investment in the regulated business.

- 7.21 By retaining the use of the RAB we continue to demonstrate to investors that the regulatory framework provides a fair opportunity to earn a reasonable return. Consumers benefit from the investment and the lower charges that result from the incentives to reduce costs. Bearing this in mind any adjustments to the RAB need to be treated with care, both in order to avoid any undue increase in the costs that licensees face in financing investment and because of the potential to increase charges, which would not be in the interests of consumers.
- 7.22 We note the comments about the size of the HAL's RAB. There are interventions that could be made to reduce the size of the RAB while acting in a way consistent with the reasonable expectations of investors, such as by accelerating regulatory depreciation or encouraging the disposal of underperforming assets, but these measures would need to be considered carefully as they might lead to higher charges.
- 7.23 We recognise the importance of adequately remunerating inflation risk by indexing the RAB. In H7 and NR23 we set a real cost of capital<sup>26</sup> and indexed the RAB in line with RPI. We plan to explore policy options for how the RAB is indexed, including both a transition to CPI (or CPIH) and/or using a nominal cost of debt. A change to CPI/CPIH would mean that the price controls track inflation more accurately given the known difficulties with the RPI measure of inflation.
- 7.24 We note the planned transition of RPI to CPIH and that this is expected to happen in 2030.<sup>27</sup> The transition would, therefore, be expected to fall within the next price control periods for both HAL and NERL. We will consider approaches that avoid the technical difficulties of a change in indexation during the price control period,<sup>28</sup> while considering issues around the 'fair bet' principle, and the impact on charges and net present values.

## Financeability

- 7.25 We intend to continue to carry out financeability analysis to support the cost effective financing of investment and discharge our financeability duties for both HAL and NERL.
- 7.26 There are both "pros and cons" associated with considering more extreme downside scenarios when stress testing, in that more extreme scenarios are less likely to occur and their significance is harder to interpret. We note that, following our H7 and NR23 price control decisions, there were no changes in the credit

<sup>26</sup> That is, a cost of capital which provides no allowance for inflation.

<sup>27</sup> See [https://assets.publishing.service.gov.uk/media/5fbd3b86d3bf7f5735e29b43/RPI\\_Response\\_FINAL\\_VERSION.pdf](https://assets.publishing.service.gov.uk/media/5fbd3b86d3bf7f5735e29b43/RPI_Response_FINAL_VERSION.pdf)

<sup>28</sup> For example, this could include an increase in the complexity of calculating charges, need for additional mechanisms and reduced transparency.

ratings of HAL or NERL and both retained investment grade credit ratings, suggesting that we have a reasonable approach to financeability. Although we acknowledge that published credit ratings focus on the licensees' actual financial structure rather than the level of gearing we assume in setting the price controls (that is, the notional financial structure).

7.27 We note too that we did not make any changes to the calculation of the price cap as a result of the financeability analysis. So, there appears to be no obvious basis for airlines' comments that the CAA's consideration of financeability has contributed to charges being too high.

7.28 We also consider that a number of stakeholders' comments were, in essence, policy preferences for the forthcoming price control reviews. We will consider and consult on our policy as we go through the price control setting process.

### **Modelling and simplification of price control calculations for NERL**

7.29 We did not specifically comment on financial modelling in the February 2024 Consultation, although we welcome comments on our approach to financial modelling. We agree with NERL's comments that we should develop a better functioning model for the NR28 price control and we are currently developing our modelling strategy for NR28 to achieve this aim.

7.30 In respect of simplification of calculations for NR28, we note that stakeholders who commented on this issue generally welcomed simplification. We will learn from the experience of NR23 about which parts of the calculation are essential and which can be removed or simplified to lead to a more proportionate and transparent regulatory framework, without unduly affecting the overall balance of risk.

### **Summary and next steps**

7.31 We expect to retain a RAB-based approach to regulation at future price control reviews, bearing in mind the advantages of regulatory consistency and providing reasonable stability to investors (which, in turn, will avoid any unnecessary increases in the costs of financing investment). Consistent with the approach adopted by other economic regulators, we expect to move from the RPI to CPI or CPIH indexation of the RAB at the next round of price reviews.

7.32 A number of airlines have expressed concerns about the size of the HAL's RAB. We will consider these issues at H8. There are interventions that could be made to reduce the size of the RAB while continuing to act consistently with the reasonable expectations of investors, but these measures would need to be considered carefully as they might lead to higher charges at H8.

7.33 We expect our broad approach to financeability in the next round of price controls to be an evolution of the approaches we used in H7 and NR23. As part

of each price control review, we will consult on the approach to downside scenarios and how best to use credit metrics to assess financeability.

- 7.34 For the NERL price control we are looking at how the underlying calculation of the price control can be simplified and how the financial model can be made more robust for the NR28 price control.



## Chapter 8

# Cost of capital

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## Introduction

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- 8.1 For the HAL and NERL price controls, we estimate the regulated company's weighted average cost of capital ("WACC") to provide an appropriate return for the capital invested in the business. Estimating an appropriate WACC is an important part of our work to ensure that charges are no higher than necessary, that the licensees can fund investment and that the regulated business remain financeable.
- 8.2 The CMA considered our approach in its work on the appeals of our H7 price control decision and supported the broad approach we had taken to the WACC. We applied a similar approach to setting the NR23 WACC.
- 8.3 In the February 2024 Consultation, we said that we expected to carry forward various aspects of our H7 and NR23 approaches for H8 and NR28. We also said that our approach will need to be adapted and improved to keep pace with emerging precedent and changing market conditions.
- 8.4 This chapter summarises stakeholder responses on the cost of capital, explains our latest views on these matters and then sets out a summary of our position on the key lessons learnt and next steps.

## Summary of stakeholder views

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### Overall approach

- 8.5 HAL and a number of airlines said that we should not rely on the broad approach that we adopted at NR23 and H7 in relation to estimating the WACC for the next price controls. In particular:
- HAL said that the H8 WACC must allow for efficient capital planning so that the airport can scale to meet demand, it should align with evidence from capital markets, and that the CMA H7 Final Decision was not an appropriate starting point;
  - BA and AOC/LACC said we should review our approach to the WACC using precedent from other UK economic regulators, European airport regulators, the UK Regulators' Network (UKRN) and actual performance. BA also said we should review how the parameters have developed to see whether this supports both the H7 and NR23 approaches and the respective allowances. VAA supported BA's response; and

- easyJet said that the approach to WACC used for NR23 should not be retained for NR28.

8.6 NERL stated it is currently too early to comment on the WACC for the NR28 review.

## Cost of capital parameters

8.7 Stakeholders made a number of detailed comments about estimation of cost of capital parameters at H7, which are summarised briefly below:

- HAL said the reduction to the beta and WACC due to the traffic risk sharing mechanism had been overestimated. It also said that we should take a different approach to estimating the cost of embedded debt (using its actual costs) and new debt (using indices and adjustments that reflect its actual debt issuance), and we should clarify the treatment of inflation at the start of the price control review;
- ACI said that the impact of covid-19 has made airports a riskier equity investment and CAA should assess the impact of the pandemic on beta;
- BA said that we overestimated the asset beta and we should remove the pandemic uplift and change the comparator group used. Airlines for America said we should reflect HAL's lower risks following the covid-19 pandemic. BA also said we should not change our approach to the total market return or the equity risk premium to account for the increase in interest rates;
- BA also said HAL should provide information to show how its debt costs translate into a nominal rate, and we should set a nominal allowance for fixed rate debt; and
- easyJet made similar points to BA on the asset beta. It also said we should consider how the equity risk premium was calculated, as the historical-based approach depends on arbitrary choices, such as the averaging technique used.

## Advisory Panel views

8.8 The Advisory Panel said we should consider the benefits of being consistent with other regulators and the UKRN guidance, and noted we should consider how to address stakeholder comments around the comparator groups for estimation of beta.

## Our views

8.9 We remain of the view that the approaches we used to setting the WACC for H7 and NR23 provide appropriate starting points for the next HAL and NERL price

control reviews. These approaches are consistent with the findings of the CMA following the H7 appeals and would maintain regulatory consistency across control periods. Nonetheless, we will also consider new precedent from other regulatory reviews, the UKRN guidance on the cost of capital, the comparators for beta estimation, new market evidence and further evidence from stakeholders as we develop and consult on our approach for H8 and NR28.

- 8.10 We note the detailed issues raised by stakeholders on the cost of capital parameters. We will consider these policy issues as part of the method statement for H8 and NR28, including reviewing new precedent, market data and evidence from stakeholders.
- 8.11 On inflation, as set out in chapter 7, we are minded to change indexation of the RAB from RPI to CPI/CPIH for the future price control reviews, which will also suggest a change in the treatment of inflation in calculating the WACC (with the real WACC calculated by reference to the CPI/CPIH rather than RPI).

## Summary and next steps

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- 8.12 The approach we adopted to calculate the cost of capital at H7 and NR23 should provide a reasonable starting point for our work at H8 and NR28, but we will also consider new precedent from other regulatory reviews, the UK Regulators Network (“UKRN”) guidance, the comparators for beta estimation, new market evidence and further evidence from stakeholders.
- 8.13 We are minded to change indexation of the RAB and WACC from RPI to CPI/CPIH for the next HAL and NERL price reviews.

## Chapter 9

# Broader strategic issues

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## Introduction

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- 9.1 This chapter sets out a summary of the responses we received on the broader strategic issues we identified in the February 2024 Consultation. We said that work on these issues would be outside the scope of the H7 and NR23 lessons learnt review, but that the conclusions from any work on these issues could inform our approach to H8 and NR28, where it is practicable to do so in the time available.
- 9.2 This chapter summarises stakeholder views on:
- the form of price controls;
  - expansion at Heathrow airport;
  - provision and operation of new infrastructure at Heathrow airport;
  - scarcity rents;
  - airspace modernisation and new users; and
  - charges and the Airport Charges Regulations 2011 (“ACRs”).
- 9.3 The issues around environmental sustainability are discussed in chapter 6. The chapter finishes with a summary of key issues and next steps.

## Form of controls

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- 9.4 In the February 2024 Consultation, we said we would consider the design of the existing controls for HAL and NERL, including the duration of the price controls and the treatment of non-regulated and commercial revenues.
- 9.5 We said that we did not plan to change the overall framework for H8 and NR28 and that we were minded to continue setting price caps based on a single-till RAB framework for a period of five years. Nonetheless, we said that we would consider alternative treatment for specific costs or parts of the price control where there is a strong case for doing so, for example, to improve incentives for efficient investment and deliver better outcomes for consumers.

## Summary of stakeholder views

- 9.6 easyJet said the current regulatory framework does not deliver the desired impact for NERL’s customers or passengers in terms of prices and service quality. It said that current arrangements such as traffic-risk sharing do not

deliver affordable or value for money charges and NERL might be earning excessive returns.

- 9.7 VAA said that the RAB approach is not suitable for HAL, where there are many complex consumer needs and activities being regulated.
- 9.8 NERL also raised whether the current model fits its future software as a service approach, which it considered would not fit with existing capex-opex boundaries. NERL said the CAA could consider a different and flexible treatment for costs within the next price control period where these could change between capex or opex allowances (for example, for software), with consequential adjustments to charges, depreciation and the RAB.
- 9.9 HAL said that the CAA should consider a longer regulatory period to help enable major capital projects that cross price control periods, and increase stability and investors' confidence. HAL also said we should consider whether the boundary of the single till still remains appropriate (which we discuss in chapter 2).

## Our views

- 9.10 As set out in chapter 7 we remain committed to using the RAB as the basis of our price control decisions. We recognise the benefits of maintaining a predictable and rational approach to regulation, which supports the efficient financing of investment in the regulated business. Nonetheless, we will consider whether we can deal with opex-capex trade-offs better at NR28.
- 9.11 The MKmetric report provides details on different models of light-touch regulation in Australia and Europe (where there is a backup of price cap or rate of return regulation), with mixed views on how well it has worked.<sup>29</sup> In the UK context, with market power and appeals, we do not consider it is practical to apply full light-touch regulation to HAL or NERL, and we consider price cap regulation with Constructive Engagement remains appropriate.
- 9.12 There are advantages and disadvantages in changing the duration of price controls. A longer period provides greater incentives for efficiency but increases the risk that changes in circumstances will undermine the protections provided to consumers and investors by the price control. On balance we do not see a clear case for changing the duration of the HAL price control.
- 9.13 For NERL, we plan to consider the case for a six-year regulatory period to reduce the overlap between the processes for future HAL and NERL price control reviews. We will consult further on this in due course.

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<sup>29</sup> MKmetric, International approaches to airport and air traffic control regulation, 16 July 2024

- 9.14 The other points raised by stakeholders around levels of charges and service quality are important issues that we will consider as part of the H8 and NR28 price control reviews.

## Expansion and provision of new infrastructure at Heathrow airport

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- 9.15 The February 2024 Consultation said that we expected the H8 price review to focus on the operation of a two runway airport. We said that we would consider how best to address issues relating to capacity expansion, if they arise again in the future, as well as potential issues arising from any credible third party proposals to provide and operate part of the infrastructure at the expanded airport.

### Summary of stakeholder views

- 9.16 HAL said it remains committed to long-term sustainable growth and is reviewing its plans. HAL said that the future framework on investment and the RAB allows it to respond to growing demand in a two runway scenario. HAL also said that experience from other airports shows third party delivery leads to significant operational complexity and risks to resilience, which would be even worse in a two runway context.
- 9.17 BA said that the absence of a framework to assess third party proposals would likely deter potential providers from coming forward. A more proactive approach could better support the development of such plans. It also said expansion must meet requirements around affordability, cost transparency, incentives, competition and environment.
- 9.18 VAA supported the CAA's proposed approach in relation to expansion at this time. It set out further detail on its views on provision and operation of new infrastructure at Heathrow airport in its confidential response.
- 9.19 Arora said that the case for competitive provision of a new terminal is less pressing while expansion is paused. It also said that the CAA appears to have ignored its duty to promote competition in provision of AOS when considering Arora's proposals for Heathrow West.

### Our views

- 9.20 We remain of the view that the approach set out in the February 2024 Consultation remains a pragmatic way forward. In particular, it is not practicable for us to assess proposals for capacity expansion and competing infrastructure without understanding at least at a high level the nature of the proposals and the likely costs and benefits for consumers. We would also expect a lengthy planning process for construction of a third runway. Therefore, we continue to plan for the H8 price control review on the basis that HAL will be operating a two runway airport.

## Scarcity rents

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- 9.21 The February 2024 Consultation noted that level and impacts of scarcity rents were considered and debated during H7 price review, but these issues might warrant further consideration in the future.

### Summary of stakeholder views

- 9.22 HAL commented on why scarcity rents might arise and the impact they might have in terms of prices for passengers. HAL also referred to recent analysis by Europe Economics and ACI Europe covering issues related to scarcity rents.
- 9.23 BA said the issue of scarcity rents is unrelated to economic regulation and any assessment should be done independently under the relevant frameworks.

### Our views

- 9.24 Given the work undertaken during the H7 price control review on these issues, we do not currently plan to re-examine these in detail as part of the H8 price review. Nonetheless, we will continue to keep these matters under review and consider any new evidence that emerges.

## Airspace modernisation and new users

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- 9.25 The February 2024 Consultation said that we will need to consider the needs of new users as we develop our approach to NR28 and Airspace Modernisation Strategy (“AMS”) as we develop our approach to H8 and NR28.

### Summary of stakeholder views

- 9.26 NERL supported our commitment to Airspace Modernisation and Future Flight. It mentioned the creation, funding and oversight of the Airspace Change Organising Group (“ACOG”), and investment by NERL in a range of airspace changes in support of the AMS. NERL said that we should provide a framework that facilitates and incentivises delivery.
- 9.27 BA said progress on delivery of airspace modernisation has been slow but the regulatory framework does not currently present barriers to delivery of the AMS or ACOG’s functions. It said that further consideration should be given to the incentives for efficient delivery and ensuring that there was no undue burden on a subset of current or future airspace users.
- 9.28 HAL said there are a number of elements related to the AMS that require further consideration, such as the treatment of costs so that regulated airports do not bear a disproportionate burden from airspace changes in other areas.
- 9.29 VAA supported airspace modernisation but said CAA costs associated with new users should be met through public funds rather than by existing airspace users.



- 9.30 easyJet said the costs incurred by NERL in managing new users should be borne by the new users. It said the charging arrangements should be designed and monitored by the CAA.

### **Our views**

- 9.31 Airspace modernisation and the efficient and effective integration of new users into the arrangements for managing airspace remain important objectives for the CAA. The price control arrangements for NR23 were based around the principle of ‘user pays’ and we would expect new users to make a proportionate contribution to the costs of air traffic management services in the future.
- 9.32 We expect to consult shortly on the development of a UK Airspace Design Service (which should enhance the effectiveness and delivery of airspace modernisation).

## **Charges and Airport Charges Regulations**

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- 9.33 In the February 2024 Consultation we explained that HAL has a relatively high degree of discretion on decisions regarding the structure of its charges, as long as they are compatible with the broad principles set out in the ACRs. We said we could consider whether to retain this approach in the future.

### **Summary of stakeholder views**

- 9.34 HAL said it should continue to have flexibility to set the structure of its charges in order to incentivise growth at the airport. It said that the process in place for setting charges ensures that it is operating in a transparent and accountable manner and sees no reason for further regulatory intervention.
- 9.35 VAA said that HAL takes advantage of its dominant market position, and it wants CAA to take a more proactive approach in reviewing how HAL sets airport charges and the Conditions of Use, which it considers to be one-sided. It would like the CAA to include these issues within the H8 price control review and beyond. It set out further details in its confidential response.

### **Our views**

- 9.36 The ACRs provide a framework that, among other things, places an obligation on HAL to set airport charges in a non-discriminatory manner and says HAL may adjust its charges for relevant, objective, and transparent reasons.
- 9.37 We understand different airlines will have different views on the appropriate structure of charges, but we are not clear whether any further regulatory intervention is warranted and would further the overall interests of consumers. If airlines consider this to be the case, we ask for evidence so we can consider these matters further alongside work on H8.



- 9.38 There may be scope for more dialogue between HAL and airlines with a view to promoting mutual understanding and resolving issues. While we do not rule out further regulatory intervention in the future, there would need to be a clear evidence base to justify action and this would need to be consistent with our statutory duties to further the interests of consumers.

## Summary and next steps

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- 9.39 For most of the broader strategic issues covered in this chapter, we do not consider there is a strong case for considering these in detail for H8 and NR28. However, there are some areas we plan to consider and consult on further:
- the case for any additional flexibility, guidance or mechanisms for addressing the opex-capex trade-off, particularly in relation to NR28;
  - the case for a six-year regulatory period for NERL, to enhance incentives for efficiency and reduce the overlap between future HAL and NERL price control reviews after H8 and NR28; and
  - airspace modernisation and the efficient and effective integration of new users into the arrangements for managing airspace remain important objectives for the CAA, and these issues will be considered as part of the work on NR28 and (where appropriate) H8.
- 9.40 Other issues such as scarcity rents and framework for competing infrastructure proposals for Heathrow expansion, would likely be part of longer-term planning and not a focus for the H8 price control review.

## APPENDIX A

## Glossary of Abbreviations

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ACI	Airports Council International Europe
ACRs	Airport Charges Regulations 2011
ACOG	Airspace Change Organising Group
ALB	Cabinet Office Public Bodies review programme (the 2023 arms length body review of the CAA)
AMS	Airspace Modernisation Strategy
ANSP	Air Navigation Service Provider
AOC	Airline Operators Committee
AOS	Airport Operations System
BA	British Airways
BP	Business Plan
CAA	UK Civil Aviation Authority
CAA12	Civil Aviation Act 2012
Capex	Capital Expenditure
CCB	Consumer Challenge Board
CE	Constructive Engagement
CISHA	Council for the Independent Scrutiny of Heathrow Airport
CMA	Competition and Markets Authority
CPI	Consumer Prices Index
CPIH	Consumer Prices Index including owner occupiers' housing costs
DCO	Development Consent Order
DO	Delivery Obligation
DfT	Department for Transport
EASA	European Union Aviation Safety Agency
EU	European Union

GAL	Gatwick Airport Limited
GT	Grant Thornton
H7	the HAL price control period from 2022 to 2026
H8	the next HAL price control review
HAL	Heathrow Airport Limited
HPF	Heathrow Passenger Forum
LACC	London Airline Consultative Committee
MPD	Market Power Determination
MPT	Market Power Test
NERL	NATS (En Route) Plc
NR23	the NERL price control period from 2023 to 2027
NR28	the next NERL price control review
OBR	Outcome-Based Regulation for HAL
Opex	Operational Expenditure
ORCs	Other Regulated Charges
PCM	Price Control Model
Q4	Quarter 4
RAB	Regulatory Asset Base
RFR	Risk Free Rate
RPI	Retail Prices Index
RP2	NERL “Reference Period 2” price control from 2015 to 2019
RP3	NERL “Reference Period 3” price control from 2020 to 2022
STATFOR	Statistics and Forecast Service
TA00	The Transport Act 2000
TMR	Total Market Return
TRS	Traffic Risk Sharing
TSU	Total Service Unit
UKRN	UK Regulators Network

VAA Virgin Atlantic Airways

WACC Weighted Average Cost of Capital

## APPENDIX B

## Our duties

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### Civil Aviation Act 2012 (CAA12)

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- B1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
- B2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under that Act in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
- B3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (that is, cargo owners). We often refer to these users as a whole by using the shorthand of “consumers”.
- B4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- B5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
- the need to secure that each licensee is able to finance its licensed activities;
  - the need to secure that all reasonable demands for AOS are met;
  - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
  - the need to secure that the licensee is able to take reasonable measures to reduce, control or mitigate the adverse environmental effects of the relevant airport;
  - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
  - the regulatory principles set out in CAA12.
- B6 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where the CAA has made a determination that the airport that they operate meets the market power test set out in CAA12. Airport operators that do not fulfil that test are not subject to economic regulation. As a result of the determinations we completed in 2014, both HAL and GAL are subject to economic regulation.

- B7 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

## Transport Act 2000 (TA00)

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- B8 The CAA's equivalent duty in respect of air traffic services to those summarised above is set out in section 2 TA00, which is reproduced below.

### 2. CAA's general duty.

1. The CAA must exercise its functions under this Chapter so as to maintain a high standard of safety in the provision of air traffic services; and that duty is to have priority over the application of subsections (2) to (5).
2. The CAA must exercise its functions under this Chapter in the manner it thinks best calculated—
  - a) to further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;
  - b) to promote efficiency and economy on the part of licence holders;
  - c) to secure that licence holders will not find it unduly difficult to finance activities authorised by their licences;
  - d) to take account of any international obligations of the United Kingdom notified to the CAA by the Secretary of State (whatever the time or purpose of the notification);
  - e) to take account of any guidance on environmental objectives given to the CAA by the Secretary of State after the coming into force of this section.
3. The only interests to be considered under subsection (2)(a) are interests regarding the range, availability, continuity, cost and quality of air traffic services.
4. The reference in subsection (2)(a) to furthering interests includes a reference to furthering them (where the CAA thinks it appropriate) by promoting competition in the provision of air traffic services.
5. If in a particular case there is a conflict in the application of the provisions of subsections (2) to (4), in relation to that case the CAA must apply them in the manner it thinks is reasonable having regard to them as a whole.
6. The CAA must exercise its functions under this Chapter so as to impose on licence holders the minimum restrictions which are consistent with the exercise of those functions.

7. Section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the performance by the CAA of its functions under this Chapter.

## APPENDIX C

# Lessons learnt workshops with HAL, NERL and airlines

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- C1 This appendix provides notes on the issues raised from the eight workshops held by CAA during the lessons learnt consultation in February 2024.
- C2 These notes are provided in a separate document.