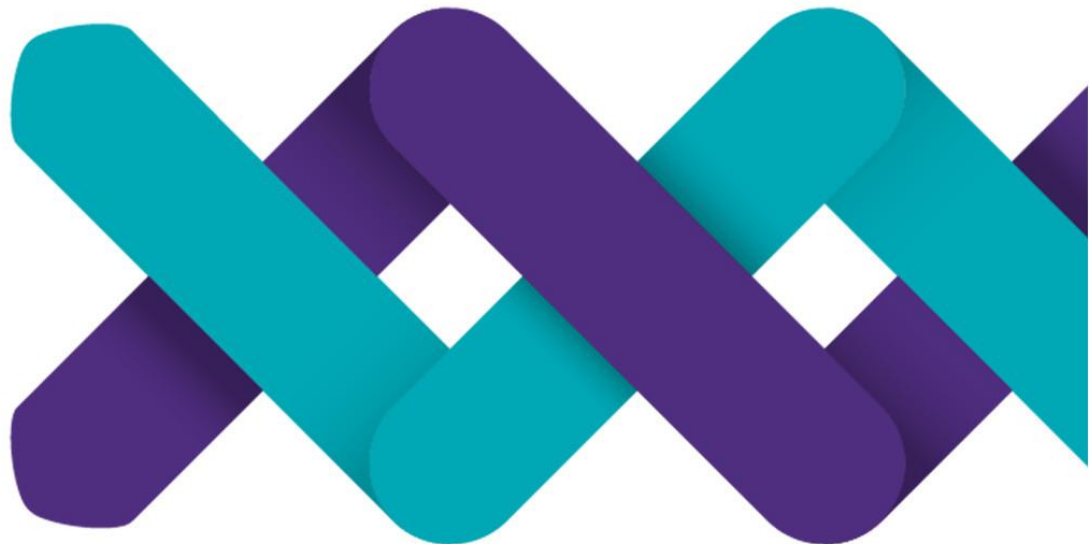




Supporting CAA's assessment of Gatwick Airport Limited's proposal to extend the current commitments framework

Final report

February 2025





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Dear Rob,

Supporting CAA's assessment of Gatwick Airport Limited's proposal to extend the current commitments framework

We have pleasure in enclosing a copy of our final report in accordance with your instructions dated 21 November 2024. This document (the **Report**) has been prepared by Grant Thornton UK LLP (**Grant Thornton**) for the Civil Aviation Authority (CAA) (the **Addressee**) in connection with providing support to you in assessing Gatwick Airport Limited's proposal to extend the current commitments framework (the **Purpose**).

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Scope of work and limitations

Our work focused on the areas set out in our scope of work, which is reproduced at Appendix A of the Report.

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Forms of report

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Contacts

If there are any matters upon which you require clarification or further information please contact Schellion Horn on 0207 865 2288 or Joel Strange on 0207 728 3423.

Yours faithfully,

Grant Thornton UK LLP.

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Executive Summary

Background

- 1.1 The Civil Aviation Authority (CAA) is the economic regulator for Gatwick Airport Limited (GAL) through a licence system.¹ The Licence, which came into effect in 2014, outlines a set of commitments. These include, among other things, a cap on the average airport charges, a requirement for a minimum level of investment, and a rebate system to compensate for any failure to meet service quality targets ('core service standards').
- 1.2 The CAA has stated that the commitments framework is intended to be a proportionate and targeted approach to economic regulation which encourages bilateral contracting and facilitates commercial, rather than regulator-led, decision making. It states that this approach furthers consumers' interests as they benefit from the greater competitive pressure on the airport associated with commercial interactions between the airport and airlines.
- 1.3 The current commitments were introduced in April 2021 and cover the four-year period to March 2025. In March 2023, GAL submitted to CAA a proposal to extend the current commitments by an additional four years, up to March 2029, arguing that the extension will provide stability and certainty while the economy and the aviation industry stabilise.² Concurrently, an important aspect of the commitments framework review is that GAL has submitted a planning application to enable the northern runway to be used for routine operations alongside the continued use of the existing main runway. In November 2024, the Planning Inspectorate provided its recommendation to the Secretary of State (SoS) for Transport. It is anticipated that the SoS will reach a conclusion by early 2025, following which there will be a six-week period during which the decision may be challenged in the High Court.
- 1.4 The CAA has been reviewing GAL's proposal, with the second and most recent consultation taking place from August to September 2024.

Scope of work

- 1.5 The CAA has requested Grant Thornton's support to assist with its review in order to:
 - ensure and demonstrate that stakeholders' arguments and evidence have been properly considered;
 - ensure that any financial projections underpinning CAA's final proposals are based on the most up-to-date evidence, taking into account stakeholders' views where appropriate and properly reflecting factors such as the uncertainty and risks that GAL faces; and
 - expand CAA's evidence base in important areas, including the likely benefits of GAL's Northern Runway Project (NRP), the potential advantages and disadvantages of a commercially oriented approach in the context of airport expansion, and consideration of the benefits and risks associated with a tighter price control.
- 1.6 To assist the CAA, this report presents an analysis that reviews and critically assesses stakeholders' evidence and arguments, particularly in relation to the profitability of GAL. Additionally, the report examines available evidence regarding the benefits of expanding capacity at GAL and evaluates the advantages and disadvantages of alternative regulation frameworks in terms of facilitating capacity expansion projects. Furthermore, it assesses the potential impact of tighter price control arrangements on GAL's incentives to advance expansion in a timely manner.
- 1.7 These issues were examined across four distinct workstreams. The remainder of the executive summary outlines the approach taken for each workstream and highlights their respective key findings.

¹ [Economic licensing of Gatwick Airport | Civil Aviation Authority](#)

² [CAP2554A: Gatwick Commitments: Proposal to extend Gatwick's commitments | Civil Aviation Authority](#)

Approach and key findings

Workstream 1: Assessment of stakeholder evidence and arguments on GAL's projected returns and profitability

- 1.8 The first workstream provided a review of the key evidence and arguments included in stakeholders' responses to CAA's August 2024 consultation. Based on those consultation responses, it also compared CAA's modelling assumptions with those proposed by consultation respondents and presented a set of sensitivity analyses to assess the impact of different assumptions on GAL's profitability.
- 1.9 There was a total of 10 responses. Regarding GAL's specific proposal to extend the current commitments, while easyJet stated that it had concerns with GAL's level of charges and service standards, it did not oppose the proposal. Three other airlines said they supported the proposal. GAL and BA expressed particularly strong views, and both presented analysis commenting on CAA's assessment of GAL's profitability and the associated assumptions. IAG, the parent company of BA and of several other airlines, expressed support for the BA response.
- 1.10 BA stated that, whilst it supports the commitments framework in general, it considers that a continuation of the regime will result in excessive charges and allow GAL to generate excess profits. As part of this study, the workstream considered BA's submission in detail, including modelling it had undertaken to arrive at its conclusions.
- 1.11 BA's modelling is based on somewhat different assumptions to that of CAA. For example, BA assumes that 20% of GAL's costs are variable with passenger traffic, compared to CAA assumptions that around 40% of costs are variable. The assumption made by BA tends to reduce GAL's projected opex and consequently inflates projected profits (relative to that assumed by CAA). On the other hand, BA appears to have overstated GAL's 2023 rent and rates costs by around £100m.³ In general however, CAA's assumptions appear to be most consistent with the available evidence and regulatory precedent. For example, CAA's assumptions about the variability of airport costs are consistent with its assumptions in its H7 price control for Heathrow and most regulators treat costs as linked to inflation (albeit with allowances for real price effects and efficiencies).
- 1.12 Another difference is that BA has also used a cost-based model to calculate a level of charges that it considers would allow GAL to finance its operations, earn a reasonable profit and finance the northern runway programme. This is based, among other things, on an allowed return similar to that which CAA allowed Heathrow Airport Limited in its Final Decision of March 2023. It is not within the scope of this work to comment on whether a particular level of profit is excessive, but it is noted that BA does not appear to have produced any evidence – beyond what has previously been considered by CAA – to suggest that profits are beyond the level estimated by CAA when it reached its initial conclusions.
- 1.13 GAL has challenged CAA's assumptions, primarily in three key areas:
- **Average charges discount.** GAL argues that average discounts should be raised from 6.1% to [%<] in light of the new contracts negotiated with airlines, which have been able to secure substantial discounts and incentives, [%<].
 - **Base levels of traffic.** GAL states that its recovery from COVID-19 has been slower than that of other UK airports. Consequently, it suggests that the CAA should revise its model and use instead passenger traffic forecasts from GAL's [%<] traffic scenario.
 - **Base level of opex (including business rates).** According to GAL, the CAA does not account for the fact that costs are rising above CPI, leading to actual opex likely being higher than forecasted by the CAA even in its 'high opex' scenario. GAL cites drivers such as higher pay awards, increased headcount for security matters, construction price inflation, and inflation in service contracts. Most significantly, GAL has advised that its business rates are also projected to increase from 2026. GAL has highlighted the risk of its business rates increasing from £[%<] million in 2023 to £[%<] million in 2026 due to a change in rateable valuation methods.
- 1.14 A series of sensitivity analyses on GAL's profitability under alternative modelling assumptions were conducted on the CAA's central model. The baseline model estimated operating profit as a percentage of fixed assets of 13.4% in 2028/29. Applying assumptions to test GAL's position on its estimated operating profit as a percentage of fixed assets in 2028/29 resulted in the following:

³ The most likely explanation is that for 2023 (and presumably earlier years), BA used figures from the accounts of Gatwick Airport Ltd rather than the holding company (Ivy HoldCo Ltd). CAA's model references Ivy HoldCo as the source of opex data.

- **Average charges discount: -0.5 percentage points.** Increasing the average airport charge discount resulted in an estimated operating profit as a percentage of fixed assets of 12.9%.
- **Base levels of traffic: -0.98 percentage points.** Applying a less optimistic forecast to passenger volumes, drawing on the estimates from GAL commitments proposal and figures in later years cited in its consultation response, resulted in an estimated operating profit as a percentage of fixed assets of 12.4%.
- **Base level of opex: -5.0 percentage points.** Applying three changes; (a) adjusting the 2023/24 starting opex to return outturn data and projecting this change forward, (b) adding the business rates increase claimed by GAL from 2026, and (c) adjusting non-rates opex in line with CPI+2 per annum, resulted in an estimated operating profit as a percentage of fixed assets of 8.4%.

- 1.15 GAL has submitted some evidence supporting its claims, and if these assumptions materialise, GAL's profits could be materially reduced compared to the levels previously assumed by CAA. Altogether, the sensitivities and changes to assumptions above in combination take the operating profit as a percentage of fixed assets down by 6.6 percentage points in 2028/29, from 13.4% to 6.8%. As such, CAA may want to consider incorporating GAL's proposed assumptions into its analysis in making its decision about the future regulatory arrangements for GAL. Further sensitivities tested are discussed in the body of the report.
- 1.16 However, there may be sources of upside (for example opportunities to reduce costs or increase commercial revenues) that have not been shared which could have the effect of increasing its profits compared to those assumed previously. Moreover, it is important to note that some of these factors – for example passenger numbers and the average discount applied – are within GAL's gift, at least to an extent. Therefore, in arriving at its conclusions, CAA may wish to consider whether the commitments regime already provides for sufficient financial headroom to accommodate many of the challenges that GAL has identified and ensure that the company remains incentivised to deliver efficiently.

Workstream 2: Benefits of capacity expansion

- 1.17 The Civil Aviation Act 2012 requires CAA to carry out its economic regulation functions in a manner it considers will further the interests of passengers and cargo owners regarding the range, availability, continuity, cost and quality of airport operating services, also where appropriate promoting competition in the provision of airport operating services. CAA also has a number of secondary duties that refer (among other things) to licensees' ability to finance their activities, promoting economy and efficiency, and allowing licensees to take reasonable measures to address adverse environmental effects. Within the context of CAA's role, the second workstream presents an assessment of the benefits of expansion at Gatwick through the NRP.
- 1.18 GAL's proposed NRP has the potential to yield substantial benefits for airport users, not only at Gatwick but also across London and the Southeast airports, particularly as passenger demand continues to rise, exacerbating existing capacity constraints. Advantages for consumers include, for example, lower prices as a result of greater competition between airlines and airports unlocked by relaxing capacity constraints; greater choice and flexibility in the number of flights, airlines, and destinations served by the airport; and improved operational resilience. It also has the potential to benefit the wider economy, for example by inducing investment and increasing productivity (although it is noted that promoting such benefits do not form part of CAA's statutory duties), as well as giving rise to material environmental impacts as a result of increased traffic both in the air and on the ground.
- 1.19 The most extensive analysis of the user impacts of expansion at Gatwick is a 2023 national economic impact assessment conducted by Oxera on behalf of GAL and submitted as part of its DCO application⁴. The Oxera study seeks to estimate the monetary value of the benefits. Using a 60-year appraisal period and expressing figures as discounted net present values in 2010 prices, the report estimates the benefits to passengers over the period as a whole to be £150bn. This benefit is primarily associated with a reduction in fares generated by greater competition between airlines at Gatwick as scarce capacity is released, and also includes benefits to "new" passengers (calculated as the difference between the actual fare and the maximum amount they would be willing to pay). Oxera also examined a "slow growth" sensitivity which assumed a slower recovery in Gatwick's passenger numbers after the Covid-19 pandemic and a lower uptake of the additional capacity created by the NRP. In this case it estimated total benefits to passengers of £107bn. Around 90% of the benefits are estimated to accrue to business travellers, with the remainder to leisure travellers.
- 1.20 It is important to point out that these estimated benefits are for passengers only, and airlines in particular would lose some revenues as a result of lower fares. Oxera estimated that the overall net benefits to users and providers (including airlines and airports) would be £13.1bn, or £6.6bn in the slow growth sensitivity. Although not a focus for

⁴ [Gatwick Airport Northern Runway Project, Needs Case Appendix 1 – National Economic Impact Assessment \(2023\)](#)

CAA, it is also worth noting that Oxera estimated wider economic benefits of £12bn, including additional government revenues – through Air Passenger Duty – of £2.5bn.

- 1.21 There are also some potential benefits to passengers that Oxera included but did not quantify in its study. These include:
- possible savings from lower surface access costs;
 - further benefits from increased competition between airports and between airlines, which could lead to further fares reductions, improvements in service quality and/or increased innovation;
 - increased operational resilience of Gatwick Airport and the London airport system, which could reduce delays caused by adverse conditions or incidents and allow for a quicker recovery; and
 - an increase in freight handled by Gatwick Airport.
- 1.22 This workstream reviewed Oxera's analysis submitted by GAL as part of its planning application to provide a view on the range and scale of benefits associated with NRP. Overall, the conceptual framework that it uses is suitable and appears broadly in line with, for example, government appraisal guidance on the assessment of transport benefits and precedent from other assessments of airport expansion.
- 1.23 That said, there are certain aspects of the study that are surprising and could potentially overstate benefits but the Oxera report does not give enough detail to test this further. For example, the report suggests a very large benefit to business travellers. In the context of fundamental shifts in business travel since COVID, and substantial uncertainty around the extent to which an expanded Gatwick will serve the business market, it is unclear whether the benefits would accrue at the level suggested.
- 1.24 Whilst the precise quantum of benefits presented by GAL's consultants should be viewed cautiously, the overall picture that it creates – which is one of substantial benefits to passengers from the NRP – seems broadly robust.

Workstream 3: Benefits of a commercially orientated approach to funding capacity expansion

- 1.25 This workstream, considered the potential advantages and disadvantages of different approaches to funding airport capacity expansion, contrasting the largely commercial approach adopted by GAL and by airports not subject to economic regulation with the more interventionist approach associated with traditional economic regulation and a regulatory asset base (RAB). The assessment is informed by case studies including CAA's regulation of HAL's proposed third runway programme, GAL's northern runway programme and Manchester Airport's transformation programme, however it also draws on the inherent features of each approach. The wider context is also important, as individual airports may possess different degrees of market power, and in practice the political environment and the perceived likelihood of obtaining planning approval are likely to affect operators' decisions on the nature and timing of investment.
- 1.26 When undertaken on a purely commercial basis, an airport operator considering an expansion project will need to assess the likelihood of being able to recover the costs of the project from the additional revenues generated. The operator will bear long-term risks and this may lead it to adopt an incremental approach to expansion (favouring smaller increments in capacity over large one-off projects) or perhaps to delay the project until the expected return is relatively high. Subject, of course, to obtaining planning approval, the operator will be free to choose the timing and delivery approach that best meet its requirements. In the case of Manchester Airport's transformation programme, the operator chose to undertake significant engagement with airlines covering the programme itself and the specific way that some of the costs would be recovered through higher future charges.
- 1.27 In contrast, an operator that has both significant market power and is undertaking an expansion project under detailed RAB-based economic regulation will enjoy a relatively high degree of protection from long-run risks. In the context of significant market power the RAB establishes an automatic relationship between investment and the future level of the price cap, which may be especially useful in the case of a very large expansion project that might require future airport charges to be materially higher than they otherwise would be. However, in view of the risk of cost overruns in major projects, regulators are often keen to provide incentives for the operator to ensure investment is efficient. While this can help to ensure that charges are no higher than they need to be, the traditional RAB-based approach can be challenging to apply to a major investment programme and may require details of the scope and expected cost of parts of the programme to be confirmed at a relatively early stage, and perhaps earlier than a developer might normally choose to on a large and complex project. This introduces some risk of inefficiency and a lack of flexibility, and could delay the implementation of the project, in addition to wider difficulties with RAB based regulation and the difficulties associated with developing effective incentives for capex efficiency.

- 1.28 HAL's third runway programme was an unusually large and complex project. CAA's oversight of the planning and early stages of the programme involved a great many consultations and working papers, with substantial stakeholder engagement and increasingly detailed scrutiny of some specific costs that represented a small proportion of the overall expected cost of the programme. Eventually the programme was paused, first due to legal challenge and then the Covid-19 pandemic. Nevertheless, in late 2019 HAL claimed that CAA had delayed the project timetable by at least 12 months.⁵
- 1.29 GAL's NRP has been taken forward in the context of the lighter touch commitments framework and, in practice, GAL appears to have developed its proposal and submitted its planning application on a largely commercial basis. Due to the likelihood that GAL will continue have at least some degree of market power, with economic regulation unlikely to prevent it from recovering previous costs except in extreme circumstances, GAL probably faces less long-term risk than an airport operator undertaking expansion on a fully competitive basis. It has progressed the project to an advanced stage without seeking guarantees of how its future charges will be determined and also without significant economic regulatory review or stakeholder challenge of its detailed proposals.
- 1.30 Overall, detailed RAB-based regulation is an approach that is trusted and understood by investors, and is part of a framework that aims to protect consumers from the risk that charges will be higher than they need to be. However, there is also a risk that the early scrutiny necessary to try to prevent cost overruns could itself lead to inefficiency and delay. It is important to acknowledge the much greater scale and complexity of HAL's third runway programme, nevertheless we can observe that in practice HAL's third runway programme floundered while Manchester Airport's transformation programme is nearing completion, GAL's NRP is awaiting planning approval and expansion projects are at different stages of development at other airports including Stansted, Luton, Birmingham and Bristol. This suggests that a commercially-oriented approach may allow airport expansion projects to make smoother progress, at least in their early stages.
- 1.31 Given the flexibility CAA has under the Civil Aviation Act 2012, it retains the option to adapt its approach to economic regulation in future. For example, if it decided to consider possible options for adjusting its regulation of GAL, it would not face a simple binary choice between the commitments framework or a detailed RAB-based approach, and could therefore also consider intermediate options that retained the key benefits of lighter-touch regulation while aiming to address any specific issues that were arising in practice.

Workstream 4: Impact of tighter price control arrangements on capacity expansion

- 1.32 GAL told the Planning Inspectorate that it is confident that adequate funding will be available for it to start work on the NRP. While the estimated cost of £2.2 billion is significant, this will be spread over a number of years and the project itself should generate significant additional revenues (through both airport charges and commercial revenues) in future by allowing GAL to accommodate a higher volume of passengers.
- 1.33 The fourth workstream therefore involved an analysis and discussion of how a tighter price control could affect GAL's incentives to progress the NRP in a timely way. The approach was to assess the internal rate of return (IRR)⁶ for the NRP programme calculated under different pricing assumptions to illustrate the potential impact of a tighter price control on the commercial case for GAL proceeding with the NRP. This was supplemented by qualitative analysis and commentary to help ensure a complete and balanced perspective on the impacts a tighter price control may have.
- 1.34 In the baseline scenario, it is assumed that the NRP proceeds and that charges are set at the level proposed by GAL's commitments framework until 2028/29, after which they remain constant in real terms. This generates additional revenue from the incremental passengers enabled by the extra capacity that serves to offset the capital cost of the NRP and the opex associated with those additional passengers. Under this scenario, the IRR of the project becomes positive after approximately 17 years. Over a 20-year investment appraisal period, the IRR becomes 4.3% in real terms, and continues to rise beyond that. This illustrates that, whilst the project may be commercially attractive, it is only likely to be viewed positively by an investor taking a relatively long-term view (over decades rather than years).
- 1.35 Alternative scenarios were considered to assess the impacts of tighter controls on the incentives for airport expansion. In principle, in making its investment decision, an investor would only consider the change in revenues associated with the incremental traffic unlocked by NRP (even though airport charges are applied equally to existing and new traffic, any decrease in revenue associated with existing traffic would be regarded as 'sunk'). Treated in

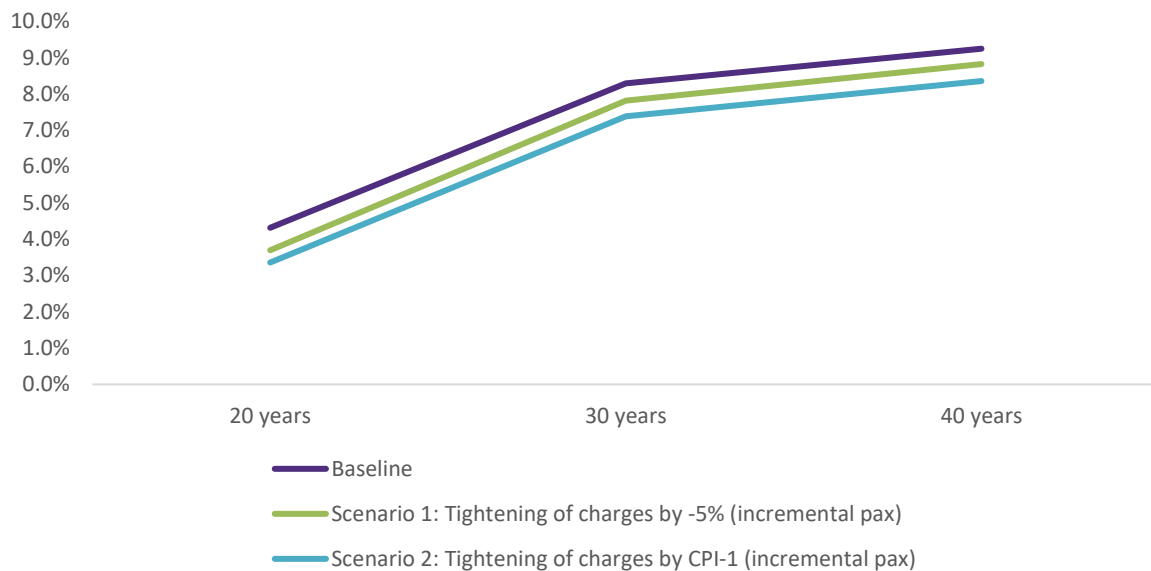
⁵ See <https://mediacentre.heathrow.com/pressrelease/detail/11928>.

⁶ That is, the interest rate which makes the sum of the net present value of all cash flows from the NRP investment equal zero.

this way, the graphs below show the impact on the IRR where charges are reduced by 5% and CPI-1 relative to the proposed commitments framework (Figure 1).

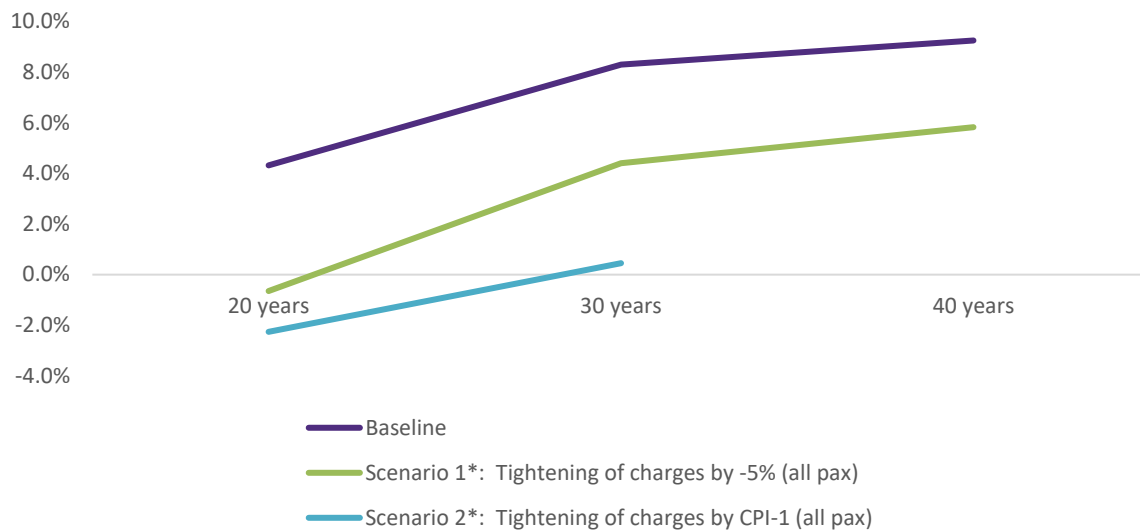
- 1.36 The impact is modest, suggesting that a tightening of the price control – unless significant – may not have a significant direct bearing on the incentives for capacity expansion. Practical considerations – for example the fact that significant costs have already been incurred and the wider political and planning environment is such that it may be more difficult to pursue expansion at some future point – may also mean that any small tightening of the price control may not materially affect incentives for expansion.

Figure 1: Impact of tightening aeronautical charges on 20-, 30-, and 40-year IRR by -5% and CPI-1 on incremental NRP passengers



- 1.37 The above approach (to only consider the change in revenues from incremental traffic of a tightening of charges) is the theoretically correct and most appropriate way for an investor to evaluate the NRP (since the impact on revenues from existing passengers of any change in charges would occur regardless of the NRP). However, the wider context potentially matters, and it is plausible that an investor may choose to view its stake in the airport as a whole. And, if it considered that a reduction in charges affected the attractiveness of its overall business, it could adopt different investment decisions. This is a highly complex set of considerations and it is difficult to know exactly whether and how an investor would proceed with expansion, for example, in a context where its wider business was not performing as well financially (for example as a result of lower charges). It is difficult to model these considerations simply, but to illustrate the point, the graph below shows the impact on the NRP IRR if the investor was to consider the reduction in revenue of a tightening of prices not just to incremental traffic, but also to existing traffic, resulting in a more significant impact on the IRR (Figure 2).

Figure 2: Impact of tightening aeronautical charges on 20-, 30-, and 40-year IRR by -5% and CPI-1 for existing and incremental passengers



- 1.38 A further risk is that the tightening of charges could be viewed (rightly or wrongly) as providing new information about CAA’s likely approach to future regulatory decisions affecting GAL. This risk arises in part because of the lack of an established set of principles and processes similar to those that CAA can use when applying RAB-based regulation to HAL and NATS, and especially as GAL does not have a RAB so there is no longer an automatic link between past investment and future airport charges. However, this risk could be mitigated by CAA explaining the reason for tightening the current price cap and providing reassurance about GAL’s ability to cover its costs in the future.
- 1.39 Overall, it is plausible that the impact of a tightening of the price control – especially if any tightening is modest – could be limited in terms of incentives for expansion at Gatwick. That said, there are some risks of doing so, especially in terms of the potential signals that could be created about the future of regulation at Gatwick at a time that is critical for GAL expansion.

1 Introduction

- 1.1 The Civil Aviation Authority (CAA) is considering Gatwick Airport Ltd's (GAL) proposal to extend its existing commitments framework over the period 2025-2029. This is happening in parallel with GAL's planning application to bring its northern runway into routine commercial operation, which would require significant capital investment.
- 1.2 The CAA has commissioned Grant Thornton to carry out analysis to inform its assessment of GAL's proposed extension of the commitments framework – a set of 'commitments' that GAL makes to its airline customers in relation to prices and quality of services. The analysis in this report centres on (1) arguments and evidence from stakeholders in relation to GAL's level of profitability; (2) the socio-economic benefits of capacity expansion; (3) the relative merits of alternative economic regulation framework in terms of facilitating capacity expansion projects; and (4) the potential impact of a tighter regulation framework on GAL's decision on whether and when to proceed with the northern runway project.

Context

- 1.3 The CAA is the economic regulator for GAL through a licence system.⁷ Since 2014, the CAA has implemented its economic regulation of GAL through a set of "commitments" that include (among other things) a cap on the average level of airport charges and a minimum level of investment and a system of rebates that takes effect if GAL misses certain service quality targets. While, on paper, the formal restrictions are similar to those applied to Heathrow Airport Limited (HAL), in practice the approaches to economic regulation are quite different (for example, the process adopted for regulatory reviews).
- 1.4 CAA has stated that the commitments framework is intended to be a proportionate and targeted approach to economic regulation which encourages bilateral contracting and facilitates commercial rather than regulator-led decision-making. It states that this approach further consumers' interests as they benefit from the greater competitive pressure on the airport associated with commercial interactions between the airport and airlines.⁸ This approach is consistent with the economic theory and regulatory practice of negotiated settlements: the idea being that – under the right conditions and with appropriate regulatory 'backstops' in place – firms and their customers may be able to reach optimal agreements between themselves.
- 1.5 The first set of commitments expired in March 2021. The process of confirming a new set of commitments was significantly affected by the Covid-19 pandemic. GAL submitted an updated and finalised set of proposals for CAA's review in January 2020, before the start of the pandemic in Europe. By October 2020, CAA reached a provisional view that GAL's proposals were likely to be in consumers' interests and consulted stakeholders on its view that it should accept GAL's proposed commitments.⁹ These new commitments came into force in April 2021 for a period of four years, and therefore expire at the end of March 2025.
- 1.6 In March 2023, GAL submitted its proposal to the CAA for an extension of the commitments framework for the period 2025-2029, which was followed by an industry consultation by the CAA in June 2023.¹⁰ The CAA published an initial assessment of GAL's proposals in August 2024.¹¹ The CAA received a number of responses to that document, which are considered in chapter 2 of this report.

Northern Runway Programme (NRP)

- 1.7 Further important context for the current review is GAL's planning application to bring its northern runway into routine commercial operation alongside continued use of the existing main runway, which would allow Gatwick to serve 80.2 million passengers per annum by 2047 with a cap of 386,000 movements per year.¹² As well as alternations to the northern runway and reconfiguration of taxiways, the proposals include pier and stand

⁷ [Economic licensing of Gatwick Airport | Civil Aviation Authority](#)

⁸ [Economic regulation of Gatwick Airport Limited: second consultation on extending the current commitments](#), CAA (2024)

⁹ [Economic regulation of Gatwick Airport Limited: consultation on new commitments](#), CAA (2020)

¹⁰ [Economic regulation of Gatwick Airport Limited: Consultation on proposal to extend the current commitments](#), CAA (2023)

¹¹ [Economic regulation of Gatwick Airport Limited: Consultation on proposal to extend the current commitments](#), CAA (2024)

¹² [Gatwick Airport Northern Runway: Planning Statement](#), 2023

amendments (including a proposed new pier), reconfiguration of other airfield facilities, extensions to both terminals, additional hotel and office space, reconfigured car parking and highway improvements, reconfiguration of existing utilities and environmental mitigations.

- 1.8 GAL has submitted a planning application to enable the northern runway to be used for routine operations alongside the continued use of the existing main runway. In November 2024, the Planning Inspectorate provided its recommendation to the Secretary of State (SofS) for Transport. It is anticipated that the SofS will reach a conclusion by early 2025, following which there will be a six-week period during which the decision may be challenged in the High Court.

Scope

- 1.9 The CAA has requested Grant Thornton to conduct:
- a review of stakeholders' evidence and arguments in relation to GAL's level of profitability, received in response to its August 2024 consultation;
 - a critical evaluation of the evidence provided in those responses in relation to GAL's level of profitability;
 - a review of existing estimates of the range of consumer benefits of capacity expansion at Gatwick;
 - an evaluation of the advantages and disadvantages of a commercially orientated approach to funding capacity expansion; and
 - an assessment of the possible impact of tighter price control arrangements on GAL's incentives to progress expansion in a timely way.

Structure of the report

- 1.10 Chapter two provides a summary and critical assessment of stakeholder response to the CAA's August 2024 consultation, with a particular focus on GAL's level of profitability.
- 1.11 Chapter three provides a review of existing evidence on the benefits of capacity expansion.
- 1.12 Chapter four provides an assessment of the relative merits of alternative economic regulation frameworks in terms of facilitating capacity expansion projects.
- 1.13 Chapter five assesses the potential impact of tighter price control arrangements on GAL's incentives to advance expansion in a timely manner.

2 Stakeholder responses and sensitivity analysis

- 2.1 In March 2023, GAL submitted a proposal to extend the commitments framework by four years from 1 April 2025 to 31 March 2029. In June 2023, the CAA invited industry views and in August 2024, the CAA published its initial assessment for consultation (CAP3012).¹³
- 2.2 CAP3012 invited stakeholder views on the following:
- Whether the CAA's approach to assessing GAL's proposal was appropriate, including the suitability of the assessment framework and the evaluation criteria used to evaluate GAL's proposal.
 - The aspects of GAL's proposal that the CAA believes require additional mitigations, and whether the proposed mitigations were reasonable.
 - Any other issues that stakeholders believed the CAA should consider when finalising its assessment of GAL's proposal.
- 2.3 This chapter provides:
- a review of the key evidence and arguments included in stakeholders' responses to CAA's CAP3012 consultation, with a focus on GAL's profitability and with particular reference to the responses from GAL and BA (which contain some of the strongest opinions and most extensive supporting documentation).
 - a comparison of CAA's modelling assumptions (used to assess GAL's profitability) with those proposed by GAL and BA.
 - a sensitivity analysis of estimates of GAL's profitability to changes in modelling assumptions.

Overview of stakeholder responses to CAP3012 consultation

A total of 10 responses were received by the CAA, primarily from airlines.

- 2.4 Table 1 provides a list of the stakeholders who responded, whether they supported or opposed GAL's proposal, and sets out key themes.
- 2.5 Most of the responses were supportive of CAA's proposed approach, with the exceptions of BA, International Airlines Group (IAG), and Communities Against Gatwick Noise Emissions, the latter highlighting the environmental impacts of the NRP and stating that charges should be increased to reflect these. GAL was mostly supportive of CAA's approach but criticised its focus on profitability analysis and also argued that the CAA should review some of its modelling assumptions. A common theme across nearly all responses from airlines was a concern over service quality and the need to ensure that GAL's investments will lead to tangible improvements in this area – however this is outside the scope of the present work. Regarding GAL's specific proposal to extend the current commitments, while easyJet stated that it had concerns with GAL's level of charges and service standards, it did not oppose the proposal. Three other airlines said they supported the proposal.
- 2.6 Some of the strongest views and most extensive supporting analysis were submitted by GAL and BA/IAG. These are considered in more detail below.

¹³ [Economic licensing of Gatwick Airport | Civil Aviation Authority](#)

Table 1: Summary of stakeholder responses, positions and key themes

Stakeholder	Position: support or oppose the CAA's proposed approach ¹⁴	Key Themes
Airport Consultative Committee	No position	Concerns regarding the pre-financing of NRP, service quality, capital investment and consultation process, as well as CAA's approach to monitoring.
British Airways	Oppose	Levels of charges, service quality, capital investment and consultation, and CAA's approach to monitoring.
Communities against Gatwick noise emissions	Oppose	Prices should be increased to reflect the impact of aircraft on noise, carbon emissions, greenhouse gases and pollution.
easyJet	Does not oppose	Level of charges, service quality and how GAL consults with airlines and invests in the airport.
Gatwick Airport Consultative Committee (GATCOM)	Support	Service quality and special assistance; would welcome clarification on what would happen to the commitments if NRP does not go ahead.
Gatwick Airport Limited	Support	The commitments framework has delivered benefits to consumers. CAA should review some of its modelling assumptions.
BA / International Airlines Group	Oppose	The commitments framework should be strengthened to address GAL's excessive charges and profits, improve service quality, and ensure necessary investment.
Norse Atlantic UK	Support	No concerns raised.
Turkish Airlines	Support	No concerns raised.
Wizz Air	Support	No concerns raised.

Source: Grant Thornton Analysis

GAL's response

- 2.7 GAL criticises the CAA for placing excessive emphasis on profitability and returns, arguing that these are not reliable indicators of whether GAL's proposal and the broader regulatory framework are in the consumers' best interests. They assert that higher profits are acceptable if they result from improved consumer outcomes, and note that the CAA has acknowledged consumer benefits under the commitments framework. GAL also highlights its track-record of efficient operations and investment in projects aimed at enhancing efficiency, such as automation of baggage handling and continued automation of check-in processes.
- 2.8 Moreover, GAL criticises the commitments framework for lacking a risk-sharing mechanism. It expresses concern that if capital expenditure (capex) and operational expenditure (opex) unexpectedly increase, GAL would bear the full burden of these additional costs due to the price ceiling. However, GAL acknowledges the flexibility provided by the framework in terms of commercial negotiations with airlines and the ability to respond to unforeseen events in a more efficient and cost-effective manner.
- 2.9 GAL also raises issues with several assumptions used by the CAA in their model to estimate profitability. These criticisms encompass areas such as benchmarking, passenger forecasts, and discounts (detailed in Table 2, next).

BA's response

- 2.10 BA considers that GAL's proposal will not be beneficial for consumers and expresses concerns over the extension of the commitments framework. BA states that, whilst it supports the commitments framework in general, it considers that a continuation of the regime will result in excessive charges and allow GAL to generate excess profits. BA's submission, including its modelling, is considered in more detail in the next section.
- 2.11 BA's main concerns are:
- GAL generating excess profits: BA argues that GAL's proposed charges are significantly inflated, potentially leading to excess profits of over £1 billion.

¹⁴ Including in relation to relevant elements of GAL's proposal that the CAA is minded to accept

- Poor service quality: service levels are inadequate, with persistent operational failures experienced by both airlines and customers.
- Imbalanced negotiations driven by lack of transparency: airlines lack transparency on GAL's costs, undermining their negotiation power. Current bilateral agreements are skewed in GAL's favour due to the imbalance between the negotiating parties.
- Poor oversight by CAA: limited oversight of capital investments and the Customer Service Standards (CSS) framework.
- Concerns about the NRP: in BA's view, the expansion of capacity poses the risk of redirecting capital investment away from necessary improvements to existing facilities. They also highlight that, despite the uncertainty surrounding the DCO, consumers are being required to pre-fund its costs.¹⁵ BA has also expressed concerns regarding the costs presented by GAL for financing the NRP, noting that these figures appear to be relatively low.

2.12 BA also presents several recommendations to CAA, including:

- Adopting a more active role in monitoring GAL, verifying deals, and ensuring fair negotiation practices between GAL and airlines;
- Introducing backstop mechanisms for both pricing and service levels;
- Including provisions to recover excess profits if the commitments framework is extended; and
- Having a reopener clause hard-coded into the license, allowing revisions if the NRP fails to secure a DCO.

2.13 Table 2 summarises key arguments from GAL and BA by theme, including outcomes/GAL's returns, airport charges, risk, investment and innovation, flexibility of the commitments framework, benchmarking, and their relationship to the NRP.

¹⁵ The NRP is due to come into operation in 2029, with further work to be completed into the mid-2030s. BA argues that GAL will fund this in part from an increase in the charges cap (relative to what it would otherwise have been) taking place between 2025 and 2029.

Table 2: Key arguments from GAL and BA responses

Theme	GAL response	BA response
Outcomes / GAL's returns	<ul style="list-style-type: none"> The CAA ought to prioritise consumer outcomes over profitability and returns. Excess profits should not be a concern if they stem from enhanced outcomes that benefit consumers. The CAA has acknowledged that the commitments framework has delivered consumer benefits. 	<ul style="list-style-type: none"> The evidence indicates excessive returns and service level shortcomings. Inflated airport charges are projected to result in annual operating margins of over 55% during the extension period, which is detrimental to consumers. Estimates that GAL is forecast to generate excess profits of at least £1 billion during the extension period.
Airport charges	<ul style="list-style-type: none"> The forecasted discount is set at [8%], influenced by recent contracts inked with airlines. These agreements have allowed airlines to secure substantial discounts and incentives, [8%]. The CAA should consider that the costs related to the enhancement of the hold baggage screening system to Explosive Detection System Standard 3 are temporary and should be reflected accordingly in the charge for capital and funding costs. 	<ul style="list-style-type: none"> According to BA, the evidence suggests excessive charges. While GAL's proposal will result in a modest decrease in real cost per passenger by 2029, the charges are currently significantly inflated. GAL's proposed charges will result in charges that are approximately 20% higher than necessary, even if it realises its low traffic forecast and has to finance the works for the NRP. A 'cost-based model' (whereby charges would be calculated by applying a regulated cost of capital to planned expenditure) would result in significant reductions in charges.
Risk	<ul style="list-style-type: none"> Under the commitments framework, GAL does not benefit from any risk-sharing mechanisms, and the price ceiling prohibits GAL from recovering cost increases through higher charges. 	<ul style="list-style-type: none"> No comment.
Investment and innovation	<ul style="list-style-type: none"> Investment or innovation are not included within the factors considered by the CAA in the commitments framework. GAL is planning to invest substantially above the minimum commitment and operates the most efficient single-runway airport in the world. 	<ul style="list-style-type: none"> There is a lack of capital oversight with detrimental outcomes for consumers, both in terms of capital invested and experience outcomes. The CAA should adopt a more active role in this regard. Additionally, CIP lacks transparency and project performance metrics such as timelines and spend. GAL's investments in the NRP will detract from required projects aimed at improving the existing terminals, airfield, and capacity.
Flexibility	<ul style="list-style-type: none"> The commitments framework enables GAL to tailor their commercial deals, which is crucial given GAL's diverse airline and passenger base. This flexibility also allows GAL to effectively address challenges in unprecedented times, such as was the case during the Covid-19 pandemic. 	<ul style="list-style-type: none"> Airport users are at a disadvantage and lack sufficient visibility and power to challenge GAL. This issue is exacerbated by the absence of a regulatory backstop by the CAA and the fact that airlines have no visibility of GAL's costs to inform negotiations.

Benchmarking	<ul style="list-style-type: none"> • Points out that there are limitations to benchmarking. • Does not agree with the CAA that international comparisons of net aeronautical revenues per passenger are less relevant than the comparator used in the PA Consulting report. 	<ul style="list-style-type: none"> • Benchmarking GAL's charges and profits against UK unregulated airports is not appropriate due to the significant market power that GAL holds. • Benchmarking should be particularly avoided in cases where there are overcharges and excess profits.
Northern Runway Project	<ul style="list-style-type: none"> • The CAA's 'no growth' scenario overestimates potential returns by assuming that expenditure on NRP would not occur. GAL argues that a proportion of NRP's capex would still need to be incurred in the event that the project does not go ahead. • Should the NRP not progress, GAL will utilise the commitments framework to engage in commercial discussions with airlines regarding investment priorities and tariffs. 	<ul style="list-style-type: none"> • CIP 2024 does not disclose the implications of a granted or denied DCO for <i>capital</i> expenditure, operational expenditure, or service standards. • GAL should put forward a set of alternative ex-ante commitments for a scenario without the NRP. • BA disagrees with the CAA that a high level of profits and returns during the extension period is justified in order to finance the NRP. GAL could fund the NRP with the excess profits generated to date. • If the NRP does not obtain a DCO, there must be a reopener hard-coded into the license for the extension period. • BA disagrees with the CAA on the assumption that capacity expansion will reduce incentives for GAL to exploit market power, as capacity will be progressively added and taken up quickly. There are concerns with the costs presented by GAL, as they seem too low.

Source: Grant Thornton Analysis

Discussion of BA and GAL positions on CAA modelling assumptions

CAA model

- 2.14 As part of the August 2024 consultation, the CAA published its assumptions and projections for GAL under three scenarios: middle case (central case), high opex, and a No DCO case.
- 2.15 The primary distinction between CAA's high and central cases is the level of opex. In the high case, there is an additional £80 million per annum (in 2023/24 prices) from 2026/27 onwards. The CAA's No DCO scenario uses the same opex projections as the central case but assumes that if the NRP does not proceed, none of the planned expenditure related to the capacity expansion will take place.
- 2.16 The estimated operating profit as a percentage of fixed assets ranges from 11.5% in the high opex case, to 16.6% in the No DCO case.
- 2.17 A detailed review of CAA's modelling assumptions was beyond the scope of this work but, in general, CAA's assumptions appear to be consistent with the available evidence and regulatory precedent. For example, CAA's assumptions about the variability of airport costs with respect to passenger volumes are consistent with its assumptions in its H7 price control for Heathrow and most regulators treat costs as linked to inflation (albeit with allowances for real price effects and efficiencies).
- 2.18 BA and GAL's positions in respect of the key variables and model assumptions used by the CAA are discussed here, and compared in Table 3 below.

BA's arguments

- 2.19 BA provided the CAA with a copy of its model, which estimates GAL's profitability and excess revenue in six scenarios, testing various assumptions related to factors such as passenger numbers and commercial revenues. BA's results are presented to support its position that GAL's proposal to extend the commitments framework will not be beneficial for consumers. Its model indicates that GAL's proposed charges are significantly inflated, potentially leading to excess profits of over £1 billion.
- 2.20 While BA has drawn on some similar assumptions (for instance, passenger forecasts), an important difference between the BA and CAA model is that BA has used a cost-based model to calculate a level of charges that it considers would allow GAL to finance its operations, earn a reasonable profit and finance the NRP. This is based, among other things, on an allowed return similar to that which CAA allowed Heathrow in its H7 Final Decision of March 2023.
- 2.21 BA also assumes that 20% of GAL's costs are variable with passenger traffic, compared to CAA assumptions that around 40% of costs are variable.
- 2.22 The above assumption made by BA tends to reduce GAL's projected opex and consequently inflate projected profits (relative to those estimated by CAA). On the other hand, BA appears to have overstated GAL's 2023 rent and rates costs by around £100m. The most likely explanation is that for 2023 (and presumably earlier years), BA used figures from the accounts of Gatwick Airport Ltd rather than the holding company (Ivy HoldCo Ltd). CAA's model references Ivy HoldCo as the source of opex data.
- 2.23 While it is not within the scope of this work to comment on whether a particular level of profit is excessive, it is noted that BA does not appear to have produced any evidence – beyond what has previously been considered by CAA – to suggest that profits are beyond the level that CAA has assessed previously.

GAL's arguments

- 2.24 GAL did not provide a separate model to support its arguments, but has critiqued some of the CAA modelling assumptions and/or data used in the model in its consultation response.
- 2.25 GAL justifies its arguments based on more recent out-turn evidence, including expected significant increases in business rates and new contracts negotiated with airlines, which directly impact airport charges and opex, and a slower recovery of passenger traffic volumes. GAL's critiques can be summarised into three main areas of challenge:
- **Average charges discount.** GAL argues that average discount relative to the charges cap should be raised from 6.1% to [8<] % in light of the new contracts negotiated with airlines, which have been able to secure substantial discounts and incentives, [8<].

- **Base level of opex (including business rates).** According to GAL, the CAA does not account for the fact that costs are rising above CPI, leading to actual opex likely being higher than forecast by the CAA even in its 'high opex' scenario. GAL cites drivers such as higher pay awards, increased headcount for security matters, construction price inflation, and inflation in service contracts. Most significantly, GAL has noted that its business rates are also projected to increase materially from 2026. GAL has highlighted the risk of its business rates increasing from £[3<] million in 2023 to £[3<] million in 2026 due to a change in rateable valuation methods. Grant Thornton has not investigated whether this assumption about increased rates is valid or otherwise.
- **Base levels of traffic.** GAL states that its recovery from COVID-19 has been slower than that of other UK airports. Consequently, it suggests that the CAA should revise its model and use instead passenger traffic forecasts advised by GAL (GAL's 'low' scenario).

2.26 In the case of base level of opex, in addition to the higher costs with business rates, there is also a difference in methodology used. The CAA uses a top-down forecasting approach based on the historical relationship between opex and passenger demand, and assumes that opex per passenger will continue to decrease in real terms over time. On the other hand, GAL's opex estimation methodology relies on out-turn opex and anticipates above-inflation cost increases in specific areas. While it is reasonable to make use of out-turn cost data rather than forecasts (where available), there is a risk that GAL may have focussed its arguments and discussion on areas subject to above-inflation cost increases. It is possible that other areas may experience cost reductions over time.

2.27 Table 3 sets out BA and GAL's positions in respect of the key variables and model assumptions used by the CAA.

Table 3: Stakeholders' positions on model assumptions

	CAA model	GAL position	BA position
Passenger forecast	<p>In 2024/25, the CAA used GAL's forecasts for 2024 (weighted at 75%) and 2025 (weighted at 25%) as per GAL's July 2024 Capital Investment Programme (CIP). The CAA then extrapolated these figures to reach 50 million by 2028/29, which aligns with the approximate mid-point between GAL's high and low forecasts for 2028 in the CIP.</p> <p>Passenger numbers remain constant across all scenarios.</p>	<p>GAL is experiencing a slower recovery in traffic compared to other UK airports.</p> <p>Passenger traffic is expected to align more closely with GAL's [§<] scenario, [§<] ([§<] million in 2028 and [§<] million in 2029).</p>	<p>BA has expressed concerns over the pessimistic traffic forecast used in the CAA's model.</p> <p>BA's analysis uses three forecasts: GAL's low and high forecasts, as outlined in GAL's commitments¹⁶, and a "BA mid scenario", which is an average of GAL's high and low scenarios.</p>
Capex	<p>Under the no runway scenario, capex excludes investment in the NRP.</p> <p>The CAA uses GAL's 2024 CIP forecasts as the source for NRP capex forecasts.</p>	<p>The CAA should not have removed the entire amount of capex associated with the NRP from the CIP under the no runway scenario.</p> <p>Under the no NRP scenario, other investment projects will be taken forward.</p> <p>2024 CIP:¹⁷ a no-NRP capex programme would invest at least £1.6 billion between April 2024 and March 2029, approximately £500 million less than the proposed 2024 base case with NRP.</p>	<p>Under the no runway scenario, capex excludes investment with NRP.</p> <p>BA uses the 2023 CIP forecasts.</p>
Airport charges	<p>The CAA commissioned a report from PA consulting to benchmark GAL's profitability and other financial performance indicators with a comparator group of non-regulated UK airports.</p> <p>In its modelling, the CAA assumes an overall average discount of 6.1%, based on</p>	<p>The CAA should update this to [§<]%, which is based on the new contracts negotiated with airlines.</p>	<p>No explicit comments made.</p>

¹⁶ [Commitments Extension](#) (page 39)

¹⁷ 2024 CIP (page 35)

projections by GAL for 2023/24 in its November 2023 tariff consultation.			
Opex	<p>CAA uses a top-down forecasting approach based on the historical relationship between opex and passenger demand, which assumes that around 60% of opex is fixed and 40% is variable with traffic. This results in 'fixed' component of £255m per year and an assumed 'variable' component of £3.50 per year per passenger (2023/24 prices).</p> <p>CAA assumes an additional £80m pa (in 2023/24 prices) from 2026/27 in High Opex case.</p>	<p>The CAA's analysis does not account for the fact that GAL's costs have been rising above CPI.</p> <p>The actual costs likely to exceed those outlined in the 'high opex' scenario, which was previously shared with the CAA in October 2023.</p> <p>GAL has highlighted the risk of changes to how its business rates are calculated, which mean a potential rates increase from £[<]m in 2023 to £[<]m in 2026.¹⁸</p>	BA assumes that opex is 80% fixed and 20% variable.
Time period	Estimates are presented on a financial year basis.	Estimates are presented on a calendar year basis.	Estimates are presented on a calendar year basis.
Commercial revenue	<p>The figures are based on the 2022/23 out-turn converted to 2023/24 prices and are constant throughout the entire period.</p> <p>Retail/car park revenue £8.32 per passenger. Other non-regulated revenues of £128.1m per year.</p>		<p>The figures are based on the 2023 out-turn.</p> <p>Retail car parking costs are adjusted for traffic growth annually.</p> <p>The property, utilities, and "Other" categories grow every year by a compound annual growth rate (CAGR) for the period 2015-2023, which has been estimated for each category.</p>

Source: Grant Thornton analysis

¹⁸ 'CAA update from London Gatwick, Business rates', dated 13 November 2024.

Sensitivity of GAL's profitability to changes in modelling assumptions

- 2.28 A series of sensitivity analyses on GAL's profitability under alternative modelling assumptions were conducted on the CAA's central model (the middle case) to test the impact of stakeholder views on GAL's operating profit as a percentage of fixed assets. Sensitivity tests were undertaken on the average charges discount, base level of opex, passenger traffic, and capex.
- 2.29 In the CAA's middle case, operating profit as a percentage of fixed assets was estimated to be 13.4% in 2028/29.
- 2.30 Applying GAL's view on the average charges discount and passenger traffic both had a relatively small impact on the estimated operating profit as a percentage of fixed assets, as illustrated in Figure 3 and Figure 4 below:
- Average charges discount: increasing the average airport charge discount, from 6.1% in the CAA's model to [8%] asserted by GAL to reflect new contracts negotiated with airlines, led to a 0.5 percentage point decrease, reducing the estimated operating profit as a percentage of fixed assets to 12.9% in 2028/29.
 - Base levels of traffic: applying a less optimistic forecast to passenger volumes, drawing on the estimates from GAL commitments proposal and figures in later years cited in its consultation response, resulted in a decrease of 0.98 percentage points. The estimated operating profit as a percentage of fixed assets under these lower traffic forecasts was 12.4% in 2028/29.

Figure 3: Impact of average charges discount sensitivities on operating profit as a percentage of fixed assets

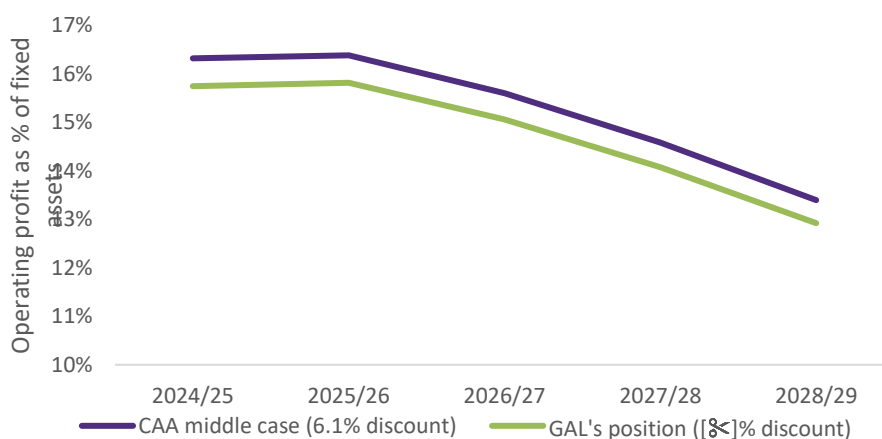
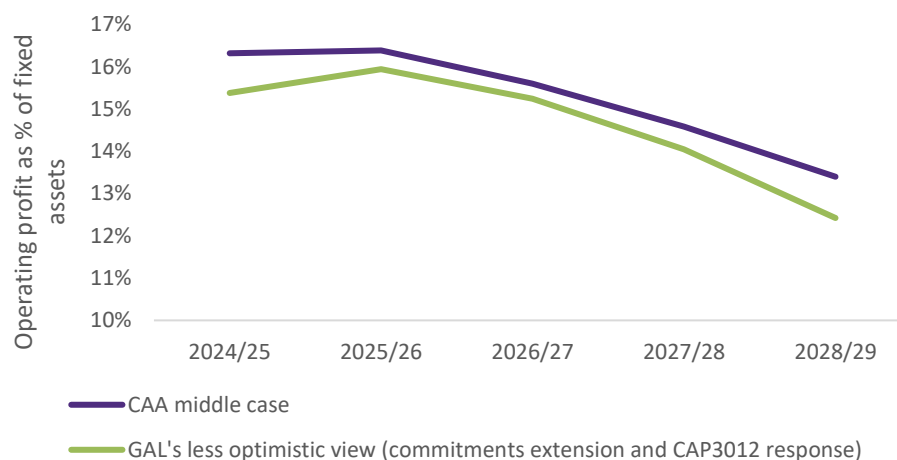


Figure 4: Impact of passenger traffic sensitivities on operating profit as a percentage of fixed assets

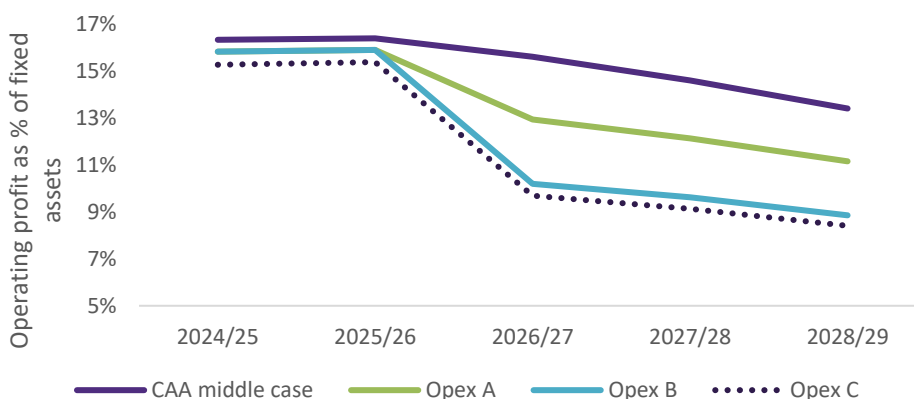


2.31 Adjustments to the base level of opex in the model had the largest relative impact on estimates of operating profit. Three levels of opex were tested:

- Opex A: This scenario used the CAA's high opex case values, adjusted to reflect the most recent outturn data for 2023/24, (the uplifted baseline opex was then carried forward).
- Opex B: As Opex A, with an additional increase to opex from April 2026 to reflect a possible increase in business rates by an additional £[8<] million. This increase was calculated as [8<].
- Opex C: As Opex B, with an additional increase in non-rates opex of CPI+2% per annum.

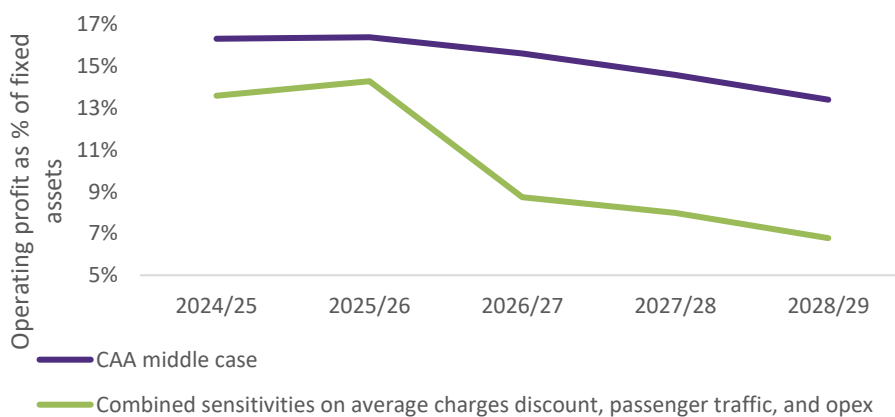
2.32 The sensitivities on opex values ranged from a -5.0 to -2.3 percentage points impact resulting in operating profit as a percentage of fixed assets ranging from 8.4% to 11.1% in 2028/29 (compared to 13.4% in the CAA middle case). This is illustrated in the below figure.

Figure 5: Impact of opex baseline sensitivity on operating profit as a percentage of fixed assets



2.33 When combined, taking GAL's views on average charges discount, passenger traffic, and higher opex (using the Opex C scenario), the estimate for operating profit as a percentage of fixed assets in 2028/29 is revised downward by 6.6 percentage points, decreasing from 13.4% in the middle case to 6.8%.

Figure 6: Impact of combined sensitivities on operating profit as a percentage of fixed assets



2.34 Further illustrative sensitivity analysis was carried out on the level of capex to assess the potential impact of a 10% and 20% optimism bias in current NRP cost estimates (which, it is understood, date back to 2019), by adjusting the capex figures upwards. Results show that a 10% to 20% uplift in capex would have a -0.98 to -1.28 percentage point impact on operating profit as a percentage of fixed assets by 2028/29.

2.35 While there are varying opinions on how the evidence should be interpreted, particularly between BA and GAL, the evidence from the consultation process and through the sensitivity analysis of stakeholder assumptions undertaken does not suggest that GAL would generate greater profits than previously estimated by the CAA. Additionally, some of the evidence submitted by GAL may indicate lower profits than previously estimated by the CAA, suggesting that it might be appropriate for the CAA to update its assumptions in light of this evidence.

2.36 All of that said, there may be sources of upside for GAL's profitability (for example opportunities to reduce costs or increase commercial revenues) that have not been shared which could have the effect of increasing its profits compared to those assumed previously. Moreover, it is important to note that some of the factors described above – for example passenger numbers and the average discount applied – are within GAL's gift, at least to an extent. Therefore, in arriving at its conclusions, CAA may wish to consider whether the commitments framework already provides for sufficient financial headroom to accommodate many of the challenges that GAL has identified and ensure that the company remains incentivised to deliver efficiently.

3 Benefits of capacity expansion

Introduction

- 3.1 The Civil Aviation Act 2012 mandates the CAA to perform its economic regulatory functions in a manner that it deems will advance the interests of passengers and cargo owners in terms of the range, availability, continuity, cost, and quality of airport operating services. Additionally, it is required to promote competition in the provision of airport operating services where appropriate. The CAA is also required to take into consideration various secondary duties, including ensuring licensees' ability to finance their activities, promoting economy and efficiency, and enabling licensees to take reasonable measures to address adverse environmental effects. These legal obligations are instrumental in shaping the CAA's role, and within this framework, the assessment of the benefits of expansion at Gatwick through the NRP forms a part of the CAA's responsibilities.
- 3.2 This chapter, firstly, assesses the benefits of expansion to consumers, which is of primary interest to the CAA, and, secondly, other potential benefits or disbenefits of the NRP, such as provider, wider society, or government impacts. This assessment primarily draws on a 2023 national economic impact assessment conducted by Oxera on behalf of GAL and submitted as part of its DCO application¹⁹ and an accompanying appendix which outlines a local economic impact assessment, including environmental impacts²⁰.
- 3.3 The report estimates benefits of GAL expansion to consumers of the London aviation system of £150 billion, over a 60-year appraisal period and expressing figures as discounted net present values in 2010 prices. This benefit is primarily associated with a reduction in fares generated by greater competition between airlines at Gatwick as scarce capacity is released and also includes benefits to “new” passengers (calculated as the difference between the actual fare and the maximum amount they would be willing to pay). Around 90% of the benefits are estimated to accrue to business travellers, with the remainder to leisure travellers.
- 3.4 The 2023 Oxera report makes several key assumptions. It uses GAL assumptions for passenger numbers up to 2047, assuming 13 million extra passengers at the end of the forecast period, representing a 20% uplift. The scheme is assumed to open in 2029, with full operational capacity by 2030. Additionally, the assessment assumes that a third runway at Heathrow will not be developed. The analysis covers a 60-year period from 2029 to 2088, encompassing all pre-2029 related development costs. Capital expenditure (Capex) is provided by GAL and 44% optimism bias. Furthermore, all figures reported are inflation-adjusted (real) 2010 prices, and impacts are presented in present value 2010 values. The analysis assumes that GAL passenger numbers will have fully recovered from the covid-19 pandemic by the time the NRP opens in 2029.

Consumer benefits

- 3.5 Capacity expansion at an airport has numerous impacts on passengers, airlines, and the airport itself. The NRP impacts include the alleviation of capacity constraints, leading to a reduction in airfares due to supply and demand dynamics, an increase in air traffic movements (ATMs), and a rise in passenger numbers resulting from lower fares and higher frequencies. While this may lead to a decrease in profits for airlines due to reduced fares, the offset comes from an increase in passenger numbers. Additionally, the expansion results in an increase in airport revenues due to the surge in the number of passengers and ATMs. These combined effects influence the value and distribution of the economic benefits within the aviation market. For instance, while lower airfares may diminish airline profits, the resulting improvement in consumer welfare from reduced fares may outweigh the providers' loss.²¹

¹⁹ [Gatwick Airport Northern Runway Project, Needs Case Appendix 1 – National Economic Impact Assessment](#) (2023)

²⁰ [Gatwick Airport Northern Runway Project, Environmental Statement, Appendix 17.9.2 Local Economic Impact Assessment](#) (2023)

²¹ This could arise from the increase in consumer surplus associated with the new passengers attracted by lower fares

- 3.6 To estimate the welfare impacts, the 2023 Oxera report calculates the consumer surplus, the difference between what a consumer would be willing to pay and what they actually pay, and provider surplus, the difference between the price the provider actually receives and what they would be willing to receive. The consumer and producer surpluses were calculated in the baseline, the NRP scenario, and an unconstrained scenario which assumes the London aviation scenario faces no passenger constraints. The difference between these scenarios of consumer and producers surplus are aggregated to calculate the change in welfare. Passenger numbers are disaggregated into origin (UK, foreign), journey purpose (business, leisure), and type (domestic, short-haul, long-haul). Average fare prices for the different market segments are represent below.

Table 4: Average fares by market segments

Market	Average Fare (£)
Domestic	55
Short-haul	80
Long-haul (business)	1,500
Long-haul (economy)	220
Weighted average long-haul	426

Source: 2023 Oxera report

- 3.7 The consumer benefits of the NRP include reduced fares as increased competition in London airports (both between airports and airlines) puts downward pressure on fares. Consumers will benefit from increased choice and greater connectivity, with more routes, more frequency of routes, and more choices of airlines that provide those routes. Additionally, increased capacity from expansion could enable Gatwick airport to better handle delays, reducing the disbenefits to passengers, although this impact will dissipate over time as the airport nears capacity again. Consumers may gain welfare benefits, through ease and cost of accessing Gatwick airport, but these are not quantified.
- 3.8 The quantified welfare benefits from the 2023 Oxera report amount to £15.5 billion for leisure passengers and £134.6 billion for business passengers over the 60-year appraisal period and in 2010 prices and values. Almost 90% of the consumer benefits are driven by business passengers. This contrasts with analysis Oxera published in 2021²², which used lower business passenger fares and estimated the consumer benefits from business passengers between £36.3-£46.9 billion over the 60-year appraisal period. This puts into question whether the business passenger consumer benefits are robust, particularly, if business passenger trends were to change in the future – for example a decrease in their willingness to pay.

Table 5: Consumer benefits from NRP

	Description	Present Value (60- year appraisal period)	Comments
Consumer Benefits	Increased passenger numbers in London airports will increase competition and result in fare reductions, due to market forces.	<p>£15.5 bn – Leisure passengers</p> <p>£134.6 bn– Business passengers</p> <p>Total £150.1 bn</p> <p>(consumer benefits in the London aviation system)</p>	Almost 90% of the consumer benefits are driven by business passengers, which uses a high average fare of £1,500 compared to previous analysis.

Source: Grant Thornton Analysis, 2023 Oxera report

Provider benefits

- 3.9 Increased competition in the London aviation sector which decreases fares results in a negative welfare impact for airlines. This can be interpreted as a welfare transfer from airlines to consumers. Despite the lower fares, providers

²² (2021)

will benefit through increased revenue as the number of passengers increases. The positive welfare impact for consumer outweighs the negative welfare impact for providers, presenting a net welfare impact from the NRP.

Table 6: Provider benefits from NRP

	Description	Present Value (60- year appraisal period)	Comments
Provider Benefits	Increased passenger numbers in London airports will increase competition and result in fare reductions, due to market forces.	-£139.3 bn – airline (dis)benefits £2.2 bn – airline revenue	Driven by the high business passenger fare.

Source: Grant Thornton analysis, 2023 Oxera report

Government benefits

Expansion at Gatwick Airport would have a direct impact on tax revenues, as tax receipts from aviation would increase with more passengers traveling from the airport. However, this would be offset by a decrease in passengers' disposable income, leading to reduced taxable spending elsewhere in the economy and causing tax receipts to fall indirectly. The government levies Air Passenger Duty (APD) on all flights by departing passengers from the UK, and it is passed on to airfares, affecting the disposable income of leisure passengers. The 2023 Oxera report estimates that the increase in passengers from the NRP would increase Government revenue from APD by £2.5 billion over a 60-year appraisal period and in 2010 prices and value. The analysis is based on 2021 Air Passenger Duty rates. Updated Air Passenger Duty rates were announced in Autumn 2024²³, which may increase the additional revenue Government receives as a result of the NPR, assuming the increased in APD do not distort passenger numbers.

- 3.10 Additionally, the increased demand at Gatwick Airport would also impact other types of taxes, such as fuel duty, VAT, rail franchises, or national non-domestic rates. These effects are not quantified in the 2023 Oxera report.

Social benefits

- 3.11 The social benefits include environmental impacts caused by additional greenhouse gas emissions from additional aircraft, construction, surface access, freight, airport buildings and ground operations. The 2023 Oxera report estimates that the monetised value of these emissions is -£1.258 billion (with a sensitivity of -£0.629 billion to -£1.886 billion using high and low carbon prices). In addition to the carbon impacts, the NRP is expected to generate additional air quality impacts from increase NO_x and PM_{2.5} from aircraft, road traffic, and other on-site operations. The total monetised benefit of these additional air quality impacts is estimated to be -£0.084 billion over the 60-year appraisal period.
- 3.12 A further social impact of the NRP will be increased aircraft noise and the disturbance it causes people living in the areas by the flight path. This impact is monetised at £0.009 billion over the 60-year appraisal period.
- 3.13 Total social benefits of the NRP, which represent a cost here, are valued between -£0.646 billion and -£2.210 billion (central estimate -£1.350 billion). The majority of this impact is due to the greenhouse gas emissions.
- 3.14 An assessment by the New Economics Foundation (NEF)²⁴ raises serious concerns about the accuracy of the monetised value of greenhouse gas emissions resulting from the expansion project at Gatwick Airport. NEF contends that the estimate provided by Oxera in their 2023 economic impact assessment is flawed, citing outdated input values and a flawed methodology. NEF attempted to replicate the calculation and found that even when using the same outdated inputs, the 2021 economic impact assessment significantly understated the carbon costs of the scheme. NEF's like-for-like assessment produced a central net present emissions value of £4.1 billion in 2010 market prices, significantly higher than the 2023 Oxera report central estimate of £1.258 billion. Furthermore, NEF

²³ [Air passenger duty, Office of Budget Responsibility](#) (2024)

²⁴ [NEF Gatwick Airport consultation 08.11.2021.pdf](#)

argues that Oxera omits international emissions and non-CO2 effects of air travel, which are essential components according to DESNZ guidance. NEF's recalculation using the updated methodology, updated carbon values, and inclusion of non-CO2 impacts resulted in a significantly higher net present value of greenhouse gas emissions compared to 2021 economic impact assessment estimate.

- 3.15 NEF's critique points to several key issues in the 2021 economic impact assessment. They highlight the outdated carbon values used in the assessment, the omission of international emissions and non-CO2 effects of air travel, and a flawed method for estimating emissions costs. NEF's re-calculation using the new BEIS carbon values and inclusion of non-CO2 impacts showed a significantly higher net present value of greenhouse gas emissions, raising concerns about the accuracy and completeness of Oxera's analysis. This suggests that a re-evaluation of the carbon costs calculation using up-to-date data and a more comprehensive methodology is necessary to provide a more accurate representation of the environmental impact of the NRP.

Local Benefits

- 3.16 The NRP will have an economic impact on the local economy. It will increase direct jobs at the airport for ground services and also indirectly from the supply chains that support these services. These additional people employed at the airport will spend their wages on goods and services in the local economy, thereby inducing more jobs.
- 3.17 The 2023 Oxera report Local Economic Impact Assessment Annex²⁵ estimates the direct, indirect, induced GVA (Gross Value Added) and jobs created from the NRP in the Six Authorities Area (West Sussex, East Sussex, Surrey, Kent, and Brighton and Hove, and the London Borough of Croydon). The report suggests that the NPR will add £0.516 billion of GVA and 6,600 jobs to the wider economy each year by 2038. These estimates are significantly lower than a similar analysis Oxera did in 2021 which estimated that the NRP would increase GVA by £1.475 billion and 18,400 new jobs in the Five Authorities Area (excluding the London Borough of Croydon).

Table 7: Local benefits from NRP

	Description	Present Value	Comments
GVA	Direct, indirect, and induced GVA in the local area from Gatwick expansion	£0.516 bn in 2038 (Direct GVA £0.263 bn, indirect GVA £0.156 bn, Induced GVA £0.098bn)	Figures are significantly lower than previous estimates, suggesting analysis is very sensitive to the assumptions used.
Employment	Direct, indirect, and induced employment in the local area from Gatwick expansion	6,600 jobs in 2038 (Direct jobs 3,200, indirect jobs 2,100, Induced jobs 1,300)	As above.

Source: Grant Thornton Analysis, 2023 Oxera report

Other benefits

- 3.18 Other benefits from Gatwick expansion that are qualitatively assessed by the 2023 Oxera report include freight benefits (where aircraft transport cargo – particularly high value or perishable goods such as pharmaceuticals- in their bellyhold), competition benefits (both between London and South East of England airports and between airlines), resilience benefits, and benefits resulting from a reduction in delays (both day-to-day and major delays) where the aviation system is less constrained.

²⁵ [Gatwick Airport Northern Runway Project, Environmental Statement, Appendix 17.9.2 Local Economic Impact Assessment \(2023\)](#)

Freight

- 3.19 the NRP will contribute to an increase in air freight at the airport by expanding the number of air traffic movements (ATMs), leading to an increase in both the frequency and range of destinations served. The forecasts provided by ICF suggest that air freight traffic is expected to increase by 20% in the long run compared to the baseline. The economic value of air freight is highlighted, emphasising its importance to time-sensitive supply chains and its ability to offer specialized services such as temperature-controlled storage for perishable foodstuffs and pharmaceuticals. Additionally, the Department for Transport (DfT) recommends appraising the impact of aviation policies on air freight, stating that an expansion at a capacity-constrained airport should lead to an increase in surplus for air freight customers. However, the text notes that detailed guidance on how such an appraisal should be conducted is not provided, and therefore a quantified assessment has not been included in the study.
- 3.20 A further study on freight commissioned by TfL²⁶, projects that by 2050, London's airport system will be at full capacity, leading to significant volumes of freight having to be transported elsewhere, resulting in additional costs. Without expansion, the additional trucking costs are estimated to be around £41.6 million per year, whereas with a second runway at Gatwick, these costs are reduced to approximately £36.1 million per year.

Competition

- 3.21 The expected increase in activity at Gatwick Airport is anticipated to draw passengers from other London airports, particularly those who would have preferred to use Gatwick, but could not, due to capacity constraints in the baseline scenario. This shift, while relatively modest in the context of overall traffic in the London aviation market, is likely to create competitive pressure on other London airports in the initial years following the new runway opening. The alleviation of capacity constraints at Gatwick, particularly during peak times, would create new slots available at times of higher demand, fostering increased competition between airlines. This heightened competition could potentially impact prices and quality offered in the London aviation market, ultimately leading to benefits for passengers. However, as market capacity becomes fully utilised over time, it is expected that shadow costs will once again increase, leading to competition taking other forms beyond pure price competition.

Resilience

- 3.22 The resilience of an aviation system reflects its ability to maintain regular operations in the face of disruptions, preventing system-wide delays and cancellations that result in increased journey time variability and decreased travel reliability. The discussion highlights that higher resilience would bring benefits to both consumers and providers of the London aviation system, mitigating costs associated with operational disruptions. The construction of the Project could potentially enhance resilience at Gatwick Airport and the London aviation system in several ways, such as increasing route frequency, allowing for faster recovery from disruptions, and contributing to system-wide resilience. However, it is noted that resilience during the construction phase would be lower, and as the excess capacity at Gatwick Airport diminishes over time, the resilience provided by the NRP would also decrease. Despite the increase in the number of passengers, the extra capacity would reduce the cost of disruption per passenger and offer flexibility in designing system-wide disruption recovery strategies. Additionally, excess capacity would enhance resilience during day-to-day and major disruptions in the London aviation system.

FDI

- 3.23 Aviation facilitates international engagements by creating trade links and investment opportunities through increased connectivity, which reduces the costs of face-to-face interactions and enhances organisational and communication efficiency. The wider benefits of increased Foreign Direct Investment (FDI) and trade are seen through their effects on productivity, particularly through technological spillovers and the transmission of know-how. Increased trade is associated with increased connectivity, affecting goods and services exports and imports. The increased connectivity and activity at Gatwick Airport from the NRP would likely lead to an increased likelihood of inward FDI and an increased volume of trade, which could result in increased productivity, gross value added (GVA), and additional tax benefits at a national level. However, the empirical causal links between FDI, trade, and economic impact are difficult to establish, and therefore the productivity benefits arising from increased trade and FDI are not quantified.

²⁶ [Implications for the Air Freight Sector of Different Airport Capacity Options, York Aviation report to Freight Transport Association and Transport for London](#) (2015)

Delays

Day-to-day delays

- 3.24 There could be benefits of the NRP from addressing unexpected day-to-day disruptions and enhancing the speed of recovery from these disruptions. Temporary fluctuations in airport operational capacity, such as short-term runway closures or adverse weather, could lead to delayed flights. Operating at near-full capacity can make it challenging to find available time slots to recover from these delays. The expected impact of disruptions depends on their frequency and duration, noting that additional capacity at Gatwick Airport would be crucial in dealing with day-to-day disruptions. Additional capacity would enable Gatwick Airport to efficiently manage short-term disruptions by offering flexibility in allocating departing flights to separate runways, leading to faster recovery and fewer knock-on delays, ultimately reducing delays for passengers and operational costs for airlines.

Major delays

- 3.25 The NRP would enable Gatwick Airport to accept more re-routed flights from other disrupted airports, thereby reducing the negative impacts of major disruptions for passengers. However, quantifying the benefits of such events is challenging due to their rarity and high costs. Gatwick expansion should help alleviate the costs of disruptions by allowing more flights to be re-routed to Gatwick Airport, resulting in fewer delays and more passengers reaching their destinations. Additionally, it notes that its impact on resilience would decrease over time as the additional capacity provided is used and excess capacity declines, but it would still provide an alternative to recover from major disruptions that otherwise would not exist.

Surface access costs

- 3.26 There may be short term benefits for passengers that would be able to fly from/to Gatwick rather than a different airport which is further away from their origin/destination. This benefit would come in the form of savings in public transport fares, fuel or travel time. Benefits from lower surface access costs may be offset by reductions in Government revenue through VAT on fuel.

Sensitivity Analysis

- 3.27 The 2023 Oxera report modelled a 'slow growth' sensitivity which assumed a slower recovery of passenger numbers after the Covid-19 pandemic. They estimated that consumer benefits would fall from £150.1 billion to £107.2 billion over the 60-year appraisal period. This is made up of £95.1 billion benefit from business passengers and £12.0 billion from leisure passengers. In this sensitivity, provider benefits fell from -£139.3 billion to £102.3 billion along with a drop in airline revenue from £2.2 billion to £1.7 billion. Despite this drop in passenger numbers, the sensitivity produced a net present value of benefits to consumers and providers of £6.6bn over the 60-year appraisal period.

Conclusion

- 3.28 NRP is estimated to have significant impact on consumer benefits, particularly in terms of reduced airfares and increased choice and connectivity. The expansion would alleviate capacity constraints, leading to lower fares and higher frequencies, resulting in a rise in passenger numbers and increased airport revenues.
- 3.29 While the welfare benefits are significant, with the 2023 Oxera report estimating consumer benefits of £15.5 billion for leisure passengers and £134.6 billion for business passengers over a 60-year appraisal period, there are considerations regarding the robustness of these estimates, particularly with regards to potential changes in business passenger trends in the future. For instance, the report indicates a substantial advantage for business travellers (considerably larger than earlier Oxera analyses), with these benefits constituting the majority of the overall benefits. Considering the significant changes in business travel due to COVID and the uncertainty regarding the extent to which an expanded Gatwick will cater to the business sector, it is uncertain if the benefits would materialize as projected in the report.
- 3.30 In addition to the quantified benefits of the NRP, there are a number of other benefits that are expected to occur which are qualitatively described. These include increased air freight capacity, competition benefits leading to

improved passenger experience, enhanced resilience to disruptions, potential for increased Foreign Direct Investment and trade, and reduced day-to-day and major delays. While most of these benefits are not the primary focus for the CAA, if the NRP can have a materials impact on reducing both day-to-day delays and major delays, then this will bring welfare benefits for consumers.

- 3.31 Whilst the precise quantum of benefits presented in the Oxera study should be viewed cautiously, the overall picture that it creates - which is one of substantial benefits to passengers from the NRP - seems broadly robust. While any forecasting exercise inevitably relies on assumptions that might be overtaken by events, it seems clear that GAL's NRP has the potential to increase capacity in a system that has experienced excess demand for a great many years. This is likely to lead to lower airfares and potentially very substantial benefits for passengers, in addition to increasing competition both between airports and between airlines.

4 Relative merits of alternative regulatory frameworks for capacity expansion

- 4.1 This chapter considers how different economic regulation frameworks may facilitate (or hinder) airport capacity expansion projects. The chapter begins with some cross-cutting observations and then discusses, in turn, Heathrow's RAB-based regulation, the approach followed at non-regulated airports and Gatwick's commitments framework. Each section provides general comments about the mechanics and incentives created by each approach, then discusses how this has worked in the case of capacity expansion in particular, and finally gives an overall assessment of their relative merits.

Cross-cutting observations

- 4.2 On paper, the formal regulatory frameworks applying to HAL and GAL are relatively similar. Both have licences issued under the Civil Aviation Act 2012, and both are subject to price caps that constrain the maximum level of airport charges and a system of service quality targets and rebates. However, HAL's price cap is more complex than GAL's. And to date, the process by which GAL's price cap is reset has been considerably shorter and simpler than, for example, the recently completed H7 review of HAL's price cap. These differences in regulatory regimes reflect the differences in HAL and GAL's markets and, in particular, differences in market power between the two airports.
- 4.3 Moreover, within each framework, the companies responded quite differently to the Covid-19 pandemic: in July 2020 HAL submitted a formal request to CAA for a large addition to its RAB to compensate for a high proportion of its lost revenues,²⁷ whereas GAL stood behind the proposal for a new set of commitments that it had finalised in January 2020, immediately before the pandemic, and which CAA accepted in 2021.
- 4.4 One of the main formal differences between the two regulatory frameworks is the treatment of investment. HAL's price cap is set on the basis of a traditional regulatory asset base (RAB), which establishes an automatic link between investment and the future level of charges. In contrast, GAL does not have a RAB and therefore there is no such automatic link.²⁸
- 4.5 RAB-based economic regulation is well-established in the UK and has facilitated significant investment across a range of regulated industries. In principle, it provides companies with a reasonable opportunity to earn a long-term return on their investment reflecting the risks being taken, while protecting consumers from the risk of excessive returns.
- 4.6 However, specific challenges may impact investment at regulated airports. These include:
- While constructive engagement between regulated airport operators and airlines provides valuable input to regulatory reviews, there is also a risk that even potentially useful investments may be challenged for strategic reasons, such as efforts from the airlines to keep airline charges low.

²⁷ HAL's initial request was for an adjustment of £1.7 billion (see [Heathrow RAB Adjustment - CAA Submission final public](#)) though it subsequently raised this to around £2.6 billion. CAA rejected most of this request, but did allow an adjustment of £300 million to incentivise additional investment in 2021 and avoid a higher cost of debt finance for HAL (see <http://www.caa.co.uk/cap2140>).

²⁸ GAL is required to calculate a "shadow RAB" in case tighter regulation needs to be reintroduced, but this is not published (see <http://www.caa.co.uk/cap1152>).

- Investment projects are often specific to individual airports. Due to the lack of suitable comparators, it can be difficult for regulators and other stakeholders to assess whether the projected costs are reasonable.
- 4.7 These are challenges that affect most airport investment projects, but they can be especially significant in potential airport expansions. In the face of growing demand and limited capacity, particularly in the South East of England, airport expansion projects have the potential to deliver substantial benefits to consumers, as discussed in an earlier chapter. However, they often require airport operators to undertake extensive investment programmes, incurring significant sunk costs as the resulting new facilities will be specific to a particular location and the provision of airport services.
- 4.8 Political and planning considerations are also very important for airport expansion projects. These factors contribute to a sunk cost problem, as airport operators are often required to incur significant costs in advance of planning applications. Failure to obtain planning approval may result in forfeiting the costs incurred up to that point.
- 4.9 Within this context, this chapter considers how different economic regulatory frameworks may facilitate (or hinder) airport expansion projects. The planning and political background is important, not least because of the extensive preparatory work required in advance of any planning application. However, the following discussion focuses on the regulatory and commercial aspects of airport expansion, and how projects may proceed under different regulatory frameworks.

RAB-based regulation

Overview

- 4.10 The use of RAB-based regulation for remunerating investment projects is well-established in many industries subject to economic regulation. Investment expenditure is added to the RAB and this leads, in future regulatory periods, to a higher price cap as the regulator's calculations will take account of both the increased value of the RAB (hence a higher allowed return) and a higher depreciation allowance. This approach is understood and trusted by investors and is generally favourable to investment as it provides the firm with a reasonable opportunity to recover its costs and to earn an appropriate return.
- 4.11 The ease of implementing a RAB-based approach in practice, as well as its effectiveness in providing incentives for efficient capital expenditure, depends on details such as the calculation of each addition to the RAB and the treatment of cost under or overruns. Additionally, in the absence of any compensating adjustments, a RAB-based approach will lead to cost recovery being frontloaded as the impact on price cap will be greatest in the early years, after an investment is made, when the value remaining in the RAB is highest.
- 4.12 For many years, the CAA applied its RAB-based approach in a relatively simple form, generally increasing HAL's RAB in line with actual expenditure and relying on retrospective (or "ex-post") reviews to consider whether any of HAL's expenditure was inefficient and therefore might be excluded from the RAB. While this approach is relatively straightforward to apply, it is not clear how effectively a system of ex-post efficiency reviews will incentivise efficient investment in practice.
- 4.13 Therefore, at a relatively early stage in the H7 price review and in light of recent ex-post efficiency assessments not leading to significant disallowed expenditure,²⁹ CAA indicated its intention to consider the use of alternative "ex-ante" incentives, under which HAL would bear a pre-determined share of cost under or overspends relative to the expected cost of a project. Given the challenge of conducting retrospective efficiency reviews for large projects such as HAL's expansion programme, the uncertainty surrounding the potential outcomes of such reviews, and the absence of any incentive to outperform baseline cost allowances under its previous ex post approach, CAA then confirmed its decision to switch to a system of ex-ante efficiency incentives for HAL's capital expenditure.³⁰
- 4.14 The ex-ante approach can be more challenging to implement, as it requires early-stage confirmation of the investment's nature and the agreed cost estimate, along with arrangements to address any required updates to the cost estimate, potential changes to the investment's scope, and other related factors. Furthermore, there needs to be a way of confirming that the investment has been successfully delivered to ensure that any underspend, for example, reflects genuine efficiency rather than incomplete project delivery.
- 4.15 In November 2023, the CAA published revised guidance on capital expenditure governance, building on existing arrangements for HAL and airlines to review and approve potential investments. This covers specifications for the information that HAL should provide on potential investment projects, arrangements for reviewing proposed

²⁹ See <http://www.caa.co.uk/cap1510>

³⁰ See <http://www.caa.co.uk/cap1876>

projects (including scope and estimated cost). It also includes a new framework for agreeing “delivery obligations” that will be used to assess whether a project has delivered what was intended and agreed by HAL and airlines.³¹

RAB-based regulation case study – Heathrow third runway programme

- 4.16 Following work by the Airports Commission between 2012 and 2015, the UK government stated its in-principle support for a third runway at Heathrow in October 2016, and this was formally confirmed in an Airports National Policy Statement, approved by Parliament in June 2018.^{32 33} In parallel, the CAA was tasked by the Department for Transport to develop its regulatory framework to support capacity expansion at Heathrow. Between 2016 and January 2019, the CAA published ten documents with a focus on the third runway project, including eight for industry consultation and two reports to DfT. Its consultations received over 80 responses in total.³⁴
- 4.17 In February 2019, the CAA began work on the H7 price control.³⁵ In March, it published its views on possible ways of implementing ex-ante efficiency incentives for Heathrow’s capex.³⁶ The CAA continued to work on other elements of the regulatory framework with a focus on capacity expansion until April 2020, when HAL decided to pause the expansion programme due to a legal challenge and the drop in demand and future uncertainty caused by the pandemic. During this period, the CAA published six documents for industry consultation.³⁷
- 4.18 Between 2021 and 2023, the CAA developed its H7 price control, now in the absence of the third runway project.³⁸ Work included an assessment of capital expenditure and the development of guidance on capital expenditure governance, which is likely to apply to Heathrow’s future capacity expansion projects, including the third runway project, as and when this resumes. This guidance indicates a significant increase in the degree of ex-ante scrutiny of HAL’s capital expenditure plans by airlines, informed by expert consultants’ advice, and with resort to appeals to the CAA. This is likely to add some cost and delay (possibly considerable) to the development and progression of future expansion projects.
- 4.19 CAA’s Final Decisions, published in March 2023, then underwent an appeal process, and the Competition and Markets Authority (CMA) published its final determination in October 2023. Further related documents were published during 2024, once the price control had begun. These are normal timescales for a typical price control.³⁹
- 4.20 This case study serves to illustrate the following points:
- Developing an effective regulatory framework takes time and effort. The CAA spent much of the period between 2016 and 2018 considering how it would regulate HAL in the event of capacity expansion, consulting with industry and advising the DfT. It then continued this work in 2019, with a focus on the setting of ex-ante efficiency incentives. Although much of this framework could be re-deployed to other airports and expansion projects, such as GAL’s NRP, it may well need adapting and developing further. This is likely to add delay, and potentially cost, to the delivery of expansion projects.

³¹ See <http://www.caa.co.uk/cap2605>

³² See [Airports Commission: final report](#)

³³ See [Airports National Policy Statement: new runway capacity and infrastructure at airports in the Southeast of England](#)

³⁴ See [The recovery of costs associated with obtaining planning permission for a new northwest runway at Heathrow Airport: final proposal \(2016\)](#), [Economic regulation of the new runway and capacity expansion at Heathrow airport: consultation on CAA priorities and timetable \(2017\)](#), [Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow \(2017\)](#), [Economic regulation of capacity expansion at Heathrow: policy update and consultation \(2017\)](#), [Economic regulation of capacity expansion at Heathrow: policy update and consultation \(2018\)](#), [Final report on airport-airline engagement on new runway capacity at Heathrow airport and proposals for further engagement and reporting \(2018\)](#), [Economic regulation of capacity expansion at Heathrow: policy update and consultation \(2019\)](#)

³⁵ See [Economic regulation at Heathrow airport from January 2020: proposals for interim arrangements](#)

³⁶ See [Economic regulation of capacity expansion at Heathrow: policy update and consultation \(2019\)](#)

³⁷ See [Economic regulation of capacity expansion at Heathrow airport: consultation on early costs and regulatory timetable \(2019\)](#), [Economic Regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion \(2019\)](#), [Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues \(2020\)](#), [Economic regulation of Heathrow Airport Limited from January 2020: notice of proposed licence modifications](#), [Economic regulation of Heathrow Programme Update April 2020](#)

³⁸ See [Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward \(2021\)](#), [Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Appendices \(2021\)](#), [Economic regulation of Heathrow Airport: H7 Final Proposals – Summary \(2022\)](#), [Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023](#), [Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023](#), [Economic regulation of Heathrow Airport: H7 Final Decision – Summary \(2023\)](#).

³⁹ See [CMA’s FD in the H7 Heathrow Airport Licence Modification Appeals \(2023\)](#), [Economic regulation of Heathrow airport: H7 final issues \(2024\)](#), [CAP3001: Economic regulation of Heathrow airport: H7 final issues – decision | Civil Aviation Authority \(2024\)](#)

- Delivering a price control, under RAB-based regulation, adds further time, effort and uncertainty. The current price control took close to three years to complete. Although only a proportion of this time will have been devoted to the assessment of capital expenditure, the final decision requires all building blocks to be in place. It is only the final determination price control that confirms allowable expenditure and gives airports the certainty and the ability of the revenues that they will be able to generate from future passengers. It seems unlikely that an airport would be able or willing to begin work on a large-scale expansion project until the final determination is issued, and conditional on a satisfactory financial outcome.
- A corollary of the previous point is that project design for major expansion projects needs to be fixed earlier on relative to the proposed start of works, which reduces flexibility to changing circumstances and could create inefficiencies. Alternatively, if the project needs to change then this could result in a re-opening of the price control process, in turn adding further cost and delay.
- Under the CAA's proposed future approach to capex expenditure governance, capacity expansion projects will be subject to a significant degree of scrutiny, with involvement from independent consultants, and the opportunity for airlines to challenge airport plans, which may also end up requiring intervention by the CAA. This is likely to cause further cost and delay to the delivery of capacity expansion schemes, both in terms of elapsed time required for this scrutiny and the possibility that plans need to be changed over time as a result. It also creates greater uncertainty over whether plans as originally envisaged by airports will pass stakeholder and regulatory scrutiny.

Assessment of the RAB-based approach

4.21 Two key strengths of using a RAB-based approach to major airport investment projects are that:

- it is generally favourable to investment, as it provides a relatively high level of long-term protection from many key risks. Companies and investors trust it to allow firms a reasonable opportunity to recover their costs and earn an appropriate rate of return. This is particularly valuable for investment projects with significant sunk costs, enabling such projects to proceed at a reasonable cost.
- it is part of a framework designed to protect consumers from excessive charges, therefore reducing the risk of consumers being overcharged for delivering the investment project or for subsequent services provided at the newly expanded airport.

4.22 In practice, however, there is a risk that the impact of these advantages may be offset by problems arising from the way that RAB-based regulation needs to be implemented. Given the risk of significant cost overruns on major construction projects, it is understandable that, in the light of HAL's expected expansion project, the CAA opted to apply its RAB-based approach with ex-ante efficiency incentives rather than relying on its previous system of retrospective efficiency reviews. The alternative might have exposed consumers to the risk of even larger increases in charges. Nevertheless, the early need under ex-ante incentives to establish (and where appropriate update) both the scope and the expected cost of different parts of the investment programme introduces several risks, including:

- a risk of delay, because of the additional up-front planning work required by the airport operator, the time taken by regulatory reviews, potential stakeholder challenges or similar processes, which are likely to be difficult as most airport expansion projects are unique and therefore difficult to benchmark.
- a risk of inefficient design because, for example, the regulatory framework requires more aspects of the design to be fixed at an earlier stage than a developer would normally prefer, and especially if the framework discourages the developer from making subsequent beneficial changes (e.g. due to the complexity of the change process, or because the developer will not capture enough of the benefits to make the change worthwhile).
- a risk of increased costs, reflecting the impact of both of the above plus the risk of regulatory gaming and the incentives that firms subject to ex ante incentives have to inflate their initial cost estimates, especially in situations where comparable cost benchmarks may not be readily available.

4.23 It is difficult to judge how much these potential risks affected HAL's third runway programme, especially as it was paused in 2020 before HAL had submitted its full planning application. However, a very substantial amount of regulatory effort had already been committed (by CAA, but also involving HAL, airlines and other stakeholders) to revising the previous regulatory framework and scrutinising HAL's emerging plans, and that there were still several significant issues that would have needed to be resolved before the project could proceed.

- 4.24 It is important to acknowledge that HAL's third runway programme is a considerably larger and more complex project than those carried out or proposed by other airports and described elsewhere in this chapter (including the NRP). The large scale of the costs involved inevitably led to close scrutiny by both CAA and airlines, and the interactions with other parties (including in relation to substantial work on the M25 motorway and a possible new rail link, plus the emergence of a potential third-party developer) raised significant challenges for the regulatory framework. A significant part of CAA's work was also focused on the treatment of "early" costs, many of which arose because the project would significantly expand the airport boundary and therefore HAL would need (among other things) to arrange the relocation of certain large commercial or other facilities, and to undertake a significant programme of property acquisition.⁴⁰
- 4.25 Even so, any airport expansion programme is likely to pose challenges for RAB-based regulation, given the likely scale of costs (and therefore the need for scrutiny even if this introduces possible delays), the likely uniqueness of the project (making cost benchmarking difficult), and the risk of significant cost overruns, thereby favouring ex ante incentives or similar approaches.

Non-regulated airports

Overview

- 4.26 Following the implementation of the Civil Aviation Act 2012, only those airports that are considered to have (or are likely to have) substantial market power are subject to ex ante economic regulation. Other UK airports remain subject to normal competition law requirements, and those with more than 5 million passengers per year are also subject to the Airport Charges Regulations 2011 which include conditions on consultation, transparency and non-discrimination. Currently, all UK airports apart from Heathrow and Gatwick, are not considered to have substantial market power and are free to determine both the level and structure of their airport charges.⁴¹
- 4.27 An airport operating in a hypothetical competitive market would likely act as a "price taker", meaning its charges would be influenced by the prevailing level of charges in the market. In such a situation, an airport operator contemplating an expansion programme would need to take a long-term view of whether the additional revenues generated would cover the expected costs of the investment, including financing costs and a return commensurate with the riskiness of the project.
- 4.28 In practice, there is no perfect competition between airports due to significant fixed costs, lumpy capacity, localised markets, airline buyer power, and network externalities. Nevertheless, the insight that a decision about a possible expansion project would likely be taken on a commercial long-term basis, depending on the likelihood that the additional revenues generated would cover the cost of the project, remains a useful one.
- 4.29 Real world considerations also introduce other opportunities and risks that might not apply to a hypothetically competitive airport. For example:
- airports are not perfect substitutes. Therefore, a major investment programme could deliver service quality improvements that would allow the airport to levy higher charges in future. Airport operators may also factor strategic interactions into their plans, for example whether neighbouring airports might also be considering their own expansion or improvement projects; and
 - relationships with major airline customers are important. Future demand risk will reflect not only the demand for air travel by local passengers but possible future decisions by airlines to reconfigure their route networks or, especially for low-cost carriers, to the location and size of their various bases. Demand risk may also arise if key airlines go out of business or need to significantly reduce their activities.

Investment in non-regulated airports case study – Manchester Transformation Programme

- 4.30 Manchester Airport's Transformation Programme (MAN-TP) is one of the largest capital investment projects in a UK non-regulated airport in recent years. The project was first announced in June 2015, phase 1 was completed in 2021 and phase 2 is due to be completed in 2025.
- 4.31 Funding of MAN-TP required an increase in airport charges, which the airport had a duty to consult airlines on. The airport formed working groups to facilitate input from stakeholders, both in relation to charges and programme

⁴⁰ See <http://www.caa.co.uk/cap1819>

⁴¹ CAA received a request in 2019 from IAG to undertake a market power determination in relation to Manchester Airport. This process was paused in 2020, as a result of the Covid-19 pandemic, and following further discussions with Manchester Airport, IAG formally withdrew its request in July 2024.

design and delivery. This created a degree of transparency over planned expenditure and on the link between proposed investment and charges.

- 4.32 Construction started in 2017, with the first major element (Pier 1) opening in 2019. Terminal 2 extension opened in 2021. The rest of the programme was paused due to the covid-19 pandemic and then resumed in 2022.
- 4.33 Updated cost estimates, produced in 2022, showed a material increase in the expected expenditure for phase 2 and in the charges required to fund the project. These were due to a combination of inflation, a drop in passenger demand, and scope changes (for example, in relation to statutory security requirements). The airport re-consulted on proposed charge increases between July 2022 and January 2023. The new charges took effect from April 2023. There have been further increases in cost estimates, which the airport has kept airlines informed of.
- 4.34 The overall MAN-TP is due to be completed by Summer 2025. There have been no formal appeals by airlines to the CAA in relation to charges levied by Manchester Airport.
- 4.35 The case study serves to illustrate the following points:
- The absence of the need to develop and implement a RAB-based regulatory framework for capacity expansion at non-regulated airports removes a major source of potential delay. Although two years passed between the project first being announced and the start of construction, this is a considerably shorter period than would have been required for a price control and earlier development of the regulatory framework.
 - Moreover, this allowed for greater flexibility in response to changes in supply and demand conditions. This will have likely led to a more efficient scheme design, quicker delivery and potentially a reduction in costs associated with delays.
 - The absence of RAB-based regulation is compatible with a reasonable degree of transparency over expansion plans and their cost, enabling scrutiny by key stakeholders. This may have been the result of competitive pressure faced by Manchester Airport and the alignment between the interests of both airport and airlines (both of which are incentivised to ensure capex is at an efficient level). It is less clear that this would be the case for an airport holding some monopoly power or if there was material disagreement on the proposed approach between airport and one or more airlines.

Capacity expansion at other non-regulated airports

- 4.36 In addition to the Manchester Transformation Programme, several other UK airports have developed significant expansion plans on a commercial basis in recent years:
- 4.37 Stansted Airport has received approval for a major terminal expansion and an increase in its capacity from 35 million to 43 million passenger per annum. Its application was originally refused by Uttlesford District Council but approved in 2023 following an appeal to the Planning Inspectorate. The resulting 5-year £1.1 billion investment programme was announced by the Prime Minister at the recent International Investment Summit in London, 14 October 2024.⁴²
- London Luton Airport Ltd has submitted an application to the Planning Inspectorate for a project including new terminal capacity, additional taxiways and other works and to raise its permitted cap from 18 million to 32 million passenger per annum. The Planning Inspectorate submitted its report and recommendation in May 2024. However, following a delay due to the general election and several rounds of clarifications and consultations, the current deadline for the SofS's decision is now 3 April 2025.
 - smaller scale expansion projects have also been developed by other airports, including Birmingham and Bristol.

Assessment

- 4.38 The evidence above suggests that a more commercially-oriented approach, in the absence of price regulation, can enable a swifter progression of capacity expansion projects, whilst allowing greater flexibility to changing circumstances and input from airport users. However, it seems likely that the competitive pressures faced by non-regulated airports are a contributing factor in achieving this outcome. If so, this assessment may not hold for airports such as Heathrow or Gatwick which are considered to hold a degree of market power.
- 4.39 At the same time, it is possible that planning and political considerations, rather than commercial or regulatory factors, presented the primary potential risk to (and perhaps impetus for) the expansion plans of non-regulated

⁴² [STN has announced £1.1bn investment to upgrade the airport](#)

airports. UK Government policy may have favoured airports other than HAL seeking to expand their terminal and other non-runway capacity,⁴³ yet they still faced potential challenges from local stakeholders.

- 4.40 From a commercial perspective, despite the reassurance provided by a track record of sustained long-term demand growth and the near impossibility of new market entry by new airports, airport operators undertaking expansion projects will still have exposed themselves to significant long-term risks. Possible responses to such situations might include some or all of the following:
- considering a range of possible options, and perhaps favouring an incremental approach over more ambitious but potentially riskier schemes.
 - requiring a relatively high expected return, in order to proceed with a project that might involve significant sunk costs.
 - seeking ways of reducing future risks, such as trying to obtain “buy in” from existing airline customers in relation to both the nature of the investment and any implications for airport charges.
- 4.41 Consistent with this, Manchester Airport undertook extensive consultation with airlines at different stages of its transformation programme, covering the programme itself and its funding approach. This included a clear explanation of the role of different funding sources (additional passengers, airport charges and ancillaries) and different options for the way that charge increases were profiled over time.

Gatwick commitments framework

Overview

- 4.42 The CAA found in 2014 that GAL had substantial market power in relation to a range of airport operating services, and this situation was expected to persist through the “Q6” period.⁴⁴ With the new flexibility introduced by the Civil Aviation Act 2012, the CAA decided to base its economic regulation on a set of commitments offered by GAL. As noted above, GAL does not have a RAB and therefore there is no direct link between investment and the future level of charges. As of today, the commitments framework is still a relatively untested approach to economic regulation. The commitments have been renewed only once, and that process was significantly affected by the impact of the Covid-19 pandemic.⁴⁵
- 4.43 The overall approach to economic regulation is lighter touch than that applied to HAL and leads to GAL’s position being somewhere between the traditionally regulated HAL and the non-regulated other UK airports. In relation to capacity expansion, however, GAL appears to have developed its northern runway proposal and submitted its planning application on a largely commercial basis. In sharp contrast to HAL’s third runway, CAA has not published any consultations or similar documents describing how its economic regulation might deal with GAL’s northern runway project.

Investment under Gatwick’s commitments framework case study – Northern Runway Programme

- 4.44 In October 2018, GAL published a draft master plan outlining three strategies for capacity expansion, one of which was to bring the northern runway into regular use. This work was done in the context of the commitments framework, which was first put in place in 2014 and then renewed in 2016, and the Airports Commission’s recommendation to proceed with Heathrow’s third runway. GAL published its final Master Plan in July 2019, following a consultation period.⁴⁶ In it, GAL proposed to begin construction on the NRP in 2025, subject to planning approval (in the form of a Development Consent Order – DCO). The project was expected to cost £2.2bn.
- 4.45 CAA began a review of the commitments framework in 2018. GAL proposed new commitments in 2020, for the period 2021/22 to 2024/25, and the CAA made a final decision to accept these in 2021.⁴⁷ In parallel, GAL continued to develop its NRP plans and submitted a DCO application in July 2023. At the same time, GAL made a proposal to the CAA to extend the commitments framework from 2025 to 2029, based on the assumptions set out earlier in this report. The CAA consulted on this in June 2023 and then again in August 2024. The first of these consultations received seven responses and the more recent one received ten. A decision has not yet been made by the CAA.

⁴³ See, for example, [Making best use of existing runways](#).

⁴⁴ See <http://www.caa.co.uk/cap1134>

⁴⁵ See <http://www.caa.co.uk/cap1973>

⁴⁶ [Gatwick Airport Masterplan 2019.pdf](#)

⁴⁷ [GAL's finalised, extended Commitments, \(2020\), Proposal to extend Gatwick's Commitments, \(2023\), Gatwick Airport Northern Runway Project: Funding Statement \(2023\)](#)

- 4.46 Both in its 2020 commitments proposal and its DCO application, GAL stated that it would bear all the planning, development and delivery costs associated with the NRP until 2024/25, with no impact on the proposed charges cap. It also stated in its DCO application that it was confident that it would be able to raise the funding required for the NRP through a blend of debt, equity and airport charges. GAL appears to have been relatively free to develop NRP as it sees fit, including the underlying funding approach. There has been some consultation with airport users but responses to CAA's consultations on the renewal of the commitments framework suggests that some airlines have concerns over the process, in particular in relation to the prioritisation between NRP and other capital expenditure.
- 4.47 The Planning Inspectorate concluded its examination in August 2024 and issued a recommendation to the Secretary of State for Transport, who is expected to make a decision in February 2025.⁴⁸ There will then an opportunity for interested parties to appeal the decision, which could result in a judicial review.
- 4.48 The case study serves to illustrate the following points:
- As with non-regulated airports, the absence of the need to develop and implement a RAB-based regulatory framework for capacity expansion removes a major source of potential delay. In the case of NRP, obtaining planning approval appears to have been the over-riding constraint dictating timescales. CAA's work to consider the renewal of the commitments framework has fit within this, adding no delay.
 - In the absence of RAB-based regulation, GAL retains a high degree of flexibility to respond to changes in supply and demand conditions, or to additional requirements that could arise from the DCO (for example, in relation to environmental mitigations). This means that such changes are unlikely to cause significant delays.
 - The absence of RAB-based regulation is compatible with a reasonable degree of transparency over expansion plans and their cost, enabling scrutiny by key stakeholders. CAA's role in approving the renewal of the commitments framework adds a further layer of protection for consumers' interests. However, airlines have expressed some concerns over the degree of transparency and engagement from GAL, which could be symptom of the greater degree of monopoly power that GAL has relatively to non-regulated airports.

Assessment

- 4.49 Similar to the non-regulated airports, GAL's NRP has proceeded to the planning application stage on a largely commercial basis, with little if any interaction with the economic regulatory framework. If the application is approved, then GAL will have strong incentives to proceed with the project in a timely manner, and to deliver additional capacity that is likely to generate significant benefits for passengers.
- 4.50 The regulatory framework also appears to have added little to no delay to the development and implementation of the project, and has allowed GAL to retain a relatively high level of flexibility.
- 4.51 GAL may potentially face additional long-term risk due to the project, particularly as there is no known agreement or understanding with airlines regarding the funding of the project, unlike Manchester Airport, and in the absence of the implicit guarantees provided by RAB-based regulation. On balance, however, this risk appears to be less significant for GAL than for the non-regulated airports described earlier. Among other things this reflects:
- the likelihood that GAL will continue to have substantial market power and, in principle, would therefore be able to increase its charges if necessary to cover some of the costs of the NRP..
 - although under the commitments framework there is no automatic link between GAL's investment and the future level of charges, it seems unlikely that CAA's future economic regulation would be applied in a way that would prevent GAL from eventually recovering the costs of the NRP, except in extreme circumstances, such as a significant proportion of the cost being deemed demonstrably wasteful or inefficient expenditure. Additionally, any risk is mitigated by GAL's ability to appeal to the Competition and Markets Authority against CAA's decisions.

Summary of potential advantages of a more commercially orientated approach

- 4.52 Adding investment to the RAB of a regulated firm is a well-established way of facilitating investment. When applied to airport expansion, it offers several potential advantages, including:

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- it is understood and trusted by investors. It also provides firms with a reasonable opportunity to recover their costs and a relatively high degree of risk protection in the longer term. This allows projects to proceed without the need for high rates of return even in the presence of significant sunk costs.
- it provides a framework for specific proposals and their expected costs to be scrutinised by the regulator and by other stakeholders, which may help to ensure that the project matches airlines' requirements and encourage efficient delivery; and
- it is part of a framework that protects consumers from the risk of charges being higher than necessary.

4.53 However, especially when applied to large and complex capacity expansion projects, there are some potential difficulties, including:

- The need for the scope and expected cost of different parts of the project to be confirmed at a relatively early stage could lead to delay and potential inefficiency. For example, the framework may require the developer to undertake more early work than it would normally choose to do so.
- regulatory scrutiny and stakeholder reviews can also lead to delays, especially in the light of a likely lack of suitable comparators and possible strategic responses by stakeholders.
- the above circumstances might also lead to increased costs, which could also arise due to regulatory gaming if the firm inflates its initial cost estimates.

4.54 In contrast, expansion proposals by airports subject to no or lighter touch economic regulation can make for a smoother process as the investment decision is likely to be taken primarily on a commercial basis, taking account of the likely incremental costs and revenues over the reasonable lifetime of the project, and without the rigidity and delays imposed by a lengthy and complex regulatory process. Airport operators are likely to be taking on significant long-term risk (possibly less in GAL's case, due to its substantial market power and ability to appeal CAA's decisions), which could lead them to wait until there is a higher expected return and perhaps also adopt an incremental approach to expansion. But this risk also leads to the possibility of relatively high returns on the upside.

4.55 Airport operators may have also more flexibility to decide how to take their proposals forward. Manchester Airport undertook several specific consultations with its airline customers over the details of the expansion program, including the implications for airport charges and the timing of any increase. There is no knowledge of any similar exercises carried out by GAL, though airlines (and others) were able to comment on GAL's draft masterplan and also participate in the consultations carried out in preparation for GAL's planning application.

4.56 It is important to bear in mind the much greater scale and complexity of HAL's third runway project, and the impact of external factors such as the Appeal Court decision and the Covid-19 pandemic. Nevertheless, progress in establishing and implementing the economic regulatory framework for HAL expansion appeared to be relatively slow and increasingly detailed, and the expected costs of the project appeared to be rising before the project was paused. In contrast, smaller expansion projects promoted by non-regulated airports are progressing, and GAL's own expansion project has reached the planning investigation stage.

4.57 It is worth noting that, under the Civil Aviation Act 2012, the CAA has the flexibility to adapt its approach to economic regulation in future. For example, if it decided to consider possible options for adjusting its regulation of GAL, it would not face a simple binary choice between the commitments framework or a detailed RAB-based approach, and could therefore also consider intermediate options that retained the key benefits of lighter-touch regulation while aiming to address any specific issues that were arising in practice.

5 Impact of a tighter price control on the northern runway project

- 5.1 GAL has stated to the Planning Inspectorate that it is confident that adequate funding will be available for it to start work on NRP. GAL has also already incurred substantial work to develop the project and submit a major planning application. This could suggest that there is a sound commercial case for NRP and that a modest tightening of GAL's price control is unlikely to fundamentally alter its commitment to the project.
- 5.2 On the other hand, NRP is a long-term project with a considerable capital outlay. A prudent and rational investor would be expected to consider the commercial case for the investment at the outset and to re-evaluate it as new information becomes available. And if this resulted in a sufficiently material deterioration to the commercial case, then such an investor could choose to delay or even abandon the project.
- 5.3 A key feature of the commercial case for the NRP is the revenue from aero charges, which is within CAA's purview. In its 2024 consultation, the CAA stated that:

"if GAL is either not able to continue with these [NRP] plans, or is not making good progress with capacity expansion, it is not clear that the level of prices and profits associated with GAL's proposal to extend its commitments would be in the interests of consumers (who would no longer receive the benefits that the new runway would offer). In this scenario, it would be appropriate to revisit the headline price reductions during the new commitment period to ensure the overall package proposed by GAL remains in the interest of consumers".

- 5.4 This chapter considers how a tighter price control would affect the commercial case for capacity expansion. This is done, first, by developing a high-level and illustrative discounted cash flow model used to calculate the project's Internal Rate of Return (IRR) under different scenarios. This is then followed by a qualitative discussion of other risks and considerations arising from a tighter price control that could have an impact on capacity expansion investment decisions.

Commercial case for expansion – illustrative analysis

- 5.5 To assess how a tighter price control could impact the commercial case for GAL proceeding with the NRP, a simple discounted cashflow model was built. The approach was to estimate and assess the internal rate of return (IRR)⁴⁹ for the NRP programme under different pricing assumptions to illustrate the potential impact of a tighter price control on the commercial case for GAL proceeding with the NRP.
- 5.6 The model calculated the internal rate of return (IRR) from the estimated incremental revenues and costs for the NRP over different time horizons. The incremental revenue and cost items considered consisted of:
- incremental aero charge revenue driven by the expected increase in passenger traffic from the NRP (see below for further discussion)
 - decremental aero charge revenue from baseline passengers, under reductions in charges.
 - variable commercial revenue from increased retail and parking charges from increased passenger traffic
 - variable opex from increased passenger traffic
 - estimated capital expenditure through to 2038 for the NRP.
- 5.7 The inputs and assumptions for the model were taken from various sources, as set out in Table 8 below. Assumptions were primarily taken from the CAA's model. This was supplemented by information from GAL

⁴⁹ That is, the interest rate which makes the net present value of all cash flows from the NRP investment equal zero.

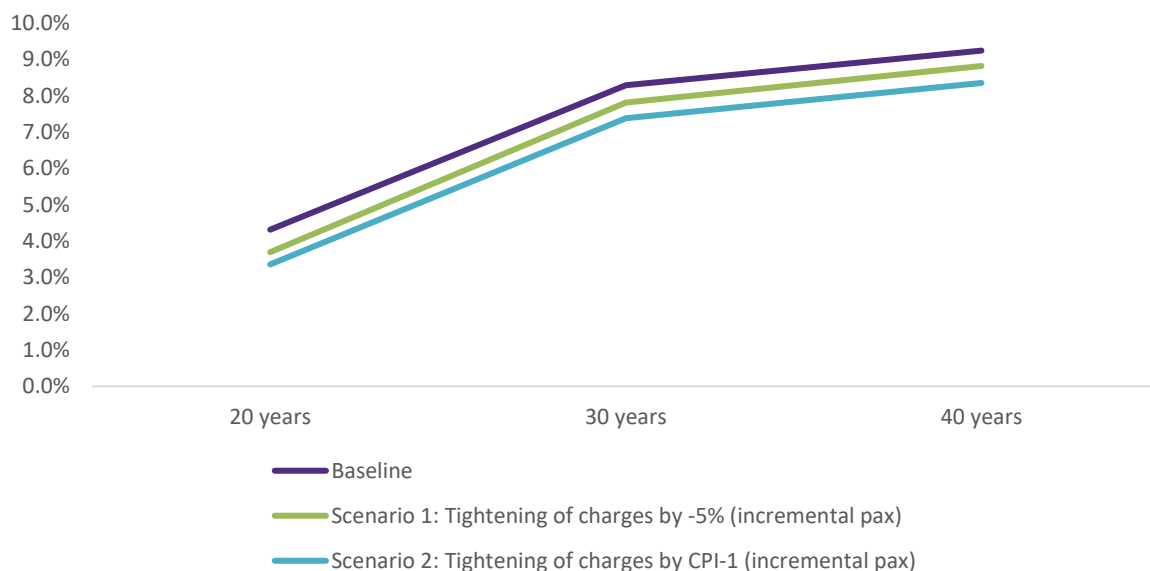
provided to Grant Thornton by CAA, including GAL's 2024 CIP and the unredacted version of its stakeholder response to the CAA consultation. Information was also drawn from GAL's publicly available 2023 DCO application.

Table 8. Inputs and assumptions for Internal Rate of Return model

Model input	Source
Passengers – with/without NRP	<p>Assumptions for scenarios with/without the NRP in 2029, 2032, 2038, 2047 were from the forecasts under the base and NRP scenarios contained in the DCO (2023) Environmental Statement, Appendix 4.3.1: Forecast Data Book (Table 9.2-1). Years in-between were extrapolated linearly. Data for 2023/24 was taken from the Draft Masterplan 2019.</p> <p>Differences in passenger traffic commences from 2029/30, when the NRP is expected to be operational. From 2047/48 onwards, traffic is projected forward as constant at the level forecasted by GAL in the DCO.</p>
Charges	<p>Gross yield per passenger, including security charges, taken from the CAA model for years 2023/24 to 2027/28, and adjusted to real 2023/24 prices to align with other model inputs. Held constant from 2029/30.</p> <p>Discount of 6.1% applied to gross yield in 2023/24 per the CAA model. [8%] applied to gross yield in 2024/25, per GAL's stakeholder response, and projected forward for the remaining periods.</p>
Variable operating expenditure per passenger	£3.50 per passenger for the variable component of opex, taken from the CAA model. Projected forward as constant.
Variable commercial revenue per passenger	£8.32 per passenger for the variable component of commercial revenue (retail and car park revenue), taken from the CAA model. Projected forward as constant.
NRP capital expenditure	NRP capital expenditure from 2025/26 to 2038/29 was taken from information provided by GAL to CAA in December 2024. This was adjusted to real 2023/24 prices to align with the other model inputs.

- 5.8 The model is used to compare the IRR under different aero charge profiles and investor assumptions. In the **baseline** scenario, charges are assumed to be set at the level proposed by GAL's commitments framework up to 2028/29, after which they remain constant in real terms. The NRP generates additional charges and commercial revenue from the incremental passengers enabled by the extra capacity that serves to offset the capital cost of the NRP and the opex associated with those additional passengers. Under this scenario, the IRR of the project becomes positive after approximately 17 years. Over a 20-year appraisal period, the IRR is 4.3%, rising to 8.3% over a 30-year horizon and 9.2% over a 40-year horizon.
- 5.9 This suggests that, whilst the project may be commercially attractive at the proposed level of charges in the commitments framework, this is only the case for an investor taking a relatively long-term view (of decades rather than years). It is also worth noting that current NRP capex estimates are based on preliminary work done in 2019 and could increase over time, not least as the result of conditions that could be imposed by the DCO. A given increase in capex would have a more than proportionate impact on the IRR, given that those costs are incurred earlier in the appraisal period and therefore carry a greater weight in a discounted cash-flow analysis.
- 5.10 The model was used to test a scenario where the charges profile is reduced by 5% across the whole appraisal period (**Scenario 1**). If only the impact on NRP-enabled incremental passengers is considered, this has a modest negative effect on the project's internal rate of return, reducing the 20-year IRR to 3.7%.
- 5.11 Under **Scenario 2**, charges are reduced each year beyond 2023/24 by CPI-1%. The impact is slightly greater but still modest, reducing the 20-year IRR to 3.4%. The IRR in the baseline, Scenario 1, and Scenario 2, are shown in Figure 7.

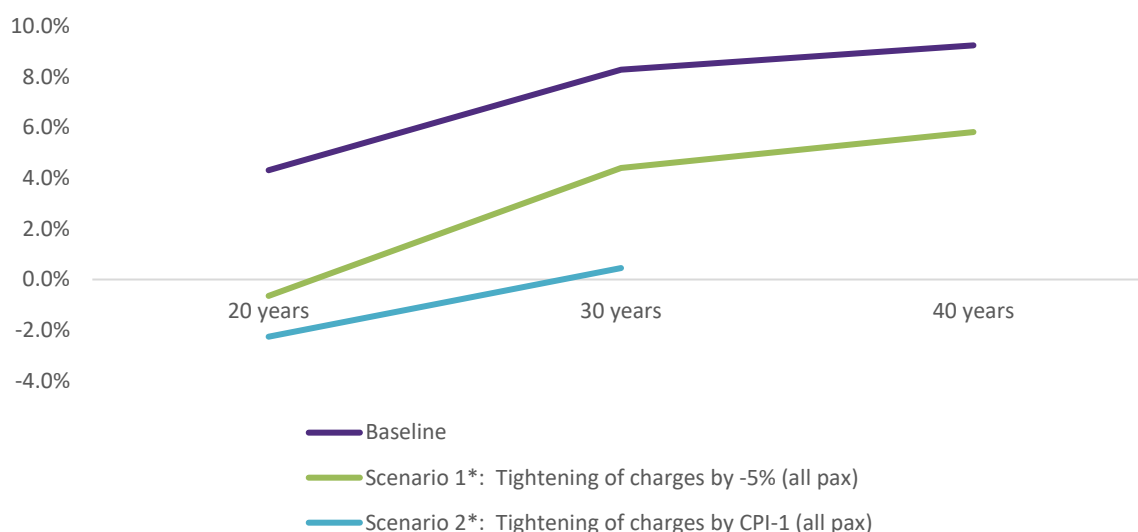
Figure 7: Impact of tightening aeronautical charges on 20-, 30-, and 40-year IRR by -5% and CPI-1 (incremental passengers only)



- 5.12 Scenarios 1 and 2 only consider the revenue impact on incremental passengers. The above approach (to only consider the change in revenues from incremental traffic of a tightening of charges) is the theoretically correct and most appropriate way for an investor to evaluate the NRP (since the impact on revenues from existing passengers of any change in charges would occur regardless of the NRP).
- 5.13 However, the wider context potentially matters, and it is plausible that investor may choose to view its stake in the airport as a whole. And, if it considered that a reduction in charges affected the attractiveness of its overall business, it could adopt different investment decisions. This is a highly complex set of considerations and it is difficult to know exactly whether and how an investor would proceed with expansion, for example, in a context where its wider business was not performing as well financially (for example as a result of lower charges). It is difficult to model these considerations simply, but to illustrate the point, **Scenario 1*** tests the impact of a 5% reduction in charges relative to the baseline scenario, taking into account the reduction in charges revenue from non-NRP enabled passengers. In this scenario, the 20-year IRR would fall considerably, from 4.3% in the baseline, to -0.6%; while the 30-year IRR would fall from 8.3% to 4.4%. Although the project may still make commercial sense to a far-sighted investor, they may consider there to be better opportunities available.
- 5.14 **Scenario 2*** tests the impact of a CPI-1% reduction in charges in each successive year beyond 2023/24, whilst taking account of the revenue impact on non-NRP enabled passengers. Under this scenario, the 20-year IRR is -2.3% and the 30-year IRR is only just positive at 0.5% (Figure 8). The 40-year IRR is not defined because the Net Present Value of the project becomes negative.⁵⁰

⁵⁰ The IRR is the discount rate at which the NPV of a project becomes zero. If the NPV of a project turns negative, it means that the project is not generating enough cash flows to cover the initial investment and earn a return. In this scenario, it is not possible to calculate a valid result because there is no discount rate at which the project's cash flows would have a positive NPV.

Figure 8: Impact of tightening aeronautical charges on 20-, 30-, and 40-year IRR by -5% and CPI-1 (for all passengers)



- 5.15 It is worth underlining that a reduction in revenue from non-NRP passengers would affect the return on investment for the entire airport estate. Investors may therefore choose to take a more nuanced view of the IRR for NRP than that presented in scenarios 1* and 2*, by attributing some of the revenue loss to NRP and some to other projects. If they were to do so, the IRR for NRP would look higher than under scenarios 1* and 2* – but still lower than under scenarios 1 and 2. Results for scenarios 1* and 2* would therefore be best seen as a lower bound.
- 5.16 Table 9 summarises the results from this analysis. It shows that if an investor were to take a 30-year view, a 5% reduction in aero charges would reduce the IRR of NRP from 8.3% to between 4.4% and 7.8%. Whilst the project would likely continue to provide a positive return (under existing cost estimates), it could risk making it considerably less financially attractive.

Table 9: Illustrative Internal Rate of Return (IRR) for the Northern Runway project under different appraisal horizons, aero charges scenarios and investor outlook

Scenario		20-year IRR	30-year IRR	40-year IRR
Baseline aero charges		4.3%	8.3%	9.2%
Baseline minus 5%	Upper bound (1)	3.7%	7.8%	8.8%
	Lower bound (1*)	-0.6%	4.4%	5.8%
Baseline and CPI-1% p.a. from 2029/30	Upper bound (2)	3.4%	7.4%	8.4%
	Lower bound (2*)	-2.3%	0.5%	

Wider considerations

- 5.17 As illustrated above, there appears to be a reasonable commercial case for NRP for a sufficiently far-sighted investor, based on the level of charges in GAL’s proposed commitments framework and current cost estimate. Meanwhile, a reduction in charges would weaken the commercial case and may lead a rational investor to question whether to proceed with the project.
- 5.18 There is also a risk that the tightening of charges could be viewed (rightly or wrongly) as providing new information about CAA’s likely approach to future regulatory decisions affecting GAL. This risk arises in part because of the lack of an established set of principles and processes similar to those that CAA can use when applying RAB-based regulation to HAL and NATS, and especially as GAL does not have a RAB so there is no longer an automatic link between past investment and future airport charges. However, this risk could be mitigated by CAA explaining the reason for tightening the current price cap and providing reassurance about GAL’s ability to cover its costs in the future.

- 5.19 At the same time, there would be other, more strategic factors, encouraging GAL to proceed with NRP, even if faced with the prospect of a lower commercial return. These would include, for example:
- GAL has already incurred sunk costs in bringing the project to this stage of development. Whilst these are negligible relative to the overall capital costs of the scheme, there may be a reluctance from airport management to abandon the scheme if there is a prospect that conditions could change in the near future, resulting in the need to incur these costs again.
 - There is a long history of sustained growth in aviation demand, which arguably creates revenue upside from investment in capacity expansion. However, this would likely have a modest impact on the commercial return for the project as it would only act to accelerate the projected growth in traffic (the capacity ceiling from NBP acting as the over-riding constraint).
 - There is also some evidence to suggest that the regulator would not penalise airports for decisions made in good faith or for the impact of factors beyond their control, for example in the context of the sudden drop in the demand due to the covid-19 pandemic and other previous one-off events. GAL and its investors may therefore reason that if the commercial return on NRP weakens, relative to expectations, the CAA would be willing to re-visit its regulatory approach.
 - There is a risk that the political and planning environment will be less favourable in future, for example because of climate change policies or if other airports expand their capacity in the meantime. This creates a strategic argument for GAL to proceed with the NRP sooner rather than later.
 - There may be a risk that a future expansion project would be subject to a different regulatory framework, perhaps encountering some of the hurdles that HAL's third runway project faced as described in earlier chapters. It may even be considered that failure to proceed with NRP in a timely manner could hasten a change a regulatory change. Proceeding now would allow GAL to benefit from the current lighter touch regulatory framework.
- 5.20 Given the analysis above, it cannot be said with confidence to what extent a tighter price control would reduce the likelihood of the NRP going ahead (in the event that planning consent is given). On the one hand, a sufficiently large reduction in charges could weaken the commercial case for the project to the point that it would no longer be attractive to investors. On the other hand, GAL could take the view that it is better for the project to proceed sooner rather than later and that there is sufficient upside in the project.
- 5.21 Should the CAA be minded to adopt a tighter price control, then it may wish to consider the evidence above in setting the level of charges and in designing and implementing its regulatory approach more generally so to preserve incentives towards capacity expansion.

A Scope of work

The scope of work for this report is reproduced below.

The adviser will:

- Review the key evidence and arguments proposed by stakeholders in response to our assessment of GAL's proposal.
- Critically evaluate all evidence submitted to the CAA that seeks to demonstrate that there are excess returns for GAL under its proposal to extend the commitments. We expect this to include:
 - a review of the price paths presented under different scenarios and evaluate whether the assumptions that underpin the analysis are reasonable.
 - where appropriate, propose more suitable scenarios and / or assumptions.
 - an assessment of the extent to which the prices (and profitability) proposed by those airlines who do not support GAL's proposal appropriately reflect (a) updated and realistic assumptions (b) the uncertainty and risks GAL faces, including around GAL's DCO application.
- Estimate the range of benefits of capacity expansion to users of Gatwick airport. We expect this assessment to:
 - be based on information that is already available on the benefits of capacity expansion, for example through evaluation of GAL's application and other sources of evidence such as the Airports Commission report;
 - include the benefits of greater competition between airlines that is likely to be facilitated by capacity expansion;
 - involve both a qualitative and quantitative assessment of benefits to passengers (and to the extent appropriate air freight/cargo).
- Evaluate the advantages, and highlight any disadvantages, of a commercially orientated approach to funding capacity expansion compared to a traditional rate of return based approach. We expect this assessment to:
 - include relevant case study examples including the arrangements that were put in place for HAL to recover costs associated with its third runway expansion project, as well as other examples of airport capacity expansion elsewhere in the UK.
- Assess to what extent tighter price control arrangements could impact on GAL's incentives to progress the northern runway project in a timely way.

B Sensitivity analysis

Table 10 presents the results of the sensitivity analysis undertaken on key assumptions in the CAA model (applied to the middle case). The assumptions used in each sensitivity scenario are detailed in Table 11 below.

Table 10: Results of sensitivity analysis

	Scenario	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29
Operating profit (% of fixed assets)	CAA middle case	14.1%	16.3%	16.4%	15.6%	14.6%	13.4%
Average charges discount							
Operating profit (% of fixed assets)	GAL's position	14.1%	15.7%	15.8%	15.1%	14.1%	12.9%
<i>Change relative to CAA middle case (pp)</i>			0.57	0.57	0.54	0.51	0.48
Passenger traffic							
Operating profit (% of fixed assets)	Less optimistic forecast	14.1%	15.4%	15.9%	15.2%	14.0%	12.4%
<i>Change relative to CAA middle case (pp)</i>			0.94	0.44	0.36	0.54	0.98
Operating expenditure							
Operating profit (% of fixed assets)	Opex A	13.6%	15.8%	15.9%	12.9%	12.1%	11.1%
<i>Change relative to CAA middle case (pp)</i>		-0.52	-0.51	-0.49	-2.67	-2.45	-2.25
Operating profit (% of fixed assets)	Opex B	13.6%	15.8%	15.9%	10.2%	9.62%	8.85%
<i>Change relative to CAA middle case (pp)</i>		-0.52	-0.51	-0.49	-5.41	-4.96	-4.55
Operating profit (% of fixed assets)	Opex C	13.6%	15.3%	15.4%	9.7%	9.13%	8.40%
<i>Change relative to CAA middle case (pp)</i>		-0.52	-1.06	-1.01	-5.91	-5.45	-4.99
Capital expenditure							
Operating profit (% of fixed assets)	10% uplift	14.1%	15.4%	15.9%	15.2%	14.0%	12.4%
<i>Change relative to CAA middle case (pp)</i>			-0.94	-0.44	-0.36	-0.54	-0.98
Operating profit (% of fixed assets)	20% uplift	14.1%	16.2%	16.0%	14.9%	13.5%	12.1%
<i>Change relative to CAA middle case (pp)</i>			-0.10	-0.40	-0.73	-1.05	-1.28
Combined sensitivities							
Operating profit (% of fixed assets)	Combined effects	13.6%	13.6%	14.3%	8.7%	8.0%	6.8%
<i>Change relative to CAA middle case (pp)</i>		-0.52	-2.73	-2.10	-6.87	-6.60	-6.62

Notes:

Opex A used CAA's high opex case values, adjusted to reflect the most recent outturn data in for 2023/24, with the uplifted baseline opex then carried forward.

Opex B is as Opex A, with an additional increase to opex from April 2026 to reflect a possible increase in business rates by an additional £[8<] million. This increase was calculated as [8<].

Opex C is as Opex B, with an additional increase in non-rates opex in line with CPI+2% per annum.

Combined sensitivities applies the [8<]% average charges discount, a less optimistic passenger traffic forecast, and an increased baseline opex (Opex C).

Table 11: Assumptions used in sensitivity analysis

Scenario	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	Source
Average charges discount (%)							
CAA middle case	6.1%	6.1%	6.1%	6.1%	6.1%	6.1%	CAA assumed an overall average discount of 6.1%, based on projections by GAL for 2023/24 in its November 2023 tariff consultation.
GAL position	[§<]%	[§<]%	[§<]%	[§<]%	[§<]%	[§<]%	GAL stakeholder response stated that [§<]% reflects new contracts negotiated with airlines.
Passenger traffic (m)							
CAA middle case	41.8	44.5	45.9	47.2	48.6	50.0	CAA extrapolation to 2028/29 of GAL forecast.
GAL position	41.8	42.8	45.0	46.5	47.4	47.6	GAL stakeholder response argued that traffic has not recovered as quickly. These values are draft from GAL commitments extension and its consultation response.
Operating expenditure (£m)							
CAA middle case	401.3	410.7	415.5	420.3	425.2	430.0	CAA based its middle case on an assumed Fixed/Variable relationship.
CAA high opex case	401.3	410.7	415.5	500.3	505.2	510.0	CAA added an uplift of £80m from 2026/27.
Opex A	418.2	427.6	432.4	517.2	522.1	526.9	CAA's high opex case values, adjusted to reflect the most recent outturn data in for 2023/24, with the uplifted baseline opex then carried forward.
Opex B	418.2	427.6	432.4	[§<]	[§<]	[§<]	As Opex A, with an additional increase to opex from April 2026 to reflect a possible increase in business rates by an additional £[§<] million. This increase was calculated as [§<].
Opex C	418.2	445.7	450.1	[§<]	[§<]	[§<]	As Opex B, with an additional increase in non-rates opex in line with CPI+2% per annum.
Capital expenditure (£m)							
CAA middle case	190.0	209.3	321.8	439.6	590.5	545.4	CAA based its middle case on GAL's forecast, including DCO.
10% uplift	190.0	230.2	353.9	483.6	649.6	600.0	Uplift of 10% applied to CAA middle case values.
20% uplift	190.0	251.1	386.1	527.5	708.7	654.5	Uplift of 20% applied to CAA middle case values.



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