Economic regulation of Heathrow Airport: H7 Final Decision – Summary

CAP2524A

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Summary

Introduction

1. This document sets out the CAA's Final Decision for the price control and associated regulatory framework that will apply to Heathrow Airport Limited ("HAL") for the five year period starting in January 2022 and ending in December 2026 ("H7").

2. This summary has four main parts:

   - this introduction;
   - a summary of the process we have followed and the Final Proposals we published in June 2022;
   - an explanation of our approach to this Final Decision and a summary of the key elements of the H7 regulatory framework for HAL; and
   - an overview of our statutory duties and the remaining steps of the process to finalise the regulatory arrangements for the H7 period.

3. Setting price controls for HAL is how the CAA fulfils one of its core functions under the Civil Aviation Act 2012 ("CAA12"). Our primary duty is to further the interest of users (collectively referred to as consumers) of air transport services regarding the range, availability, continuity, costs and quality of airport operation services ("AOS").

4. Heathrow airport retains its unique position for passengers and freight owners as the UK's only hub airport and the UK's largest airport in terms of both passenger numbers and the value of the cargo it handles. HAL has significant market power and, left unconstrained, it has the potential to damage the interests of consumers, for example through:

   - higher prices;
   - lower quality services and facilities; and
   - inefficiencies, such as in overrunning capital projects, both in costs and time, and higher than necessary opex.

5. To further the interests of consumers, we have sought to ensure that HAL's future charges will be "no higher than necessary" in the sense of representing appropriate value for money. We do so by basing our projections on efficient costs and creating incentives on HAL to invest in capital projects efficiently,

provide an appropriate quality of service and to seek out further efficiencies in the future.

6. Our approach is based around a “single till” which involves making projections of HAL’s total efficient costs and netting off projections of its revenues from commercial activities such as from car parking and retail outlets, other regulated charges and revenue from cargo flights. This allows us to estimate the revenue that HAL needs to collect from its airport charges and helps to ensure that airport charges are no higher than is necessary. The price control is then calculated by dividing this revenue by our forecast of passenger numbers to give an allowed level of price cap revenue per passenger (“maximum yield”) that HAL can collect from airport charges.

7. The H7 review has been particularly challenging for a number of reasons including:

   - capacity expansion issues dominated discussions in the period 2017-2019, before our decision in early 2020 to focus on the existing two runway configuration of the airport;
   - the impact of the covid-19 pandemic on passenger numbers at Heathrow airport as well as across the global aviation industry, which was particularly marked in the period from early 2020 to the middle of 2022;
   - the relatively low quality of certain aspects of the business plan information provided by HAL[1] and its opposition to the release of key information on issues such as its approach to passenger forecasting; and
   - the difficulties associated with forecasting volumes, costs, revenues and macroeconomic variables in a rapidly changing external environment.

8. Within this context, HAL and airline stakeholders have continued to put forward diametrically opposed positions on the key issues throughout the H7 process. These positions are consistent with their commercial interests, with HAL suggesting airport charges should increase significantly and airlines saying they should be significantly lower.

9. We have responded to these challenges with a consistent focus on the interests of consumers as required by CAA12, discharging this duty through developing an appropriate and evidence-based view of the various elements of the price control.

[1] In particular the lack of detailed information on a number of its capital expenditure programmes as discussed in our Initial and Final Proposals

Summary of our process

2017 - 2020

10. The process for setting the H7 price control began in 2017 and has been conducted in the light of our duties under CAA12 which are discussed further below. Initially, the focus was on how best to adapt the regulatory framework to support the expansion of Heathrow airport following the Government's decision to adopt the findings of the Airports Commission that Heathrow airport should be the location of new runway capacity in the South East of England. In order to enable stakeholders to focus on these issues, in November 2019 we put in place an interim price cap ("iH7") for the two years (2020 and 2021) following the end of the Q6 price control period (2014 to 2019), while work continued on the detail of capacity expansion.

11. HAL paused its plans for expansion in the light of the Court of Appeal's decision that the Airports National Policy Statement (which underpinned capacity expansion at Heathrow airport) had not been lawfully made and the onset of the covid-19 pandemic. Bearing this context in mind in April 2020 we said that the H7 review would focus on a two runway airport, with the intention of having a new price control in place from 1 January 2022.

12. In the first quarter of 2020, the global aviation industry started to be affected by the covid-19 pandemic. The pandemic had a marked impact on the number of passengers passing through Heathrow airport and had a very significant impact on its revenues, costs and profits.

13. HAL issued a revised business plan ("RBP") in December 2020. HAL's RBP base case implied a very significant increase in airport charges compared to the iH7 price control period due in part to lower passenger volumes in the H7 period. HAL's base case for H7 assumed an average charge of £30 per passenger (2018 prices) compared to an average of around £22 (nominal prices) for 2020.

2021 - present

14. In July 2020 HAL had made a request to the CAA for a significant upward adjustment to its regulatory asset base (RAB) from 2022 to help protect it from the impact of the covid-19 pandemic. We considered detailed representations on this matter through two rounds of consultation (in October 2020 and February 2021) before deciding in April 2021 that making a targeted adjustment of £300 million to HAL's RAB was a transparent and proportionate intervention that was needed at that time. We considered this adjustment would:

- support HAL in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic; and

- secure that the notional company could finance its activities and avoid higher costs of debt finance that could increase charges for passengers in the future.

15. HAL provided an updated business plan ("updated RBP") at the end of June 2021. The updated RBP noted that lower levels of passenger numbers expected over the H7 period meant that airport charges would need to rise beyond the level identified in the RBP. The updated RBP included two scenarios, one implying average charges over H7 of £32 per passenger, and the other implying charges of £43 per passenger (each in 2018 prices).

16. In this light, we developed our Initial Proposals for the H7 price control and issued them for consultation in October 2021. Given the very uncertain circumstances prevailing at that time, we based the Initial Proposals on a relatively wide range of airport charges for the period 2022 to 2026 (£24.60 to £34.40 per passenger in 2020 prices). We also put in place an interim holding cap for 2022 which was set at the mid-point of the range in the Initial Proposals (£29.50 per passenger in 2020 prices or £30.19 per passenger in nominal prices).

17. We followed consultation on the Initial Proposals with a subsidiary consultation on draft licence modifications to support the Initial Proposals and a working paper on Outcome Based Regulation ("OBR") in November 2021. Having considered the responses to all of these publications, we issued the Final Proposals for the H7 price control in June 2022.

Summary of the Final Proposals

18. The June 2022 Final Proposals set out the price control and other arrangements that we considered would protect consumers and discharge our other statutory duties, including:

    - new forward-looking incentives for capital expenditure efficiency, designed to promote efficiency in the longer-term and ensure prices are no higher than necessary;
    - consumer-focused proposals for the development of an approach to OBR and improved quality of service incentives for HAL;
    - an approach to testing HAL's financeability based on an efficiently financed notional company, designed both to allow HAL to finance new investment while also protecting consumers from any risks and costs that might be associated with higher levels of debt finance;
    - new investment of some £3.6 billion (in 2020 prices) including funding for improvements in security arrangements and baggage handling; and

- charges starting at the level envisaged by the holding cap in 2022 of £27.39 in 2020 prices (£29.50 in nominal terms) and then reducing in real terms in each year until reaching a level of £24.50 in (in 2020 prices) in 2026.

19. The Final Proposals were accompanied by a notice under section 22(2) of CAA12 setting out proposals to modify HAL's licence to put the new H7 price control arrangements into effect.

20. In response to the Final Proposals HAL took a similar approach to that in previous stages of the process, suggesting that the proposed charge was too low and raising a wide range of challenges on all key areas of the building blocks and the price control as a whole. Airlines also repeated many of the concerns they had raised at earlier stages of the process, suggesting that the proposed charge was too high and should be no more than around £18.50 on average across the H7 period. Airlines considered that the Final Proposals included a number of fundamental errors in relation to areas such as the passenger forecast, the cost of capital and the RAB adjustment.

Developments since Final Proposals

Passenger forecasts

21. The Final Proposals noted that, if strong evidence were to emerge during the period of consultation that indicated our Final Proposals forecast of passenger numbers was no longer appropriate for 2022 and beyond, and that retaining this forecast would create significant bias, then we would consider adopting a new passenger forecast and revising our proposals for the H7 price control on this basis.

22. We said that our approach to dealing with these matters would include the following steps:

- we would consider new information to determine whether we should adopt a revised passenger forecast;
- only if the information we receive strongly suggested that a significantly different passenger forecast is warranted would we consider changes to the Final Proposals;
- if we were to adopt a revised passenger forecast, we would make consequential changes in the levels of operating cost and commercial revenues used in our price control calculations; and
- we would also seek to ensure that the position on financeability and, in particular, the position on key credit metrics was consistent with the analysis supporting the Final Proposals.

23. We have seen a larger increase in passenger numbers at Heathrow over 2022 than we had anticipated in the Final Proposals. We are now clear that passenger numbers in 2022 were around 10 per cent higher than we assumed in Final Proposals, with consequential impacts for HAL's operating costs and commercial revenues. Ignoring these changes to the baseline (even after taking account of the impact of the new traffic risk sharing ("TRS") arrangements) would create significant distortions and bias to the first year of the price control period. This information also strongly suggests that a different passenger forecast is warranted over the remaining years of the price control period.

24. In updating our passenger forecast, we have made some important adaptations and changes to reflect the fact that we now have actual passenger data for 2022. Further details of our approach are set out further below and in chapter 1 (Passenger forecasts).

Other updates

25. The Final Proposals marked a key milestone in a lengthy and detailed consultation process through which we have given stakeholders extensive opportunities to make their views and concerns known to the CAA. Nonetheless, we have given careful consideration to the representations from HAL and airlines who have argued that (i) we should take significantly different approaches to the key assumptions that drive the level of the price control and (ii) change our proposals in relation to key aspects of the regulatory framework.

26. We do not consider that wide-ranging changes to our assumptions or approach would be appropriate and so have retained the broad approach set out in the Final Proposals. The reasoning for these decisions is set out in the following chapters of this document.

27. In December 2022, HAL provided a further update to its business plan (several months after the period of consultation on our Final Proposals has closed). This update implied an average charge over H7 of around £40 per passenger (2020 prices). We conducted a review of the information contained in this update and found no evidence that warranted a change in our approach or to the allowances used to calculate the price control allowances.

28. Nonetheless, there are a further two areas (in addition to the passenger forecast and the consequential changes to operating costs and commercial revenues) where we have decided it would be appropriate to make changes. These are to update for changes in the wider macro-economic environment and to correct for matters which we regard as computational errors and inconsistencies in the Final Proposals.

Macroeconomic developments

29. Developments in the wider economy since we published the Final Proposals gave rise to a high degree of volatility in forecasts of inflation and interest costs, particularly over the summer and into the autumn period. These matters are largely outside the control of HAL's management and, if we were not to take account of the latest information, it would undermine the robustness of our approach to testing HAL's financeability and risk us inadvertently setting the price cap at a level which would be detrimental to consumers (either in terms of the cap being too high leading to higher prices or too low possibly jeopardising financeability and investment).

30. Bearing the above in mind, we have decided that circumstances are sufficiently different to 'business as usual' conditions to support an update to the Final Proposals for the latest forecasts of inflation and interest rates.

31. Inflation is used in several distinct parts of the price control setting process including:

- our calculation of HAL's revenue requirement;
- the annual inflation indexation of HAL's price cap by the CPI; and
- indexation of the RAB by the RPI and the calculation of its cost of capital.

32. We have updated our assumptions to base our modelling on the Office for Budget Responsibility forecasts of CPI and RPI that were set out in its November 2022 economic and fiscal outlook.[2] Consistent with our wider approach to updating for inflation, we have also updated our input price inflation and real wage forecasts to take account of the latest inflation outlook. Our updated estimates of operating costs use the real rate of input price inflation for each relevant category of cost derived from the Office for Budget Responsibility's November 2022 forecasts of CPI inflation and other available forecasts as appropriate. This approach recognises that HAL's revenues will automatically increase in line with out-turn CPI inflation.

33. In addition, yields on UK government and corporate bonds have increased substantially since the Final Proposals cut-off date of March 2022. We have, therefore, updated our estimates of the risk-free rate and cost of debt to reflect these changes, as well as the corresponding changes in forecast inflation. We have also updated our estimate of the cost of new debt to reflect the availability of actual market data for 2022.

[2] See https://obr.uk/efo/economic-and-fiscal-outlook-november-2022/.

Computational errors and inconsistencies

34. From our assessment of the responses to the Final Proposals, we identified a small number of minor computational errors in relation to the calculation of certain categories of commercial revenues that we have corrected in this Final Decision. Further details are set out in chapters 5 (Commercial revenues) and 13 (Calculating the price cap and financeability).

35. We have also corrected an inconsistency between the reference index used to calculate the cost of new debt and our target credit rating in light of stakeholder feedback.

Overall impact of these changes

36. As noted above, our broad approach to setting the price control and establishing new regulatory arrangements for H7 remains unchanged from the Final Proposals. Taken together, the impact of the changes to the passenger forecast, the changes deriving from different inflation and interest rate assumptions and the correction of errors and inconsistencies change our proposals for airport charges by no more than about 5 per cent.

37. CAA12 requires that we consult further on the licence modification if we make significant changes to the modification published as part of our Final Proposals. In determining whether a further consultation would be appropriate we considered:

- our statutory duties and the interests of consumers in obtaining earlier certainty on the level of the price cap for the H7 period;
- the importance of basing the price cap on reasonably up-to-date information;
- the likelihood that further new information would continue to emerge that might lead to the CAA needing to consider further changes; and
- the requirements for consultation under CAA12 including the need to reconsult if our decision were to differ significantly from the notice in the Final Proposals.

38. Having considered these factors and the evidence available to us, we are of the view that the interests of consumers would be best served by proceeding directly to this Final Decision without a further round of consultation. This Final Decision confirms the broad approach to establishing the regulatory framework for H7 as set out in the Final Proposals. Taken in the round, we do not regard the changes that we have made since the Final Proposals are such that the modifications that we have decided to make to HAL’s licence to implement the H7 price control differ significantly from those set out with the Final Proposals.

Summary: key elements of the Final Decision

39. A detailed discussion of our approach to the calculation of each building block and element of the regulatory framework, including any updates we have made since the Final Proposals, is set out in the relevant chapters of this decision document. The following is a summary of our key decisions.

Passenger numbers

40. As discussed above, we have updated our forecast of passenger numbers to reflect the latest information including actual data from 2022. In December 2021, airlines had forecast that Heathrow airport would serve 72 million passengers in 2022 while HAL had forecast 45.5 million, which it updated to 52.8 million in April 2022. The forecast we used for the Final Proposals was 54.9 million compared to the actual figure of 61.6 million.

41. Our approach to passenger forecasting is designed to ensure that the price control is calibrated in an appropriate way and that we make reasonable allowances for operating costs, commercial revenues and capital expenditure. The forecast used in this Final Decision is shown in the table below, together with the forecasts provided by stakeholders.

Table 1: Passenger forecasts for H7

Passengers (million)	2022	2023	2024	2025	2026	H7
AOC/LACC Aug-22	65.0	80.4	82.0	83.6	85.0	**396.0**
HAL Dec-22 High	61.6	73.0	76.8	79.8	81.5	**372.7**
HAL Dec-22 Mid	60.7	66.6	69.8	73.4	75.6	**346.1**
HAL Dec-22 Low	59.2	57.7	61.7	66.5	69.2	**314.3**
CAA FD Mid	**61.6**	**73.0**	**78.9**	**80.7**	**81.3**	**375.5**

Source: CAA

Capital expenditure

42. Our capital expenditure (“capex”) allowances are set out in Table 2 below. The only changes since the Final Proposals are to update for the new inflation assumptions that we are using in this Final Decision as described above.

Table 2: Capex allowances for H7

2020 CPI prices £ million	2022	2023	2024	2025	2026	H7
Total	367	567	703	1,017	967	**3,620**

Source: CAA.

43. There are important investments that HAL intends to make in the coming years that should further improve not only the passenger experience, but also the safety, security and resilience of the airport. Our estimate of the investment HAL

will make includes next generation security scanners and a new baggage system in Terminal 2, which are collectively expected to cost about £1.3 billion and should bring considerable passenger benefits, including an improved security experience and more resilient infrastructure.

Operating Expenditure

44. Our final allowances for operating expenditure ("opex") are set out in Table 3 below. These are designed to allow HAL to provide an efficient, high quality of service at Heathrow airport. The changes from the Final Proposals relate to:

- updated forecasts of inflation;
- the forecast of higher passenger numbers during H7 has led to a £74 million increase in the allowance; and
- we have updated our forecasts of real wage inflation which has reduced the level of the allowance by £60 million and for real energy costs which has increased our forecast by £76 million.

45. On this basis, the total opex allowance used to calculate the H7 price control is £5,895 million, as set out in the table below.

Table 3: operating expenditure allowances for H7

2020 CPI prices, £ million	2022	2023	2024	2025	2026	H7
Total	1,145	1,148	1,188	1,213	1,201	**5,895**

Source: CAA.

46. Since the Final Proposals, we have increased our estimate of HAL's operating expenditure by £95m to £5.9 billion (2020 CPI prices) over the five years. This takes account of higher forecast passenger numbers and should support the ongoing recruitment of new staff and allow HAL to provide a good quality service as passenger numbers continue to recover into the summer season.

47. We will carry out a further review of the opex allowance for two specific cost categories (pension deficit repair costs and business rates) in the second half of 2023 as we did not have sufficient information to complete our analysis with a view to making any final adjustments for this Final Decision. Should any adjustments to HAL's price control be required to reflect the outcome of this work, we would bring forward proposals for a licence modification to put the required changes into effect in a timely manner.

Commercial and cargo revenues

48. Our final allowances for commercial and cargo revenues are set out in Table 4 below. The changes from the Final Proposals relate to:

- the forecast of higher passenger numbers during H7, which has led to an increase of £124 million in our forecasts of revenues;
- we have corrected for errors in our calculations of surface access revenues, which has decreased our forecast by £38 million; and
- we have updated our inflation assumptions, which has reduced our forecast by £24 million.

49. As a result, our total allowance for HAL's commercial revenues and cargo is £4,379 million over the H7 period. This is £62 million higher than the allowance that we included in the Final Proposals.

Table 4: commercial revenue allowances for H7

2020 CPI prices, £ million	2022	2023	2024	2025	2026	H7
Total excluding cargo	735	816	889	917	930	**4,287**
Cargo	35	20	14	12	11	**92**
Total including cargo	770	837	903	928	941	**4,379**

Source: CAA.

50. As noted in chapter 5 (Commercial revenues) we intend to conduct a review of our allowance for revenue from the terminal drop-off charge in late 2024 and also consider whether there should be any changes for the revenues associated with pod parking.

The cost of capital

51. Table 5 below sets out the weighted average cost of capital (WACC) estimate that we have used in this Final Decision compared to the Final Proposals. The vanilla WACC excludes any allowance for corporation tax costs, which are dealt with separately.

Table 5: Weighted Average Cost of Capital

	Final Decision		Final Proposals	
	Hi	Lo	Hi	Lo
Post-tax cost of equity	8.32%	5.59%	9.56%	5.45%
Cost of debt	0.67%	0.67%	0.43%	0.43%
Vanilla WACC	3.73%	2.64%	4.08%	2.44%
Point estimate	3.18%		3.26%	

Source: CAA

52. These figures reflect updated forecasts of the risk-free rate, the cost of debt (including the correction of an inconsistency between the reference index used to

calculate the cost of new debt and our target credit rating) and inflation. There is no change to our estimates of HAL's beta or the total market return.

53. The net impact of these is a reduction in the WACC of 8 basis points from 3.26% to 3.18%.

RAB adjustment

54. We have retained the position on the RAB adjustment as set out in the Final Proposals and so have preserved the £300 million adjustment set out in the April 2021 RAB Adjustment Decision and the Final Proposals.

Allowance for asymmetric risk

55. Our estimate of the asymmetric risk allowance has been updated since the Final Proposals to take account of our revised passenger forecast and the consequential changes to operating costs and commercial revenues. The resulting allowance is not significantly different from that made in the Final Proposals and is set out in the table below.

Table 6: asymmetric risk allowance for H7

2020 CPI prices £ million	2022	2023	2024	2025	2026
Asymmetric risk allowance	0	8	19	25	25

Source: CAA analysis

Traffic Risk Sharing

56. We have decided to implement the TRS mechanism as described in the Final Proposals. This should:

- reduce the risk of significant gains or losses for HAL that could arise from changes in passenger numbers over which it has only limited control. This will allow us to continue to set a five-year price control, which will provide greater certainty for stakeholders and stronger efficiency incentives for HAL and, in the longer term, should lead to lower charges and better service quality for consumers; and
- by confirming the risks that HAL is expected to bear during H7 and by reducing HAL's exposure to the current uncertain environment, it should help avoid unnecessary upward pressure on HAL's cost of capital. This will lead to lower charges for consumers than they otherwise would be and will support HAL's financeability.

Outcome Based Regulation

57. The OBR framework will remain broadly as set out in the Final Proposals. This includes a suite of measures, targets and incentives underpinned by six outcomes that are intended to capture the main aspects of airport operation

services that are important to consumers. The only changes from the Final Proposals are to remove one covid-19 related measure that both HAL and airlines agreed is no longer relevant, and to introduce a small number of minor clarifications to the way that particular measures are calculated.

58. There will be 20 measures that will be subject to financial incentives. Many of these are carried over from the existing Service Quality Rebates and Bonuses scheme, although four of them (helpfulness/attitude of security staff, wi-fi performance, availability of check-in infrastructure, and hygiene safety testing) are new and cover areas that directly address the passenger experience. There will also be new reputational incentives that cover aspects of service quality (such as baggage misconnections and punctuality) that are important to consumers but are jointly provided by HAL and other parties (such as airlines and ground handlers) and were excluded from our previous regulation of service quality at Heathrow.

59. We have also confirmed our intention to carry out a mid-term review of the Outcome Based Regulation framework in 2024 with a strictly defined scope as set out in chapter 3 (Outcome based regulation).

Capex incentives

60. We continue to be of the view that implementing the forward-looking incentive framework set out in the Final Proposals is in the interest of consumers. Key elements of this framework include:

- an incentive rate of +/-25% will be applied to any under/overspend against a project's budget agreed as part of the capex governance process;
- each project will be required to have agreed delivery obligations ("DOs") relating to the project's expected output(s), quality requirements and timing;
- if DOs are not met, there will be a proportionate adjustment to HAL's revenues to protect consumers from consequences of non-delivery; and
- there will be a cap on the overall level of capex, but with the flexibility to make adjustments where appropriate.

61. Alongside this Final Decision, we are also issuing a consultation on our proposals for enhancing the current governance arrangements around capex incentives. It will be important that both HAL and airlines respond positively to this guidance and improve the quality of engagement that takes place on capex projects. This should also support the effective implementation of our H7 proposals.

Other Regulated Charges

62. Other Regulated Charges ("ORCs") are charges for specified services and facilities that are collected separately from the regulated airport charges (which are subject to the price control). These services and facilities currently include the provision of baggage systems, check-in desks, heating, water and electricity utility services, and common IT services.

63. We remain of the view that there are advantages to consumers in the greater transparency and simplicity of an approach to ORC charging framework that reflects marginal costs but also adheres to key ORC charging principles of transparency, user pays and cost pass through so that the costs are allocated appropriately to users. We have also decided to implement measures to strengthen the associated ORC governance arrangements including underpinning the ORC protocols in HAL's licence, a one-off independent review of ORC costs, and a new dispute resolution function.

The level of charges

64. Based on the assumptions discussed above we have updated our calculation of the revenue requirement and yield per passenger is as shown in Table 7 below:

Table 7: Final Decision revenue requirement and unprofiled yield per pax

£ million 2020, CPI real	2022	2023	2024	2025	2026	Total
Operating costs	1,166	1,168	1,207	1,233	1,221	5,995
Regulatory depreciation	841	879	918	970	1,022	4,629
Allowance for asymmetric risk	-	8	19	25	25	78
Allowed return (incl. tax)	616	620	653	659	658	3,208
Gross revenue requirement	2,623	2,675	2,798	2,888	2,926	13,909
Commercial revenues (incl. ORCs)	(906)	(982)	(1,061)	(1,098)	(1,111)	(5,159)
Cargo revenues	(35)	(20)	(14)	(12)	(11)	(92)
Net revenue requirement	1,682	1,672	1,723	1,778	1,803	8,658
Passengers (million)	61.6	73.0	78.9	80.7	81.3	375.5
Unprofiled yield per pax (£)	27.31	22.90	21.84	22.04	22.18	23.06

Source: CAA

65. We are not changing the 2023 price cap as part of this Final Decision as HAL has already set its airport charges for 2023 and within year changes in airport

charges may not necessarily be passed on to passengers. As a result, it is not clear that making an adjustment midway through the charging year would be in the interests of consumers. The difference between the interim holding cap and the underlying revenue requirement for 2022 and 2023 has been adjusted in an NPV-neutral way through our calculation of the price cap for H7 as a whole.

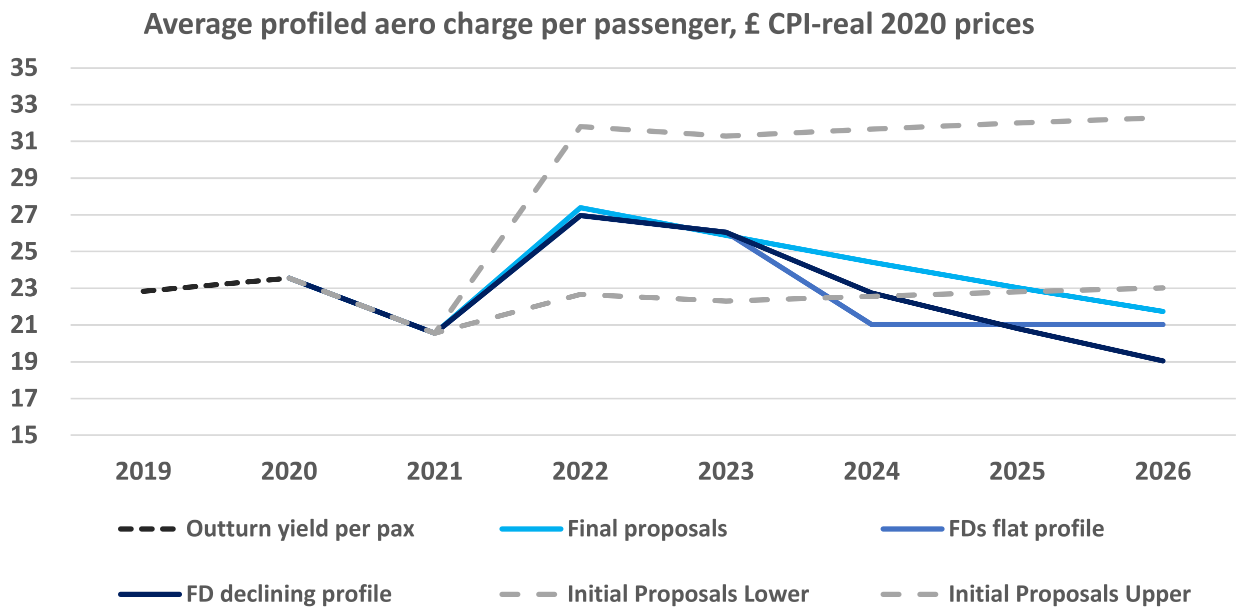
The profile of charges

66. The Final Proposals set out a declining price cap in real terms over the period of the H7 price control. As part of our financeability assessment for this Final Decision we looked at two possible profiles:

- a declining profile, as used in the Final Proposals; and
- a flat profile for the period 2024-26.

67. These profiles are shown in Figure 1 below.

Figure 1: Declining and flat price cap profiles



Source: CAA

68. From our assessment of financeability, we have concluded that a flat profile of charges from 2024 to 2026 would better promote consumers' interests and financeability. This Final Decision, is based on a flat price cap profile for 2024-

26, combined with the 2022 and 2023 previously specified holding caps.[3] Table 8 summarises the resulting price cap.

Table 8: Price cap for the H7 price control in 2020 real and nominal prices

£/pax	2022	2023	2024	2025	2026
Allowed aeronautical charges (CPI 2020)	26.96	26.06	21.03	21.03	21.03
Allowed aeronautical charges (Nominal)	30.19	31.32[4]	25.43	25.24	25.28

Source: CAA

The lower level of real charges from 2024 should benefit consumers and as discussed above, this price cap profile of charges also supports financeability as discussed further below.

Financeability

69. As with the Final Proposals, we have assessed the credit metrics of the notional company against the threshold required for a BBB+ investment grade credit rating which we consider would allow it to access a sufficient volume of debt finance at a reasonable cost. We note that the price path set out in Table 8 above would allow the notional company to maintain credit metrics consistent with a BBB+ investment grade credit rating. We also note that the average FFO to net debt ratio in 2022-24 is 8.2% which remains above the 7.0% level that Standard & Poor's ("S&P") has referred to as a key threshold in respect of HAL's class A debt. On this basis, we consider that the notional company should be capable of obtaining and maintaining a BBB+ rating.

70. We have also looked at financeability from an equity perspective. This is consistent with the approach we adopted in the Final Proposals including calculating the dividends payable by the notional company and the associated IRR. The total dividends assumed for the notional company amount to £1.5 billion over the five years of H7 (in CPI-real 2020 prices). This is equivalent to an average nominal dividend yield of 4.1%, which we consider represents a healthy cash return to shareholders. For reference, the average yield of FTSE100 companies over the period 2015-2021 was 3.88%.

[3] See CAP2305 for our decision on the holding cap for 2022 and CAP2515 for our decision on the holding cap for 2023.

[4] HAL's price cap for 2023 was set in January 2023 by means of a holding cap. The maximum revenue per passenger specified in the holding cap decision is £31.57 rather than the £31.32 shown above. The figure of £31.32 reflects the underlying revenue requirement for 2023 excluding the impact of capital triggers and the payment of the 2021 service quality bonus.

71. The nominal Internal Rate of Return ("IRR") of cash flows to investors in the notional company over the H7 period is 11.9% which demonstrates that, taking account of capital growth, overall returns available to shareholders in the notional company are consistent with the allowed cost of equity.

72. The above evidence indicates that this Final Decision is financeable for shareholders in the notional company. We note that the dividends that the notional company is projected to generate provide a buffer for debt financeability in a downside scenario, as well as supporting equity financeability in the base case. The introduction of the TRS Mechanism discussed below also supports financeability. If passenger volumes were to be materially below our forecasts then shareholders stand to benefit from an increase in the RAB.

73. Overall, we conclude that this Final Decision for the H7 price control is financeable.

74. As we have noted above our assessment of financeability has been carried out on the basis of a notional company with a level of gearing of 60%. In 2022, the gearing of Heathrow Funding Limited was higher than this and it is for HAL's management and shareholders to manage the consequences for HAL's financing of higher levels of gearing. We note that during the pandemic, HAL's ultimate owners have not supported the group with additional equity finance, in contrast to the shareholders of many aviation businesses.

75. Key to our assessment of the notional company's business risk is the introduction of new risk sharing arrangements such as the TRS mechanism and the robust approach we have taken to estimating its cost of capital. We note that our approach to the cost of capital reflects an equity beta of above one (so we are assuming HAL's shareholders will be remunerated for systematic risk exposure that is higher than for the market as a whole) and the decision we have made to index HAL's RAB by the RPI rather than CPI. It is important to take the treatment of inflation properly into account in comparing our estimate of HAL's cost of capital with the estimates made by Ofgem and Ofwat for utility companies, where the cost of capital is estimated using the CPI. Overall, we are confident that our approach to the assessment of HAL's cost of capital is robust and it reflects the higher levels of risk associated with investments in airports compared to water and energy network companies.

76. Taken together our approach to the TRS and the cost of capital should support the financeability of the notional company and its access to BBB+ financing. Nonetheless, it is for credit rating agencies to determine the credit rating of the actual company and it is for HAL's shareholders to provide any support that might be appropriate to allow the actual company to continue to access debt finance on reasonable terms.

Our duties as economic regulator of HAL

77. Setting price controls for HAL is one of our core functions under CAA12. In doing so, our primary duty in carrying out our functions under CAA12 is to:

> *"further the interests of [present and future] users[5] of air transport services regarding the range, availability, continuity, cost and quality of airport operation services"* [6]

78. In discharging its duty under section 1(1), the CAA has "secondary duties" to "have regard to" (that is, consider) the following:[7]

- The need to secure that HAL is able to finance its provision of AOS at Heathrow airport (which we refer to as "financeability"): in considering HAL's ability to finance its licensed activities, we have been clear throughout the H7 process that the correct approach is to focus on a "notional company" and that the responsibility for the actual financing choices made is for HAL's management and shareholders. This approach reflects that taken by other regulators, as well as the Explanatory notes published alongside CAA12 when it came into force.[8] We have sought to ensure that the approach taken allows for HAL to be financed on a reasonably prudent basis, but this does not involve the CAA regulating on the basis of HAL's actual financing structure as this would transfer the risk of the financing choices HAL makes to consumers. We have considered the impact of our proposals on the likely credit rating of the notional company as part of ensuring our proposals are financeable.
- The need to secure that all reasonable demands for AOS are met: we have considered issues such as how best to support the recovery in passenger numbers and services at Heathrow airport. This has included making estimates of capital and operating costs that are consistent with an appropriate approach to developing, maintaining and operating the airport and that charges are no higher than necessary to support that investment.

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[5] Users are defined in section 69 CAA12 as passengers and those with "a right in property" carried by air transport services and are referred to collectively by the CAA as "consumers".

[6] See section 1(1), CAA12. Section 1(2) CAA12 makes clear that the CAA must, "where appropriate", carry out its functions in a manner which it considers will promote competition in the provision of airport operation services. The CAA considers that, while important, this duty is less relevant to its work in setting price controls.

[7] See section 1(3) CAA12.

[8] See: https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

- The need to promote economy and efficiency on the part of HAL: this has been of particular relevance in considering our approach to setting allowances for efficient levels of opex, capex and commercial revenues and to our proposals to develop new forward looking incentives for capital expenditure.
- The need to secure that HAL is able to take reasonable measures to address the environmental effects of the airport: our approach to capex should secure the licensee's ability to mitigate environmental effects by promoting targeted, efficient and effective investment. This should enable HAL to take appropriate steps in moving its operations towards "net zero".
- The "Better Regulation Principles":[9] our actions are transparent and accountable through our consultation processes (including the informal engagement with HAL and airlines) and the appeal rights to which our decisions are subject. We consider a range of potential options/approaches to ensure our approach is proportionate to furthering consumers' interests.

79. If there is a conflict between:

- the different interests of consumers, such as between cost and quality; or
- between the interests of present and future consumers

section 1(5) CAA12 provides that we must further such of those interests as the CAA thinks best. This requires the CAA to consider in the course of our decisions the necessary trade-offs (such as those between lower prices and higher quality services and between consumers' short-term interests and their long-term interests) that can arise in setting the price control and requires that we use our discretion to address these trade-offs.

80. Although airlines have the right to appeal this Final Decision,[10] we do not have a duty to consider their interests under CAA12. So, it would not be appropriate for us to consider the interests of the airlines' businesses as a standalone factor. However, airlines' views, and the evidence that they have provided in the lengthy consultation process supporting the development of this Final Decision, are important in helping us to determine how to take decisions in the interests of consumers and there are areas, such as in relation to the operation of the airport, where they may have very significant insight into the operational impact of our proposals.

[9] These are the principles set out in section 1(4) CAA12.

[10] This is the final decision to modify HAL's licence set out in a notice under section 22(6) CAA12.

Next steps and Implementation

Next steps

81. We are issuing a Notice of licence modifications under section 22(6) of CAA12 as set out in Appendix C and providing explanatory text which summarises our reasoning and rationale for the licence modifications we are making to implement this Final Decision on the H7 price control.

82. HAL, as the licence holder, and any provider of air transport services whose interests are materially affected by the final decision (typically airlines operating from Heathrow), may apply to the CMA within six weeks of the publication of this Final Decision for permission to appeal our decision to modify HAL's licence under section 25 of CAA12.

83. An appeal may be brought on the grounds that (i) the decision was based on an error of fact, (ii) the decision was wrong in law, or (iii) an error was made in the exercise of a discretion (see section 26, CAA12).

Structure of our Final Decision document

84. Section 1 sets out details of the passenger forecast, overall framework and proposals for outcomes based regulation:

- Chapter 1 - Passenger forecasts;
- Chapter 2 - Regulatory framework; and
- Chapter 3 - Outcome based regulation.

85. Section 2 sets out details of our final decisions for the main cost and revenue building blocks:

- Chapter 4 - Operating expenditure;
- Chapter 5 - Commercial revenues;
- Chapter 6 - Assessment of capital expenditure;
- Chapter 7 - Capex incentives; and
- Chapter 8 - Other regulated charges.

86. Section 3 sets out details of our final decisions for financial building blocks, key price cap issues and implementation:

- Chapter 9 - Weighted average cost of capital;
- Chapter 10 - The H7 Regulatory Asset Base and HAL's request for a RAB adjustment;
- Chapter 11 - Allowance for asymmetric risk;
- Chapter 12 - Financial framework;

- Chapter 13 - Calculating the price cap and financeability; and
- Chapter 14 - Implementing through the Licence.

87. Of the appendices:

- Appendix A sets out a summary of our duties and Appendix B provides a glossary of terms used in these Final Proposals;
- Appendix C sets out details of the modifications we are making to HAL's licence to implement this Final Decision; and
- Appendices D to H provide further information on the main issues set out in this Final Decision.

88. We are also publishing alongside this Final Decision consultations on the governance arrangements for capex incentives and Other Regulated Charges.

89. We are also publishing our final Price Control Model and Cost of New Debt Indexation Model along with Skylark Consulting Group's consultancy report on our Approach to H7 Traffic Forecasting (CAP2524I).