

# Economic regulation of Heathrow Airport Limited: H7 Final Decision

## Appendices D – H

CAP2524E3



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## APPENDIX D

# Q6 Capex Review

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## Introduction

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- D1 For the reasons explained in chapter 6 (Assessment of Capital Expenditure (Capex)), the capex that HAL incurs helps support the range, availability, continuity, cost and quality of the airport operation services that HAL provides, and supports the safe, secure and reasonably resilient operation of the airport.
- D2 Efficient capex is added to HAL's RAB so that the costs of it can be recovered by HAL from consumers through the allowances we set for regulatory depreciation and the return on the RAB. So, capex plays an important role in determining the overall level of airport charges in the longer term.
- D3 The current regulatory framework for capex includes an after the fact ("*ex post*") review of the capex incurred by HAL during the Q6 period, under which expenditure is subject to an efficiency assessment at the end of the price control period. Any capex that is determined to be inefficient through this assessment may be "disallowed" from HAL's RAB and, therefore, excluded from the calculation of airport charges for the H7 price control, so furthering the interests of consumers.
- D4 This Appendix sets out our final decision for the outcome of *our ex post* review of HAL's capex during Q6, including:
- a summary of the Final Proposals;
  - a summary of stakeholders' views and our responses to those views; and
  - our final decision on these matters.

## The Final Proposals

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- D5 The Final Proposals were:
- to reduce HAL's opening RAB by £12.7 million to reflect inefficiencies identified in relation to spending on the Cargo Tunnel project;
  - to reserve the option of conducting a further review of efficiency of the Main and Cargo Tunnel projects once those projects are complete (or at the end of the H7 price control period if this is earlier);
  - not to make any further adjustments in relation to the remaining eight capital projects we have reviewed;
  - to require HAL to update its capex governance documents; and

- to retain the option of reviewing capital projects that were ongoing during iH7 at the end of H7 if there is evidence that these had been delivered inefficiently. This may be the case if, for example, the IFS (or other stakeholders) identify potential inefficiencies in projects within this period, and present evidence of such inefficiencies.

## Summary of stakeholders' views

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- D6 HAL repeated its concern that there should not be an adjustment of £12.7 million, claiming that the CAA has not presented clear evidence that HAL's actions directly attributed to wasted spending or lost benefits. HAL said that any iH7 projects that may require review should be reviewed in a timely manner.
- D7 BA asked if we had reviewed the project documentation submitted through the capital governance process and sought clarification on whether those projects that had occurred in the Q6+1 extension period were covered by our review. It was concerned that we could potentially be at risk of error by failing to consider capex efficiency in the Q6+1 extension period in particular (in addition to potentially reviewing capital projects that were ongoing during iH7 at the end of H7).

## The CAA's Final Decision

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- D8 As set out previously including in the Initial Proposals and the Final Proposals, we have clearly explained why we are of the view that £12.7 million is an appropriate adjustment to make to address HAL's inefficiency in relation to the Cargo Tunnel project. In particular, we commissioned our expert advisors Arcadis to carry out a review of these costs<sup>1</sup>, as part of which all relevant capital governance documents were reviewed.
- D9 We have also continued to monitor progress on these projects through capital governance groups and still have the option to review the tunnels projects at a later date, if appropriate. We also confirm that we may review capital projects that were ongoing during iH7 at the end of H7 (including any relevant projects that commenced in Q6+1) if there is evidence that these have been delivered inefficiently.
- D10 In our Initial Proposals and Final Proposals we said that HAL had not provided any compelling new information in relation to our efficiency assessment of the Cargo tunnel. Having reviewed HAL's response to our consultation on Final Proposals we can confirm that this remains the position and HAL has again failed to provide any compelling new information. We therefore confirm the position we set out in the Final Proposals and have decided to reduce HAL's

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<sup>1</sup> For further details, see Economic regulation of Heathrow: working paper on the efficiency of HAL's capital expenditure during Q6, September 2020, CAP1964: [www.caa.co.uk/CAP1964](http://www.caa.co.uk/CAP1964)

opening RAB by £12.7 million to reflect inefficiencies identified for the Cargo Tunnel project.

- D11 As noted in Final Proposals we have decided not to make any further adjustments in relation to the remaining eight capital projects we have reviewed. We confirm that we will consider further reviews only if stakeholders present us with compelling evidence of further inefficiencies in these projects. Any such reviews will be undertaken before the end of the H7 period.
- D12 As set out in chapter 7 (Capex incentives), we expect HAL to update its capital governance documents to take account of, among other things, key issues raised by our review of these Q6 projects.



## APPENDIX E

# Early Expansion Costs

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## Introduction

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- E1 Early expansion costs relate to expenditure incurred by HAL on developing its plans for additional capacity at Heathrow airport by the construction of a third runway and associated terminal and other buildings. These costs were incurred mainly between 2017 and early 2020, prior to HAL's decision to pause its plans for expansion in light of the Court of Appeal's decision to set aside the Airports National Policy Statement ("NPS"). While the Court of Appeal's decision was subsequently overturned by the Supreme Court, expansion was quickly overtaken by the onset of the covid-19 pandemic and remains paused.
- E2 We have previously confirmed that HAL's efficiently incurred early expansion costs should be added to its RAB and recovered during the H7 price control period and beyond.<sup>2</sup> In making these commitments, we took the view that developing expansion was in the interest of consumers at the time the expenditure was incurred.

## The Final Proposals

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- E3 In undertaking our assessment of early expansion costs for Final Proposals, we built on the work we did for Initial Proposals, which had involved the careful review of information that HAL submitted, the raising of questions with HAL and detailed question and answer sessions with a range of relevant HAL subject matter experts, to help us form a view on the strength of the evidence submitted. Our assessment covered a number of categories of cost including:
- Category B and C costs incurred before March 2020 (these form the vast majority of the total cost);
  - wind down costs;
  - appeal costs; and
  - the Interim Property Hardship Scheme.
- E4 Further details of our approach to assessing each of these cost items are set out in Appendix E of the Final Proposals.

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<sup>2</sup> Economic regulation of Heathrow Airport Limited: working paper on Q6 capital expenditure and early expansion costs CAP1996 2.4(a) and 2.26

E5 In light of this assessment, the costs that we included in the Final Proposals to be added to the RAB exclusive of financing costs in both nominal and 2020 prices are shown in table E.1 below. In total, the Final Proposals included a reduction to the RAB of £7 million which is 1.4% of total early expansion costs to reflect our efficiency assessment. This reduction comprised:

- a reduction of £4 million for Category C costs incurred in 2019 and 2020, that we assessed during our work for the Initial Proposals and Final Proposals; and
- a reduction of £3 million for Category B costs incurred in 2017, based on our earlier assessment of those costs.

**Table E.1: Final Proposals RAB additions for Early Costs (excluding financing costs)**

£million Nominal prices and 2020 prices	2017	2018	2019	Jan-Feb 2020	Wind down costs (includes IPHS and appeal costs)		Total
					2020 (March onwards)	2021	
Category B	65	108	157	11	14	1	356
Category C	6	11	68	20	17	4	126
<b>Total (nominal)</b>	71	119	225	31	31	5	483
<b>Total (2020 prices)</b>	75	122	227	31	31	5	491

Source: CAA

## Summary of stakeholders' responses

E6 In response to the Final Proposals, HAL put forward similar arguments that it had in response to the Initial Proposals including:

- that it disagreed with the CAA's assessment of inefficiency on costs incurred before March 2020; and
- it continued to disagree with the CAA on its approach to apply a financing cost of 4.83% on early expansion costs for the period after January 2020.

E7 BA said that:

- HAL had incurred Category C expansion costs at its own risk in the absence of a regulatory policy being in place for those costs in the way it had been for Category B costs;



- the disapplication of consumer protections (such as risk sharing arrangements) when the expansion project was paused has allowed HAL to obtain a favourable regulatory settlement for the project;
- it disagreed with our approach to wind down and appeal costs, referring to the lack of governance arrangements and airline scrutiny of these costs;
- the simultaneous recovery of all wind-up costs, IPHS and appeal costs is not appropriate, as BA continues to believe that HAL has unilaterally withdrawn from the expansion project; and
- our approach to the efficiency assessment appears to give HAL a significant advantage noting information asymmetries, and that the budgets that HAL originally devised were ultimately ineffective.

## Our views

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- E8 In response to HAL’s points regarding the efficiency assessment, we set out our policy clearly in the April 2021 working paper, Initial Proposals, and in the Final Proposals. We have reviewed information provided by HAL and carried out detailed analysis that supports our position on inefficiencies, and on proposed disallowances. Similarly, our treatment of financing costs for costs incurred after January 2020 was set out clearly in the Initial Proposals and in the April 2021 working paper. HAL has not provided additional evidence or arguments to persuade us that the proposed adjustment is wrong.
- E9 In response to BA’s argument on the treatment of Category C costs, we note that this policy position was consulted on, and then confirmed in the Initial Proposals so we do not accept the argument that these costs should be excluded from the RAB.
- E10 In relation to BA’s concerns on our approach to the assessment of efficiency, we agree that the assessment of development costs such as early expansion costs is a challenging process given information asymmetries and the bespoke nature of some categories of cost. We draw attention to the following points:
- we have previously set out our assessment approach in detail in previous publications, including the Initial Proposals and the Final Proposals, and have taken account of stakeholder feedback on our approach;
  - we have sought and identified further information from HAL which has allowed us to carry out comparative analysis (including internal benchmarking) of several cost categories, which strengthened our analytical evidence base;

- while we agree that HAL’s programme management and financial planning was inconsistent with good practice in many respects, we have assessed out-turn costs against budgets for relevant cost categories and have sought information from HAL on the reasons for variances against its budgeted costs. Where there were unexplained discrepancies, we have proposed disallowances to reflect inefficiencies for those categories;
- while we agree that early expansion costs have not been subject to explicit airline assessment (as this assessment has been CAA’s responsibility), the majority of these costs have been subject to regulatory scrutiny and airlines have had a number of opportunities to comment on these cost allowances; and
- we reiterate our view that HAL has not “unilaterally withdrawn” from the expansion process and, therefore, we do not consider there is a case for changing our overall policy for the recovery of expansion costs already incurred.

## **Assessment and the CAA’s Final Decision**

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- E11 We have reviewed all the evidence submitted. As a result of the assessment process which was been set out in detail in the Initial Proposals and the Final Proposals (summarised above) we remain of the view that the costs HAL incurred before March 2020 included a relatively small number of inefficient elements which should be deducted from the RAB. In this light, our final decision is to confirm the position on early expansion costs set out in our Final Proposals as shown in table E.2 below. The totals to be added to the RAB take account of two adjustments:
- our disallowances for inefficiency, which reduce the RAB addition by £7 million as explained in paragraph E5 above; and
  - the in-year fixed allowances for Category B costs of £10 million per annum for the period 2016-2020.<sup>3</sup>

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<sup>3</sup> For more details of these allowances, see the [Initial Proposals Appendices CAP2265E](#)

**Table E.2: Final Decision RAB additions for Early Costs (excluding financing costs)**

					Wind down costs (includes IPHS and appeal costs)		
<b>£million Nominal prices (unless stated)</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>Jan-Feb 2020</b>	<b>2020 (March onwards)</b>	<b>2021</b>	<b>Totals<sup>4</sup></b>
<b>Category B</b>	65	108	157	11	14	1	356
<b>Category C</b>	6	11	68	20	17	4	126
<b>Total (nominal prices)</b>	<b>71</b>	<b>119</b>	<b>225</b>	<b>31</b>	<b>31</b>	<b>5</b>	<b>482</b>
<b>Total (2020 prices)</b>	<b>75</b>	<b>122</b>	<b>227</b>	<b>31</b>	<b>31</b>	<b>5</b>	<b>491</b>

Source: CAA

- E12 As stated in the Final Proposals, if expansion should re-start in the future, we would seek to put in place a clear policy on how any expansion costs can be recovered by HAL including the requirement that HAL should demonstrate that any work carried out previously is not duplicated. If it appears to be necessary in the interests of consumers to develop such a policy, we will consult further on these matters.

<sup>4</sup> The equivalent figure for the total in nominal prices presented in the Final Proposals is £483m: this rounded estimate has been adjusted to allow for the precise disallowances described above

## APPENDIX F

# Financial Resilience and Ring Fencing

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## Introduction

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- F1 This Appendix sets out our final decision on changes to the financial resilience and ringfencing rules in Part E of the Licence, including the reasons for and the effects of the modifications we have decided to make. The text of the modifications to the Licence that we have decided to make is set out the Notice at Appendix C. All references to conditions in this Appendix are to the modified and re-numbered conditions set out in the Notice at Appendix C.
- F2 We have reached this decision having developed our approach through a series of consultations and working papers.<sup>5</sup> The modifications focus on a relatively narrow set of changes to the Licence which will:
- clarify HAL’s obligations;
  - improve the flow of information to the CAA; and
  - make the financial resilience and ring fencing provisions in Part E of the Licence more consistent with the regulatory regime as a whole.
- F3 The Draft Licence Consultation, and Final Proposals discussed possible modifications to the Licence to:
- make minor changes to the sufficiency of resources obligation and the obligations on HAL to provide “sufficiency of resources” certificates to reflect the development of the Licence since it was granted and to ensure internal consistency within the Licence by requiring HAL to have sufficient assets to operate the airport “in accordance with the Licence”;
  - make clear the equal importance of financial and operational resilience by requiring separate sufficiency of resources certificates for each of (i) financial and (ii) operational resources in place of the existing combined certificate;

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<sup>5</sup> These proposals have their origin in the context of expansion, our intention to consider the need for changes in the financial resilience arrangements for HAL having been mentioned first in January 2017 (see CAP1510 ([www.caa.co.uk/CAP1510](http://www.caa.co.uk/CAP1510)) at paragraph 5.35) and being developed in subsequent consultations and working papers (see especially the August 2019 Working Paper, and the June 2020 Consultation (at Appendix F)), the Draft Licence Consultation and Final Proposals (at Appendix I).

- propose new requirements to provide additional supporting evidence in circumstances where the directors of HAL draw the CAA's attention to matters that may affect HAL's resilience;
- include a new requirement in the Licence to ensure that the CAA has notice of, and access to, the same information that HAL provides to credit markets; and
- clarify the "good behaviour" undertaking given to HAL by the ultimate holding company and ensure that directors had appropriate knowledge of that undertaking.

F4 Stakeholders did not make substantive representations on the modifications that we proposed in the Final Proposals, save that HAL suggested that the CAA carefully consider the implementation dates used for the conditions.<sup>6</sup>

## **Our views and the CAA's Final Decisions**

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### **Overarching reasons for making modifications to the financial resilience and ringfencing rules**

- F5 Even though we consider that, in practice, and in part because of the protections for HAL put in place by its financing platform,<sup>7</sup> the chance of HAL experiencing financial distress is "a low probability event", if this were to materialise, it could potentially have a high impact on consumers. HAL is also part of a wider group of companies that supports a relatively high level of debt. That said, HAL is, to an extent, "insulated" from indebtedness incurred by entities "higher up" the corporate structure by being part of the "whole business securitisation" structure created by its financing platform.
- F6 In this context and in the light of our experience of the operation of the existing financial resilience and ring fencing arrangements since the commencement of the covid-19 pandemic in early 2020, we have decided that the present regime, while generally fit for purpose, should be improved better to further the interests of consumers. So, we have decided to make appropriate modifications to HAL's licence to enhance the existing rules to protect the interests of consumers in the event that HAL experiences financial distress. At the same time, we maintain the view that we have set out throughout the development of this policy that we do not consider that it would be proportionate for the CAA to implement financial resilience rules into HAL's licence that would "cut across" HAL's financing platform, because this could create unnecessary costs for HAL.

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<sup>6</sup> This issue is dealt with in the section on Implementation below.

<sup>7</sup> See condition B3 (Promoting economy and efficiency).

- F7 We consider that it remains appropriate for us to place significant reliance on the provisions in the Licence that provide early warning of difficulties because these protect the interests of consumers as they may enable the CAA to consider action tailored to the matter arising.
- F8 In this light, the modifications that we consider that it is necessary for us to make better to protect the interests of consumers are limited to addressing the following issues:
- the existing licence conditions are neither as clear as they could be, nor have they kept pace with other developments in the Licence since the Q6 Price Control, specifically the introduction of the “economy and efficiency” obligation in Condition B3 of the Licence;
  - the current arrangements in relation to the certification of sufficient resources do not clearly demonstrate the equal importance of HAL maintaining sufficient financial and operational resources, nor do they ensure that the CAA is provided with appropriate and timely information if a problem is emerging; or
  - the identity of the ultimate controller is not as clearly defined as it should be;
  - the scope of information that HAL’s group companies must hold as a result of the ultimate controller undertaking is not as clear as it should be to ensure that the ultimate controller undertaking functions effectively to protect the interests of consumers; and
  - the licence does not assure appropriate prominence for the “ultimate controller undertaking” in HAL’s broader corporate governance structure or processes, especially with new directors.

### **The reasons for and the effect of the specific modifications we have decided to make**

- F9 We have decided to make modifications to Part E of the Licence and these are in the Notice set out at Appendix C. We consider that these changes are a necessary, proportionate and targeted intervention whose effect will be to further the interests of consumers by mitigating the risks described above. Specifically, these changes will:
- ensure that the drafting of each of (i) the sufficiency of resources obligation and associated certificates and (ii) the ultimate controller obligation in the Licence is clear, consistent and, where relevant, reflects changes to the Licence since Q6;



- illuminate any issues that HAL’s directors identify in preparing the relevant “resources” certificate, to facilitate the CAA’s understanding of those issues, enabling the CAA to determine whether more information is required, for example through formal or informal information requests;
- clarify the requirements and scope of the ultimate controller obligation; and
- ensure that there is proper knowledge of the ultimate controller undertaking within HAL’s broader corporate structure and processes.

F10 We consider that these changes will not:

- affect HAL’s financeability as they do not include changes that would cut across its financing platform or impose material compliance costs on it;
- undermine the responsibility of HAL’s management and shareholders for its financial stability;
- create a false sense of security by specifying the matters that should be reported to the CAA as the circumstances at hand may well not be identifiable in advance and such an approach is not consistent with the more “holistic” approach taken in the certification obligations and associated obligation to inform the CAA;
- lead to any pre-determined regulatory intervention or enforcement action; or
- change our focus from the notional company in setting the price control.

F11 The CAA’s assessment and response to any scenarios coming to our attention through the operation of these obligations will depend on the nature of the issues raised and the quality of the information provided. As a result, it is not possible for the CAA to be more precise about these matters, save to say that the aim of these provisions is not to support pre-determined regulatory intervention or, of itself, to be a trigger for enforcement action.

### **Modification to the sufficiency of resources and certification obligations to promote consistency**

F12 We have decided to make limited modifications to condition E2.1 to ensure that it is consistent with the rest of the Licence as it has been modified since the implementation of the Q6 price control. The changes we have decided to make are to require HAL to maintain sufficient financial resources and sufficient operational resources to support the operation of the airport “in accordance with the licence”.

F13 As noted in our previous consultations, the interaction of the modified condition with, for example, the obligations on HAL to develop, maintain and operate

Heathrow airport in an economical and efficient manner<sup>8</sup> will also have the effect of setting an appropriate and internally consistent “benchmark” or standard against which the sufficiency of HAL’s resources can be assessed.

### **Modifications to the sufficiency of resources certificates**

- F14 We have decided to modify condition E2.2 and create a new condition E2.3 to give equal prominence to operational and financial resources. The effect of these modifications is to split and clarify the “sufficiency of resources certificates” so that HAL is required to provide separate certificates for each of (i) operational and (ii) financial resources.
- F15 The certificates will, save for being tailored into separate certificates for each of (i) financial and (ii) operational resources, be in broadly the same form as at present, except for some changes and re-ordering to improve the clarity and readability of the certificates and for consistency with the amended sufficiency of resources obligation in condition E2.1.
- F16 Together with condition E2.4 (formerly condition 2.3) we consider that this will promote the provision of information to the CAA at a consistent level of detail for each of (i) financial and (ii) operational resources.
- F17 Given the importance of these conditions in providing assurance to the CAA and facilitating dialogue and, potentially, further information requests or action by the CAA to protect consumers to support continuity in the provision of AOS at Heathrow, we consider that this change is appropriate and proportionate to ensure:
- an appropriate level of assurance and information flows to the CAA on both operational and financial matters, avoiding the CAA needing to rely on management “goodwill” to ensure an appropriate flow of information, especially given the inevitable information asymmetry between regulator and the regulated company; and
  - each certificate will have equal weight
- especially in the context of airport performance more generally during the recovery of the pandemic.
- F18 Since the obligations to maintain sufficient resources, coupled with the certification obligations cannot be expected to anticipate all future risks on their own and could not have been expected to have helped HAL to predict the impact of the covid-19 pandemic, we consider that the ongoing obligation to inform the CAA if the directors no longer hold the expectation in the last certificate(s) they gave continues to play a vital role in the ongoing regulatory regime in providing

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assurance to the CAA. As a result, we have decided not to change the period of the “forward look” that directors should make in considering the certificates, because doing so, as explained in our Final Proposals, would significantly and inappropriately dilute the effectiveness of these combined obligations.

- F19 We do not consider that the drafting of the obligation in the Certificates set out in conditions E2.2 and E2.3 in Appendix C will require directors to certify compliance with licence conditions that they might not know would be in force during the “forward look” period because the certificates refer to only those licence conditions to which HAL reasonably expects to be subject.
- F20 We consider that the effect of these changes, combined with the ongoing obligation to inform the CAA of issues that might call the latest certificate into question, will, when combined with the obligation in the modified condition E2.5 have the effect of enabling the CAA to enter into dialogue with the licensee in a timely way. It will enable us to assess the position and determine what, if any, further information we should seek, or action we may wish to consider to protect consumers. As such it will support the interests of consumers in the continuity of the provision of AOS at Heathrow, lessening the chance of distress causing disruption to consumers.

### **New requirements on supporting information for the sufficiency of resources certificates**

- F21 We have decided to modify the licence so that HAL is required to provide appropriate information to enable the CAA to consider whether it needs to act to protect the interests of consumers (or at least to enable it to make further information requests to establish the position further). This obligation is set out in the revised and re-numbered condition E2.6 in the notice set out at Appendix C and requires further information to be provided in circumstances where HAL has provided a “qualified” sufficiency of resources statement pursuant to condition E2.2(b) or E2.3(b) drawing the CAA’s attention to specific matters.
- F22 In order to ensure that appropriate detail is provided to the CAA, we have decided to modify the Licence at Condition E2.6 to require that the supporting information HAL provides with the certificates sets out:
- a “central” case with “positive” and “negative” sensitivities relating to the specific matter(s) to which the directors are drawing the CAA’s attention; and
  - a description of the impact of the sensitivities on its financial and/or operational resources, as appropriate.
- F23 As discussed in Final Proposals, we consider that this approach targets the obligation appropriately and is proportionate to the aim of the condition because the further information contemplated by the obligation is not needed in either:

- a “business as usual” period where HAL’s directors expect to have sufficient resources for the following two years, because the information will not disclose matters of importance to the interests of consumers; or
- any scenario in which HAL’s directors do not expect to have sufficient resources, because the CAA should already be aware of the issue through either a previous “qualification” of the most recent certificate, or the directors informing the CAA that they no longer have the expectation in the most recent certificate, as required by condition E2.4 of the licence.

F24 We also consider this approach ensures that the licensee’s directors retain responsibility for issues as they arise.

### **New obligation on the provision of financial market information**

F25 While:

- HAL publishes extensive information on its website and through the London Stock Exchange Regulatory News Service (“RNS”), to comply with its market obligations and financing platform; and
- the CAA monitors the RNS

HAL is in sole control of when material is released through the RNS, so is better placed to know when such material becomes available.

F26 As with information provided as part of the annual certification process, it is not appropriate for the CAA to rely on the goodwill of the licensee to notify the CAA that it has released this material as it is of clear relevance to HAL’s financial position. To address this, we have decided to modify the Licence by inserting a new condition E2.8 to require HAL to inform the CAA that it has published new material on its website. We consider that this targeted approach is proportionate to the benefits to consumers of the CAA accessing this information in a timely way.

### **Modifications to clarify the identity of the ultimate controller and ensure appropriate awareness of the undertaking it gives to HAL**

F27 The “ultimate controller undertaking” is an important tool for ensuring that consumers’ interests are not undermined by actions taken elsewhere in the licensee’s corporate structure. However, for this obligation to be fully effective, it is important that:

- the identity of the ultimate controller (known as the “Covenantor” in the licence) is clear;
- the ultimate controller and HAL’s group companies can readily identify the information that they must hold under the ultimate controller obligation so they can ensure this information is available to the CAA; and

- the directors of the ultimate controller are aware of the existence and content of the ultimate controller undertaking.

F28 As our previous consultations have discussed, up to now, the licence condition has neither identified the ultimate controller with sufficient clarity, nor made sufficiently clear to what information it applies. We consider that these issues can readily be addressed without changing either the identity of the ultimate controller or the intensity of the obligation on HAL in practice. To effect this, we have decided to modify the Licence to:

- make clear that the definition of the ultimate controller set out in condition E2.10 is identifiable by reference to terms defined in the Companies Act 2006; and
- clarifying that the information that the subsidiaries of the ultimate controller need to hold are those records that the licensee may reasonably need to carry on the activities permitted under the Licence.

F29 We consider that this approach ensures that this obligation will be limited to ensure group companies do not have to hold information that they would not otherwise hold for their functions within HAL's group.

F30 The objective of ensuring that the relevant directors are aware of the nature and extent of the ultimate controller undertaking can be discharged effectively by ensuring that HAL writes to any new director of the ultimate controller on appointment to its board, making them aware of the undertaking.

F31 As a result, we have decided to modify the Licence, effectively to make this part of new directors' "induction" into the role, to be done within a week of their appointment. This short period is needed to mitigate the risk that the new appointee starts being involved in board decisions which could have an impact on HAL before they become aware of the undertaking. We consider that this is a proportionate approach to raising the profile of this obligation in the particular circumstances of HAL's governance structure. New condition E2.13 implements this decision.

## **How these modifications meet our duties under CAA12**

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F32 In deciding on the modifications discussed above, we have had particular regard for the need to:

- secure that HAL can finance its activities, by taking care not to cut across its financing platform, which would provoke an expensive and disruptive refinancing;
- promote economy and efficiency on the part of HAL by not imposing obligations on HAL that would be costly to comply with; and

- secure that reasonable demands for AOS are met by promoting the financial and operational stability of HAL and the ability of the CAA to become aware of and address any concerns that might arise in a timely manner.

F33 We have also had regard to the Better Regulation Principles, in particular that:

- action is needed for the reasons, and to progress the aims, set out above; and
- these Final Proposals are proportionate, having been designed to achieve the aim of addressing the matters set out in those paragraphs in ways that address the need for action without creating any significant increase in the regulatory burden on HAL.

F34 Of particular relevance to our assessment of the proportionality of our proposals are, that they will:

- only require additional information in limited circumstances, otherwise relying on materials currently produced for market participants; and
- not cut across HAL's financing platform; but
- will still promote the CAA having the information it needs in circumstances where it needs more information to determine its appropriate course of action in the interests of consumers.

F35 Overall, for the reasons set out above, we consider that taking steps to promote the financial resilience of HAL and facilitate the CAA in taking any steps that might be needed to address any resilience issues that may arise is in the interests of consumers and the modifications discussed in this Appendix will promote consumers' interests to these ends.

## Implementation

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F36 Appendix C to this Final Decision makes clear that the modifications we have decided to make will come into effect on 1 May 2023. As a result, the certificates that HAL will be required to submit to the CAA under condition E2 in 2023 will be governed by the obligations as they stand as at the date of this Final Decision. HAL will be required to submit certificates in the form required by the modified licence conditions for the first time in 2024.

F37 Our decision also has the effect of requiring HAL to procure a revised ultimate controller undertaking to take account of the modifications to condition E2 that we have decided to make. We shall write to HAL separately to specify the form of the undertaking that is required. No new undertaking will be required before the modified licence conditions come into effect on 1 May 2023.



**APPENDIX G****Policy guidance on reopening a price control**

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- G1 This guidance is intended to clarify how we are likely to deal with a future request to reopen HAL's price control. It confirms the guidance on these matters that we set out in the Final Proposals.
- G2 Consistent with our decision on setting the Q6 price control and the position under CAA12, our view remains that:
- HAL may request that its price control be reopened at any time; and
  - we would consider any such request in the light of our statutory duties under the circumstances prevailing at the time.
- G3 However, we consider that there is a high threshold for reopening a price control that is only likely to be met in exceptional circumstances.
- G4 We further clarify that:
- in principle, other parties are also able to request that HAL's price control is reopened. As with any request from HAL, we would consider a request from a third party in the light of our statutory duties in the context of the circumstances prevailing at the time;
  - there are different ways that any decision to amend HAL's price control could be implemented. These include amending an existing price control formula in the Licence part way through the period, using the process set out in section 22 CAA12, or by changing our approach to setting the next price control, for example by adjusting the way we calculate the opening regulatory asset base ("RAB") for the next period. Each of these routes would allow our decision to be appealed to the CMA at the time they are implemented through a modification to the Licence; and
  - we could also decide ourselves to reopen a price control (rather than in response to a specific request from HAL or a third party). Any such decision would be implemented as described above and any decision to modify the Licence subject to the same appeals mechanism.
- G5 We also note that:
- we would only expect there to be a strong case for reopening a price control in exceptional circumstances;

- our decision in May 2021 to adjust HAL's RAB by £300 million, as set out in the RAB Adjustment Decision, demonstrates that we are willing to reopen a price control, particularly in exceptional circumstances, and that we will do so only to the extent that this will further the interests of consumers;
- for the H7 period, we are introducing a traffic risk sharing mechanism which should reduce the likelihood that the exceptional circumstances that might justify reopening a price control could arise solely as a result of traffic being higher or lower than forecast;
- when considering whether and how to respond to any request to reopen a price control, we are likely to have regard to the benefits for consumers of regulatory certainty and consistency;
- we would expect any request to reopen a price control to be accompanied by specific evidence demonstrating the need for such action and in particular how this will further the interests of consumers; and
- this guidance is not intended to set any expectation as to how we would deal with any specific future reopening request (other than we would do so in the light of our statutory duties and the prevailing circumstances, and that there is only likely to be a strong case for reopening a price control in exceptional circumstances) or to commit to adjust the price control if HAL faces a risk over and above any particular threshold.

**APPENDIX H****Rolling forward the RAB**

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**Purpose and basis of the calculation**

- H1 This Appendix specifies the detail of the formulae that we intend to use for tracking the regulatory asset base (“RAB”) for the purposes of setting the H7m price control.
- H2 The equations set out below are based on the projections made by the CAA in reaching this Final Decision on the charge conditions for the H7 price control period from 1 January 2022 to 31 December 2026.

**Inflation adjustment**

- H3 The data used in calculating inflation adjustments is published by the Office for National Statistics (“ONS”) as follows:
- (a) consumer price index (CPI): CPI INDEX 00: ALL ITEMS 2015=100 (the D7BT series); and
  - (b) retail price index (RPI): RPI ALL ITEMS Jan 1987=100 (the CHAW series).
- H4 From these CPI and RPI data, we have adopted the following series:
- (a)  $RPI_{Dec,t}$  is the RPI index for December of Regulatory Year  $t$ ;
  - (b)  $RPI_{Dec,t-1}$  is the RPI index for December of Regulatory Year  $t - 1$ ;
  - (c)  $RPI_{Annual,t}$  is the arithmetic mean of monthly RPI index values for each month in Regulatory Year  $t$ ;
  - (d)  $CPI_{Annual,t}$  is the arithmetic mean of monthly CPI index values for each month in Regulatory Year  $t$ ; and
  - (e)  $CPI_{Annual,2020}$  is the arithmetic mean of monthly CPI index values for each month in Regulatory Year 2020.

H5 From these five series we have constructed the following inflation adjustment terms:

Inflation adjustment	Used for
$\frac{RPI_{Dec,t}}{RPI_{Dec,t-1}}$	Annual RPI growth from December of Regulatory Year $t - 1$ prices to December of Regulatory Year $t$ prices
$\frac{RPI_{Dec,t}}{RPI_{Annual,t}}$	RPI growth from annual average of Regulatory Year $t$ prices to December of Regulatory Year $t$ prices (within year RPI growth)
$\frac{RPI_{Dec,t}}{RPI_{Annual,2018}}$	RPI growth from 2018 RPI annual average prices to December of Regulatory Year $t$ prices

H6 In each year, the RAB is expressed in December RPI-real prices of that year. The CAA assumed ordinary depreciation figures are expressed in 2018 RPI-real annual average prices.

H7 A value corresponding to a Regulatory Year can be expressed in different price bases and denoted by the subscripts as follows:

Price base	Subscript
RPI prices in December of the previous Regulatory Year	Dec, $t - 1$
RPI prices in December of that Regulatory Year	Dec, $t$
Annual average RPI prices of that Regulatory Year	Annual, $t$
Annual average RPI prices of Regulatory Year 2018	Annual, 2018

### Composition of the RAB

H8 The RAB of Regulatory Year  $t$  consists of two elements:

$$RAB(t)_{Dec,t} = \text{Basic } RAB(t)_{Dec,t} + \text{Cumulative profiling adjustment}(t)_{Dec,t}$$

where:

- (a)  $RAB(t)_{Dec,t}$  = the RAB of Regulatory Year  $t$
- (b)  $\text{Basic } RAB(t)_{Dec,t}$  = the Basic RAB of Regulatory Year  $t$
- (c)  $\text{Cumulative profiling adjustment}(t)_{Dec,t}$  = Cumulative profiling adjustment of Regulatory Year  $t$ . This is the adjustment to reflect profiling/smoothing of charges within a regulatory period.

## The Opening Basic RAB

H9 The Opening Basic RAB of Regulatory Year  $t$  equals to the Closing Basic RAB of Regulatory Year  $t - 1$ , both expressed in RPI prices in December of Regulatory Year  $t - 1$ . That is:

$$\text{Opening Basic RAB}(t)_{\text{Dec},t-1} = \text{Closing Basic RAB}(t-1)_{\text{Dec},t-1}$$

H10 For H7, the Opening Basic RAB of Regulatory Year 2022 expressed in RPI prices in December of Regulatory Year 2021,  $\text{Opening Basic RAB}(2022)_{\text{Dec},2021}$ , is £17,476.872 million. Detailed calculations are given in chapter 10 (The H7 Regulatory Asset Base and HAL's request for a RAB adjustment).

## Annual Basic RAB roll-forward

H11 The annual Basic RAB roll-forward is given by:

$$\begin{aligned} & \text{Closing Basic RAB}(t)_{\text{Dec},t} \\ &= \text{Opening Basic RAB}(t)_{\text{Dec},t-1} \times \frac{\text{RPI}_{\text{Dec},t}}{\text{RPI}_{\text{Dec},t-1}} \\ &+ \text{Actual capex}(t)_{\text{Annual},t} \times \frac{\text{RPI}_{\text{Dec},t}}{\text{RPI}_{\text{Annual},t}} \\ &- \text{Proceeds from disposals}(t)_{\text{Annual},t} \times \frac{\text{RPI}_{\text{Dec},t}}{\text{RPI}_{\text{Annual},t}} \\ &+ \text{TRSA}(t)_{\text{Annual},t} \times \frac{\text{RPI}_{\text{Dec},t}}{\text{RPI}_{\text{Annual},t}} \\ &- \text{CAA assumed ordinary depreciation}(t)_{\text{Annual},2018} \times \frac{\text{RPI}_{\text{Dec},t}}{\text{RPI}_{\text{Annual},2018}} \end{aligned}$$

where:

- (a)  $t$  represents Regulatory Years 2022, 2023, 2024, 2025 and 2026;
- (b)  $\text{Closing Basic RAB}(t)_{\text{Dec},t}$  is the RAB at the end of Regulatory Year  $t$ ;
- (c)  $\text{Opening Basic RAB}(t)_{\text{Dec},t-1}$  is the Opening Basic RAB at the beginning of Regulatory Year  $t$ ;
- (d)  $\text{Actual capex}(t)_{\text{Annual},t}$  is the capital expenditure that has been spent in Regulatory Year  $t$ ;
- (e)  $\text{Proceeds from disposals}(t)_{\text{Annual},t}$  is the proceeds from disposals in Regulatory Year  $t$ ;
- (f)  $\text{TRSA}(t)_{\text{Annual},t}$  is the adjustment to the RAB in Regulatory Year  $t$  for the part of the traffic risk sharing adjustment that is not implemented by adjusting allowed charges in H7. It is calculated as follows:
  - (i)  $\text{TRSA}(2022)_{\text{Annual},2022} = 0.7 \times \text{ARS}(2022)_{\text{Annual},2022} \times (1 + \text{RWACC})^{4.5}$ ;
  - (ii)  $\text{TRSA}(2023)_{\text{Annual},2023} = 0.8 \times \text{ARS}(2023)_{\text{Annual},2023} \times (1 + \text{RWACC})^{3.5}$ ;

- (iii)  $TRSA(2024)_{Annual,2024} = 0.9 \times ARS(2024)_{Annual,2024} \times (1 + RWACC)^{2.5}$ ;
- (iv)  $TRSA(2025)_{Annual,2025} = ARS(2025)_{Annual,2025} \times (1 + RWACC)^{1.5}$ ; and
- (v)  $TRSA(2026)_{Annual,2026} = ARS(2026)_{Annual,2026} \times (1 + RWACC)^{0.5}$ ;

where:

1.  $ARS(t)_{Annual,t}$  is calculated in the same way as  $ARS_t$  in Condition C1.21 of HAL's licence; and
  2. RWACC is the pre-tax RPI-real weighted average cost of capital which shall have a value of 4.04%; and
- (g) CAA assumed ordinary depreciation  $(t)_{Annual,2018}$  is the CAA's assumed ordinary depreciation in Regulatory Year t. The values over H7 are given by:
- (i) Regulatory Year 2022: £778.365 million;
  - (ii) Regulatory Year 2023: £788.810 million;
  - (iii) Regulatory Year 2024: £817.054 million;
  - (iv) Regulatory Year 2025: £860.134 million; and
  - (v) Regulatory Year 2026: £898.404 million.

### Adjustments in addition to annual Basic RAB roll-forward

- H12 In addition to the annual roll-forward formula set out in in paragraph H11 above, at various points of H7, we may make adjustments to the RAB, with appropriate indexation factors applied, to reflect our policy decisions on capex efficiency as required. We will adopt an evidence-based approach to conduct efficiency assessments on HAL's capex and early expansion costs and the associated financing costs, in order to ensure that only efficient capex is remunerated.
- H13 For 2026, we will make an adjustment to the RAB through the  $CODI(2026)_{Dec,2026}$  term to allow for the difference between forecast and out-turn cost of new debt indexation during H7. The calculation of  $CODI(2026)_{Dec,2026}$  is given by the workbook titled "CAA\_cost\_of\_new\_debt\_indexation.xls" which is a part of this Appendix.