



Consumers and Markets Group

Mike King
Director of Regulation
Heathrow Airport Limited (HAL)

By e-mail

20 December 2023

Final Terms of Reference for the Independent Review of Heathrow Airport Limited's cost allocation methodology for Other Regulated Charges – Outcome of Consultation

Dear Mike

Thank you for your recent response to our consultation on the draft Terms of Reference for the independent review of HAL's cost allocation methodology for Other Regulated Charges (ORCs). We received responses from HAL, Heathrow AOC, IAG, Arora Group, and Mills & Reeve on behalf of Padox UK. All the responses are being published on the CAA website alongside this letter.

Our assessment of the responses is attached (Appendix I). As a result of consideration of the responses, we have made some minor changes in the final Terms of Reference (Appendix II). We wish to reiterate for the benefit of all respondents that, as set out in Condition 2.4 of HAL's licence, the focus of the review is on HAL's cost allocation methodology: questions of ORC tariff structures and associated regulatory policies are, therefore, not included within the scope of the Terms of Reference. HAL should now proceed to initiating the tendering process for the appointment of the independent reviewer, in good time for the project to commence by 1 March 2024 at the latest.

In order to help ensure the independence of the review, you should share with us in due course your shortlist of firms for the review and how you will ensure that the appointed firm has no conflicts of interest. HAL should also engage as appropriate with ORC users at this part of the process.

Please do not hesitate to contact us if there are any others matters that you wish to discuss in advance of the tendering process.

Yours sincerely,

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APPENDIX I

Assessment of Responses to Draft Terms of Reference

Overview

A draft Terms of Reference was published by the CAA on 1 November 2023, and comments have been received from the following stakeholders:

- Heathrow Airport Limited (HAL);
- Heathrow Airline Operators Committee (AOC);
- International Airlines Group (IAG), on behalf of Aer Lingus, British Airways and Iberia;
- Arora Group; and
- Mills & Reeve, on behalf of Pandox UK (trading as Hilton Garden Inn London Heathrow Airport).

These responses are published on the CAA's website. Our summary and assessment of responses is provided below.

HAL's response

HAL welcomed the review in broad terms and the proposed timelines. It requested that it be provided with an opportunity to review a draft of the report for factual accuracy before finalisation. However, it disputed the basis for the annuity cost included in the H7 Final Decision and whether the approach to the recovery of annuities is in consumers' interests: it considered this could lead to inefficient outcomes and could be inconsistent with the single till approach. In relation to the cost allocation review, HAL sought clarification on two specific issues:

- the definition of 'airline' and 'non-airline'; and
- what would constitute a 'windfall loss' or 'windfall gain' which would require adjustment through the licence.

CAA views

We agree with HAL that it should be provided with an opportunity to review a draft of the report for factual accuracy before finalisation. In general, we would expect HAL to work very closely with the independent reviewer throughout the review to provide the necessary data and information to facilitate the review, and to provide explanations and feedback to the independent reviewer as required.

We note that HAL continues to disagree in principle with the CAA's approach at H7 to the recovery of fixed costs and annuities in relation to non-airline ORC users. These

matters were considered carefully in our Final Decision on the H7 price control and we do not intend to reopen that decision as part of this process.

Our previous estimates of fixed costs and annuities have been based on data provided by HAL. We note the concerns of HAL as to the suitability of that data for this purpose and we expect this to be an important matter that is examined in detail as part of the independent review.

In response to HAL's two specific requests for clarification, our response is as follows:

- a definition of 'airline' is provided in HAL's licence (see Condition A3). If it becomes apparent that any further clarification is required, this can be discussed in the course of the study.
- the concept of 'windfall' gains or losses (paragraph 8.47 of the H7 Final Decision) is referring to the possibility that the independent review might identify significant issues that, if addressed (and in the absence of suitable adjustment) could result in a windfall gain or loss for HAL. This could occur, for example, in relation to an agreed change, following the study and consideration by the concerned parties, to the amount of non-airline 'fixed costs and annuities' allocated to ORC users during H7 as compared to Table 8.2 of the H7 Final Decision.

Heathrow AOC's response

Heathrow AOC stated that it was in agreement with the draft Terms of Reference and provided the following additional comments:

- in case of a differentiated pricing approach, which it said the airline community strongly supported, the independent reviewer would need to determine whether the definitions of airline and non-airline used by HAL were appropriate and, in particular, airlines considered that ground-handlers directly involved in the provision of airline support should qualify for differentiated pricing;
- the Terms of Reference should make explicit the statement in Condition C2.4 of HAL's licence that the independent reviewer should report to the CAA and not HAL;
- additional independent reviews should be conducted every two years to ensure the cost allocation methodology remains consistent with the intentions of Heathrow's licence and adapts to any significant changes in the structure of ORCs or of the airlines' and non-airlines' shares of ORCs;
- the assessment should include whether there are proper financial controls in place to ensure that the allocation of costs is completed in a consistent and accurate manner; and
- given that the non-airline fixed costs for the last three years had not been recovered, the review should consider the timescales over which they should be recovered and resolve the matter in a way which is fair to all parties and consistent with the H7 Final Decision.

CAA views

As noted above, the relevant definition of 'airline' is provided in HAL's licence (see Condition A3). If it becomes apparent that any further clarification is required, this can be discussed in the course of the study.

We agree that the Terms of Reference should be explicit that the independent reviewer will report to the CAA. While this was mentioned in our covering letter to the draft Terms of Reference, it was not mentioned in the draft Terms of Reference itself. We have, therefore, moved relevant elements of our covering letter - specifically, the extract of Condition C2.4, and the section entitled "Approach to the review" - to the Terms of Reference.

In advance of receiving the report and recommendations of the independent reviewer, we do not consider that it would be appropriate at this stage to specify the frequency of future reviews, if any. The forthcoming H8 price review will, in any case, provide an opportunity to consider whether the approach taken to ORCs for H7 remains appropriate in the future.

We agree that the independent review may consider whether there are appropriate financial controls in place to ensure that the allocation of costs is completed in a consistent and accurate manner. We consider this would be covered under Item 1 of the existing 'Scope of the independent review', which requires the independent reviewer to determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified.

With regard to any unrecovered non-airline ORC fixed costs for 2022 and 2023, we regard this as a matter to be considered separately in setting ORC prices rather than as part of a review of the cost allocation methodology.

IAG's response

IAG queried whether the ORC users will have the ability to assist in the selection of the independent reviewer, and stated that it would expect HAL to agree the appointment of the independent reviewer with the CAA and the ORC users, and for the CAA to reserve the right to appoint the independent reviewer if no agreement can be reached. It also sought confirmation that ORC users would be engaged in future periodic reviews in a similar manner to this independent review. It also thought that LACC (or a subset) should be involved in the review as well as ORCG - the ORC governance group for airlines operating at Heathrow - given the scope of work.

With regard to the scope of the review, IAG said that:

- it should take into account materiality and timescales relating to non-collected revenues over the past three years;
- any commercial impacts between HAL and non-airlines should be for HAL to resolve;

- it is not expecting an assessment of capital efficiency to be part of this review; and
- the review should assess the benefits of transferring all direct costs of airline-only ORCs into airport charges.

IAG also suggested evidence for the independent reviewer to consider should include full transparency of HAL's contractual arrangements, a "full cost build of ORC services to the lowest level of granularity available within HAL's internal modelling", and consideration of the amounts that HAL were charging for annuities and overheads prior to H7, as a benchmark.

CAA views

HAL's licence condition C2.4 requires HAL to appoint the independent reviewer following consultation with the CAA and ORC users. HAL is, therefore, not required to agree the appointment of the independent reviewer with ORC users. Nevertheless, to help ensure the credibility of the independent review, we are asking HAL to share with us its shortlist of firms for the review and how it will ensure that the appointed firm has no conflicts of interest. HAL should also engage as appropriate with ORC users at this part of the process.

Matters relating to future periodic reviews are outside the scope of this process.

Condition 2.4 also specifies that the objective of the independent review is "to validate that the cost allocation methodology ensures that the costs of the Specified Facilities are allocated between airlines and non-airline users of the Specified Facilities on a fair and reasonable basis". The treatment of non-collected revenues, commercial impacts between HAL and non-airlines, and consideration of whether direct costs of airline-only ORCs should be transferred into airport charges are all, therefore, outside the scope of the independent review. We have now reproduced Condition 2.4 in the Terms of Reference to clarify that the approach to the review should be consistent with the obligations in HAL's licence.

With regard to evidence to be considered, HAL is required by its licence to facilitate this review and should, therefore, provide the independent reviewer with whatever information it reasonably requires. We do not anticipate this will extend to requiring HAL to share contractual arrangements with third parties with the independent reviewer but it will require full transparency from HAL of how costs are allocated to cost centres in its management accounting system and then allocated between activities and users, and of how fixed costs and annuities are recorded, calculated and allocated, so that the independent reviewer can assess whether the costs and cost allocations are reasonable. However, comparing HAL's costs with earlier periods, as suggested by IAG, is outside the scope of the review.

Arora Group's response

Arora expressed concern that the scope of the draft Terms of Reference is too narrow and will not include a comprehensive review of the costs used to calculate ORCs. In particular, it said that there should be a detailed review and sharing of how annuities are calculated (including review of HAL's fixed asset register to ensure the right costs are allocated to each Specified Facility), and the timeframe of the review should be expanded by at least two months to provide sufficient time to carry out a comprehensive review. It argued that the review should also compare ORCs set by HAL against those being applied at comparable UK airports, and identify reasons for volatility in HAL's ORC charges over time.

Arora also said that it would not be appropriate for the independent reviewer to be asked to review whether HAL's cost allocation methodology is informed by its competition law obligations, as this was a matter for HAL and the CAA.

CAA views

We agree with Arora that the review will need to be detailed and comprehensive in order to properly assess whether costs are allocated on a fair and reasonable basis. This is reflected in the draft Terms of Reference (item 1 under "Scope of the independent review") which requires the independent reviewer to "Determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified, are appropriate and have been assessed at a reasonable level of detail to support a robust cost allocation methodology...".

This will cover both the allocation of direct costs and the allocation of fixed costs, annuities and business rates. In relation to fixed costs and annuities specifically, the independent reviewer is also asked (item 4 under "Evidence guidance") to consider "a. the appropriate set of assets in the cost base for each individual Specified Facility" and "b. an appropriate allocation of shared assets in the cost base for each Specified Facility". We therefore consider these points are adequately reflected in the Terms of Reference.

Regarding timescales, while we agree a reasonably comprehensive review is required, we consider that this can be completed by the end of May 2024 given appropriate priority and allocation of sufficient resources. A later conclusion to the study may compromise the ability to consider the implications of the results of the study in time for 2025 ORC charging decisions.

Given the focus of the review on whether cost allocations at Heathrow are reasonable, we do not see a persuasive case for wider benchmarking, as the costs at other airports will reflect the specific circumstances of those other airports rather than Heathrow.

On competition, the Terms of Reference ask the independent reviewer to "consider...the extent to which HAL's cost allocation methodology is informed by its obligations under competition law and other relevant legislation". Our intention here is

for the independent reviewer to note any legal considerations identified by HAL as informing its cost allocation methodology, we are not asking the independent reviewer to give a view on whether any such obligations have been met or adequately considered.

Mills & Reeve's response (on behalf of Pandox / Hilton Garden Inn London Heathrow Airport)

Mills & Reeve cited previous concerns over the lack of transparency of ORC fixed costs to emphasise the importance of the transparency of the independent review, particularly in relation to the calculation of fixed costs and related assumptions such as identification of the relevant assets, depreciation profiles and discount rates.

Mills & Reeve also said:

- that the review should cover the calculation of fixed costs, as well as their allocation, and that the assumptions which informed the fixed costs included in Table 8.2 of the CAA's H7 Final Decision were outdated and should be reconsidered as part of the independent review;
- it would be inappropriate for HAL to appoint the independent reviewer, even with engagement with CAA and ORC users and that the CAA should ensure an appropriate appointment in consultation with all parties; and
- energy costs charged to its client by HAL were several times the market rate, and prevent, restrict and distort competition in relation to the provision of airport services at Heathrow - and reminded the CAA of its concurrent competition powers with the CMA in this regard.

CAA views

Transparency is an important principle underlying ORC pricing, and ORC users should be provided with sufficient information by HAL to enable them to understand how their charges have been calculated. The output of the study will be shared with the ORC governance groups and other ORC users, and the independent reviewer is expected to engage with ORC users in the course of the review.

We can confirm that the scope of the review covers the calculation of fixed costs: Item 1 of the Scope requires the independent reviewer to "Determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified, are appropriate and have been assessed at a reasonable level of detail to support a robust cost allocation methodology". If, following the independent review, it becomes apparent that an alternative level of fixed costs/annuities to that used at the H7 review would be more appropriate, we will consider the best approach to dealing with these matters (including avoiding 'windfall' losses or gains as noted above).

HAL's licence condition C2.4 requires HAL to appoint the independent reviewer following consultation with the CAA and ORC users. HAL is, therefore, not required to agree the appointment of the independent reviewer with ORC users. Nevertheless, to

ensure the credibility of the independent review, we will ask HAL to share with us its shortlist of firms for the review and how it will ensure that the appointed firm has no conflict of interest. HAL should also engage as appropriate with ORC users at this part of the process.

Finally, we note Mills & Reeve's comments on the CAA's wider competition powers, and its concerns expressed over energy costs. We also note that energy costs recovered by ORCs are within the scope of the independent review.

APPENDIX II

Terms of Reference

Background

Following the implementation of the H7 Final Decision, Condition C2.4 of HAL's licence states as follows:

"The Licensee shall facilitate and pay for an independent review of the appropriateness of the cost allocation methodology to validate that the cost allocation methodology ensures that the costs of the Specified Facilities are allocated between airlines and non-airline users of the Specified Facilities on a fair and reasonable basis. The terms of reference of the review shall be set by the CAA after consultation with the Licensee and users of the Specified Facilities. The independent reviewer for this purpose will be appointed by the Licensee following consultation with the CAA and users of Specified Facilities, and shall report to the CAA and copies of that report shall be made available to users of the Specified Facilities. The Licensee may recover its costs for this review through ORC charges."

In November 2023, the CAA consulted HAL and ORC users on a draft Terms of Reference for the review.

Scope of the independent review

The independent review will consider available evidence and, as appropriate, comment on and make recommendations for improvement of the cost allocation methodology for ORCs. The review will:

1. Determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified, are appropriate and have been assessed at a reasonable level of detail to support a robust cost allocation methodology. This will determine whether the right costs are used in the methodology;
2. Assess HAL's approach to the allocation of costs to each Specified Facility for which it charges ORCs. This will determine whether the right costs are allocated to each Specified Facility;
3. Assess HAL's approach to the allocation of costs to airline and non-airlines users of the Specified Facilities to determine whether it is fit for purpose to allocate costs between airline and non-airlines users on a fair and reasonable basis. This will determine whether the costs are correctly allocated between airline and non-

airline users of each Specified Facility across both ORC's and the Airport Charge; and

4. In the light of the above, assess the appropriateness of HAL's approach to the allocation of fixed costs and "annuities" to each Specified Facility and between airline and non-airlines users.

In assessing whether the costs are allocated on a fair and reasonable basis, the review shall consider whether the allocation of those costs reflect the ORC charging principles¹, including those of "transparency", "cost reflectivity" and that the "user pays".

The review shall also consider:

- the operation of the cost allocation methodology used by HAL to set ORC charges for 2024;
- the extent to which HAL's cost allocation methodology is informed by its obligations under competition law and other relevant legislation;
- whether HAL has considered any other matters when devising its cost allocation methodology;
- whether there are significant issues that may need to be addressed through HAL's licence to avoid windfall gains or losses for HAL;² and
- whether improvements need to be made to HAL's accounting and information systems/processes to improve the robustness of cost allocation for consideration by HAL, ORC users and the CAA.

Evidence guidance

Relevant sources of evidence for the independent review will include (but not be limited to):

1. CAA's H7 Final Decision and relevant guidance on ORCs;
2. HAL's approach to consulting on its cost allocation methodology and options for pricing;
3. ORC user feedback on the cost allocation methodology;
4. HAL's records and methodology for including:

¹ CAP2591 Page 13, ORC protocol principles

- a. the appropriate set of assets in the cost base for each individual Specified Facility;
- b. an appropriate allocation of shared assets in the cost base for each Specified Facility;
- c. an appropriate share of Operating Costs in the cost base for each individual Specified Facility and its allocation to different users; and
- d. an appropriate share of “on-costs” and overheads in the cost base for each Specified Facility and its allocation to different users.

Approach to the review

The timeline for the independent review process is as follows:

- 1 November 2023 – CAA consultation on draft Terms of Reference for comment;
- 28 November 2023 – deadline for comments;
- Mid-December 2023 – CAA publish final Terms of Reference (this letter and Appendices);
- January/February 2024 – HAL to procure and appoint the independent reviewer following engagement with the CAA and ORC users;
- March-May 2024 – independent review of HAL ORC cost allocation methodology;
- End May 2024 – independent review report to be submitted to CAA and ORC users.

The independent reviewer will be expected to have expertise in accounting practices as well as a good understanding of airport operations. In procuring the independent reviewer, HAL will need to assure their independence and that there are no conflicts of interest and/or that appropriate mitigations are put in place to manage any conflicts of interest.

The output of the study will be a report provided to the CAA, which will also be shared with the ORC governance groups and other ORC users. The independent reviewer should look to engage with HAL, the CAA and ORC users in the course of the review.

The independent review will need to be completed in good time for any issues to be addressed prior to the next ORC pricing consultation for 2025 due in September 2024. To facilitate this, the independent review should be completed by 31 May 2024 at the latest.