

# Setting future price controls – review of approach

CAP 2618

## Contents

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# Introduction and Summary

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## Purpose of the review and approach

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- 1.1 In 2023 we completed the price control reviews for Heathrow airport (“HAL”, the “H7” review) and for NATS (En Route) plc (“NERL”, the “NR23” review). Our final decision on the H7 review was referred to the CMA by both HAL and airlines. Following a detailed investigation, the CMA concluded that “the CAA’s Heathrow price control struck broadly the right balance between ensuring prices for passengers are not too high and encouraging investors to maintain and improve the airport over time”.<sup>1</sup> Nonetheless, we intend to review our approach to setting price controls to identify opportunities to improve the efficiency, timeliness and effectiveness of the processes and outcomes.
- 1.2 It is also important to recognise that the context, priorities and issues will be different for the future price controls for each of HAL and NERL (and that there are some differences in the statutory frameworks applicable to each). As a result, we will need to adapt our approach to ensure that the price controls we set continue to be relevant and meet our statutory duties in the Civil Aviation Act 2012 (“CAA12”) and Transport Act 2000 (“TA00”).
- 1.3 We are carrying out a review of our approach to setting price controls (including the lessons learnt from H7 and NR23) to inform our overall approach to future price controls. We will conduct this work in consultation with relevant stakeholders and we are discussing the scope and governance with the Department for Transport (“DfT”), to make sure there is sufficient independent input to appropriately support a robust and objective approach to this work.
- 1.4 We are working on the basis that this independent input should include the use of expert consultants to explore specific issues and the use of an advisory panel to comment on our overall approach and conclusions. We will seek to finalise the role and composition of the independent advisory panel in the coming weeks, alongside continuing to discuss the overall approach to independent input with the DfT.
- 1.5 We consider that this independent input should be appropriately targeted to provide a review of areas where we should consider different approaches to the next price controls for HAL and NERL. For example, it may be useful to seek external input from the advisory panel and expert consultants on topics such as:

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

- how we make sure the price control reviews reflect consumer priorities;
- our approach to assessing efficient opex and capex, including the benefits and resilience from planned investment;
- recent lessons learnt from other UK regulated sectors that could be applied to the CAA's price reviews; and
- our approach to gathering high quality business planning information from the regulated companies.

1.6 We welcome views from stakeholders on which topics we should seek external input on.

1.7 In July 2023, the DfT published its review of the CAA as part of the Cabinet Office Public Bodies review programme (the 2023 arms length body ("ALB") review of the CAA).<sup>2</sup> Our intention is that this CAA review will also meet recommendation 5.6 from the 2023 ALB review of the CAA, as set out in Figure 1 below.

#### **Figure 1: Recommendation 5.6 from the 2023 ALB review of the CAA**

The process for conducting economic regulation should be reviewed when the current Heathrow review (H7) is concluded.

Given the short timescales before the commencement of the H8 review, it is recommended that this review should be of the 'process, governance and mechanics' on the basis agreed between the CAA and DfT.

As the H7 decision is currently the subject of an appeal, it is inappropriate to make specific recommendations about the current process. However, we recommend that the review should include 'lessons learned' from all the CAA's economic regulatory activity, and not just H7.

In addition, the department, taking into account the views of the CAA and other interested parties, should consider whether a wider review of the basis, scale and scope of all the CAA's economic regulatory activity is required.

Source: Newman review published 17 July 2023.

1.8 The ALB review also said that the DfT should consider whether a wider review of the basis, scale and scope of all the CAA's economic regulatory activity is required. If the DfT decides to proceed with this wider review the CAA would support the DfT in completing this wider review as appropriate. This would be outside the scope of this lessons learnt review.

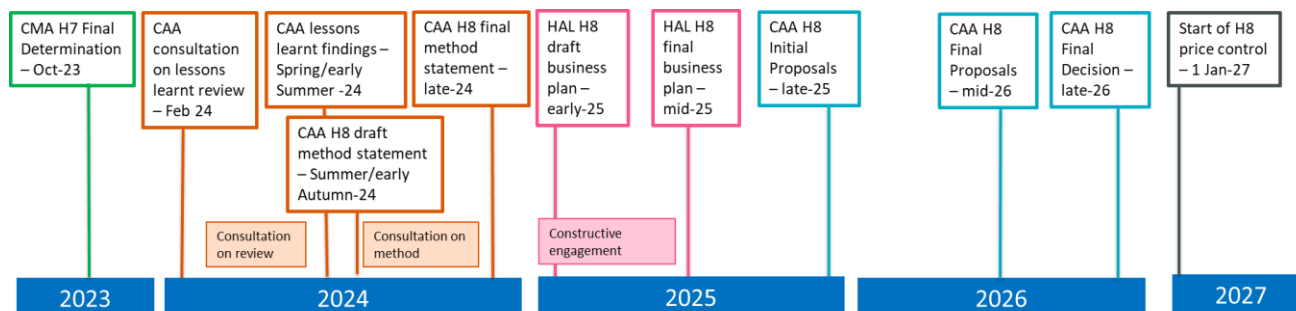
<sup>2</sup> [Civil Aviation Authority review - GOV.UK \(www.gov.uk\)](https://www.gov.uk/civil-aviation-authority-review)

## Scope of this review and timetable

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- 1.9 This document sets out our initial views on the scope of this lessons learnt review and on the key issues we should consider for the next price control reviews for HAL and NERL. For the lessons learnt and key issues, we have organised these around the three main themes set out in the recommendation from the ALB review, namely:
- the process for setting price controls. This should cover all steps of the process in how we set price controls and where we can make improvements;
  - the governance of price controls. This should cover the roles of CAA and other stakeholders and how we ensure that documents are high quality and the price control review will achieve its aims, and be timely and efficient; and
  - the issues around our approach to estimating the price control building blocks (including operating costs, capital expenditure and returns) that we use to determine the price control revenue that the licensee should recover over the period of the new price controls.
- 1.10 We welcome views from stakeholders on those issues we have identified and also welcome views on any areas that stakeholders think we should include in the scope of this lessons learnt exercise that are not identified in this consultation. Our approach to gathering stakeholder views is discussed further below.
- 1.11 This review will need to be completed in a timely way to feed into our approach to setting the next price control for HAL (starting 1 January 2027) and NERL (starting 1 January 2028). Figure 2 provides an indicative draft timetable for the completion of the next HAL price control review (H8). In order to start the H8 review in a timely way our present view is that we would need to be able to consult on a draft method statement for the H8 review by the summer or early autumn 2024. This means that there are some limitations to the time we have to complete this review as our conclusions will help determine the approach we take to both the H8 and NR28 reviews. We will seek to be flexible in our approach to this review, and in particular, try to distinguish between issues where decisions need to be made earlier to start the H8 process, and issues where we can take some more time before reaching decisions.

### Figure 2 – Indicative timetable for H8 price control review



Source: CAA

- 1.12 Before we finalise the timetable for the H8 review we will need to take account of stakeholder views and the findings from this lessons learnt exercise and review. We also note that the timetable for the NR28, if left unchanged, would naturally follow on just one year behind the H8 review and there would be significant overlap between these processes. In chapter 2 we explore options for reducing the overlap between these two price control reviews.
- 1.13 The aim of this consultation is to provide an initial view on the lessons learnt from the H7 and NR23 reviews and to start to identify the key issues for the H8 and NR28 reviews. We are seeking stakeholders' views on which issues should be considered as part of this review and that input will inform the final scope of this review. The intention is to discuss the lessons learnt with stakeholders over the coming months with a view to reaching conclusions on these matters in spring or early summer 2024.
- 1.14 If stakeholders also have initial views on the answers to the questions on each key issue set out in chapter 2, it would be helpful to understand these views and the supporting reasons as soon as practicable so to help inform our overall judgements on the scope of the review and the draft method statement for the H8 review. We will look to identify key issues for the H8 review and publish a draft method statement for the H8 review by summer 2024.
- 1.15 The relatively tight timetable for this review means that broader and more strategic issues will require more extended assessment and consultation over a longer timetable before we can reach a view on the appropriate way forward. We have identified some of these issues in chapter 3 and welcome views of stakeholders both on the scope of the issues we have identified as well as any initial views on the issues themselves. We will want to discuss with DfT to what extent the work on these issues forms part of the CAA's work or is part of any wider DfT review on the basis, scale and scope of all the CAA's economic regulatory activity, as set out in the recommendation from the 2023 ALB review.

## Views invited

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- 1.16 We are consulting and seeking views on all parts of this document, including the scope of the lessons learnt review, the key issues, the broader strategic issues and next steps.
- 1.17 As part of our proposed approach to stakeholder engagement on this review, we have arranged workshops between CAA and stakeholders to seek views on particular issues, and we may follow these with structured interviews to seek on particular issues. A key focus of this engagement will be ensuring that we properly understand and explore stakeholders views on the lessons learnt from the H7 and NR23 reviews. This is in addition to written submissions in response to this consultation. For reference, we provide a list of the key documents and price control building blocks for each of the H7 and NR23 price controls in appendix B.
- 1.18 Responses to this consultation should be clearly labelled which area they are responding to and sent to [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk) by 17:00 on 20 March 2024.
- 1.19 We expect to publish the submissions we receive on our website as soon as practicable after the consultation period ends. Any material that is regarded as confidential should be clearly marked as such, with an explanation of why the information is confidential, and included in a separate annex. We have powers and duties with respect to the disclosure of information under Schedule 9 of the TA00, Section 59 of CAA12 and the Freedom of Information Act 2000 and it may be necessary to disclose information consistent with these requirements.
- 1.20 Any questions related to this decision document should be sent to Stewart Carter at [stewart.carter@caa.co.uk](mailto:stewart.carter@caa.co.uk).



## Chapter 2

# Scope of the review and key issues

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## Purpose of the review

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- 2.1 The purpose of our review is to help ensure our approach to economic regulation:
- is fit for purpose and achieves outcomes that meet our primary and secondary statutory duties under CAA12 (for the regulation of HAL) and TA00 (for the regulation of NERL), including furthering the interests of customers and consumers;
  - allows for the setting of price controls in an efficient, effective and timely way, including effective consultation with stakeholders; and
  - is flexible to respond to challenges and changes the sector will be facing in the future.
- 2.2 It will also meet the recommendation of the ALB review as we will consider the process, governance and mechanics of how we set price controls, drawing on lessons from the recent reviews for HAL and NERL.
- 2.3 Nonetheless, there is a relatively short timescale for this review given the timetable for the next HAL and NERL price control reviews. Bearing this in mind this review will focus on lessons learnt from our previous reviews and key issues for the H8 and NR28 reviews.
- 2.4 We expect to focus on the key areas where we can improve on the efficiency and effectiveness of the current approach, and how we can adapt our existing frameworks to improve outcomes for consumers.

## Overall scope

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- 2.5 The recommendation from the ALB review is that we should review the lessons learnt *“from all the CAA’s economic regulatory activity, and not just H7.”*
- 2.6 This review of the lessons learnt will focus on how we set price controls for HAL and NERL, and any areas with direct links to the price controls, such as the airport charging regulations. We do not propose to review the economic regulation of airports that have not been found to have met the market power test in CAA12 or other areas of economic regulation.
- 2.7 The review of the commitments framework that applies to Gatwick Airport Limited (“GAL”) will also be outside the scope of this review. The current GAL price control arrangements are subject to an ongoing review and are based on a

lighter touch set of commitments, that encourage bilateral contracting between the airport and airlines. Nonetheless, we will consider any lessons learnt from the regulation of GAL for our work on the HAL and NERL price controls.

- 2.8 The ALB review suggested the lessons learnt review should consider the “process, governance and mechanics” of how we regulate. We understand this to mean we should consider lessons learnt on:
- the process for price controls. This should cover the steps of the process in how we set price controls and where we can make improvements;
  - the governance around price controls. This should cover the roles of CAA and other stakeholders and how we ensure that documents are high quality and the price control review will achieve its aims, and be timely and efficient; and
  - the issues around our approach to estimating the price control building blocks (including operating costs, capital expenditure and returns) that we use to determine the price control revenue that the licensee should recover over the period of the new price controls.
- 2.9 This review will not include issues around implementation of price controls, monitoring and enforcement.
- 2.10 The aim of this consultation is to identify the key issues for this review. Set out below is an initial list of key issues with lessons learnt and key questions that we will need to consider for the approach to the H8 and NR28 reviews. We are seeking stakeholders’ views on which issues should be considered as part of this review, and that input will inform the final scope of this review. In the light of this feedback and our further assessment we will consider whether we should streamline the existing list of issues and/or add new issues, with a view to ensuring our work to develop the approach to the H8 and NR28 price control reviews is appropriately targeted and proportionate. The intention is to discuss the lessons learnt with stakeholders over the coming months with a view to reaching conclusions on these matters in spring or early summer 2024.
- 2.11 If stakeholders also have initial views on the answers to the questions on each key issue, it would be helpful to understand these views and the supporting reasons so to help inform our overall judgements on the scope of the review and the draft method statement for H8. We will look to identify key issues for the H8 review and publish a draft method statement for the H8 review by summer or early autumn 2024. The draft method statement on H8 will be for consultation and stakeholders will be able to comment on the key issues for the H8 review.
- 2.12 We also provide examples in the next chapter on the broader strategic issues that it may be helpful to consider. Given the time available for this review, we intend to deal with these broader strategic issues to a separate and longer timetable. These issues will typically require more extended assessment and

consultation before we can reach a view on the appropriate way forward. We would welcome stakeholder comments on these issues and our broad approach to dealing with them over a longer timetable.

## Key issues for the review

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- 2.13 As set out above, this section contains an initial draft list of key issues, lessons learnt and key questions that we will need to consider for the approach to the H8 and NR28 reviews. We are seeking stakeholder views on these. We are also open-minded to other views where stakeholders consider we should take a different approach.
- 2.14 In considering the lessons learnt from the most recent reviews, it is important to reflect on the context in which those reviews occurred. In the case of H7, the review initially started with an expectation that the price control would be an important part of the regulatory arrangements for a third runway at Heathrow. However, there were significant changes in circumstances as the review progressed, including the impacts of the covid-19 pandemic and the need to refocus the review on a two runway airport, and these matters contributed significantly to the delays in the price control review process. In a similar way with NR23, the review followed on from a shorter than usual price control (with this shorter duration reflecting the uncertainties created by the pandemic) and required significant extra work to reconcile to actual costs, and was completed later than planned. In learning lessons it is important to reflect on how much this context affected the reviews, and the degree to which those factors would occur in the future.
- 2.15 While this review in part focuses on what the CAA can do differently in terms of the process for the review, it is important to also consider the roles played by the regulated entities and their airline customers in the reviews. We would encourage those parties to consider in their responses, and perhaps through engagement with each other, what suggestions they can make about how they can best work together in future reviews.

## The process for setting price controls

- 2.16 Market power: CAA12 sets out a process for market power determinations of airports. Only if we have found that an airport operator meets the market power test, and that price control regulation is a proportionate and appropriate response to that market power, can we set price controls. We last completed and published market power determinations for Heathrow and Gatwick airports in 2014. Our initial view is that a change in this assessment for Heathrow would seem to be highly unlikely, particularly given the recovery in traffic levels since the progressive removal of covid-19 traffic restrictions and the runway capacity constraints are likely to endure at the airport at least in the medium term.

2.17 With respect to NERL the TA00 does not provide for market power determinations. The provision of en route air traffic services by NERL are widely regarded as a monopoly activity where ongoing regulation and price control will be appropriate.

**Lessons learnt:** our existing approach to dealing with the risk of abuse of substantial market power by HAL and NERL is reasonable, through economic regulation and licences.

**Questions for the review:** is our initial view on HAL's market power assessment reasonable and are there any other factors that you consider would have a material impact on the outcome of a market power determination for HAL?

2.18 Objectives: we will consider defining specific objectives for either or both of the upcoming HAL and NERL price controls. These objectives would complement and be fully aligned with our statutory duties and could be useful if there are any specific factors that will be especially important for forthcoming reviews. For example, in January 2017 we consulted stakeholders on our proposed priorities for the H7 review, following the Government's announcement of its preferred option for airport expansion in the South-East of England.<sup>3</sup> Equally, identifying specific objectives could be useful if there are desired outcomes that it will be important to prioritise in future price control reviews.

**Lessons learnt:** the use of key policy objectives can help in providing a clear focus for the work of the price control review.

**Questions for the review:** are there particular outcomes or objectives the CAA should focus on as part of the upcoming HAL and NERL price controls?

2.19 Proportionate and transparent regulation: for NERL in particular, we consider that the RP3 and NR23 reviews have highlighted the complexity of the price control framework. The current regulatory framework for NERL has increased in complexity through recent price controls to respond to the impact of the covid-19 pandemic on traffic levels, deal with other uncertainties and respond to new requirements such as airspace modernisation and new users of airspace, while continuing to have regard to the Eurocontrol Principles.

2.20 We consider there may well be ways in which our regulation of NERL could be simplified and made more proportionate without making fundamental changes to the nature of the regulation or to the allocation of risks. For example, the calculation of charges and the RAB could be simplified by removing specific true up mechanisms where there is no evidence of asymmetry in the underlying risk that they relate to.

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<sup>3</sup> See [CAP 1510](#).

- 2.21 We will consider lessons and opportunities to make our approach and framework more proportionate and transparent. This could include simplifying certain aspects of the regulatory framework, especially where they have been modified to become increasingly complex over time, and also considering whether there are opportunities to improve consistency between different parts of the framework. We are mindful of the need to continue to discharge our statutory duties, and to have regard to the Eurocontrol Principles as we make any changes.
- 2.22 We invite stakeholders to suggest areas of regulation that could be simplified and to share their views on the relative merits of seeking to simplify the regulation of HAL and NERL.
- 2.23 Lessons learnt:** for NERL in particular we should look at opportunities to simplify the regulatory framework.
- Questions for the review:** are there areas of the H8 and NR28 frameworks that should be simplified or where the current approach is not transparent or proportionate?
- 2.24 Constructive engagement: constructive engagement involves detailed discussion between the regulated company and its airline customers and has been a key part of the price control process for a number of periods. This process was disrupted during H7 due to the impact of the covid-19 pandemic. We intend to consider how well constructive engagement has worked and whether there are opportunities to refine the scope, nature or timing of the process to improve its effectiveness at future price control reviews.
- Lessons learnt:** constructive engagement continues to be an important part of the process for setting price controls in the aviation sector.
- Questions for the review:** do you have suggestions on how to improve constructive engagement for H8 and NR28? Do you have suggestions for how the regulated entities and airline customers could best work together and engage effectively in future reviews?
- 2.25 Timetable: the timetables for H7 and NR23 were extended a number of times (including to allow licensees more time to provide business plan information, for stakeholders to respond to consultations and for the CAA to complete further analysis). While external events around expansion at Heathrow airport and the impact of the covid-19 pandemic were significant drivers of these delays, we recognise there may be scope to improve the process to make the process more robust, efficient and timely.
- 2.26 One of the issues that we face is the difficulties created for the CAA in appropriately resourcing both the HAL and NERL price control reviews when they run in parallel, which would risk delays to the process and undue pressures

on CAA and stakeholders. Our initial timetable for the H8 review envisages that it will start in 2024 with final decisions being made in late 2026. The NR28 price control would naturally follow a year behind, which would create the parallel running of these reviews through 2025 and 2026. One option to reduce the amount of parallel running would be to start the NR28 review a year later and make final decisions on these matters in 2028, rather than 2027. Nonetheless, there would also be disadvantages in this approach as we would need to put in place interim price control arrangements for 2028, which would be trued up/down against our final decision.

**Lessons learnt:** running the H7 and NR28 price control reviews in parallel put a significant strain on CAA resources, which contributed to the delays to the price control reviews.

**Questions for the review:** do you have views on the timetables for H8 and NR28, including the advantages and disadvantages of completing the NR28 review between 2027 and 2028?

## Governance around price controls

2.27 Management of process: we intend to review our approach to managing the overall price control review process to make sure it is effective and timely. As well as looking at CAA processes, we will consider the need for clearer and stronger expectations around timely submissions of information and responses to consultations from HAL, NERL and other stakeholders. During the recent reviews, some submissions to consultations and responses to requests for information have been provided late or incomplete, which have contributed to the need for further correspondence to confirm information and hence delays to the review process.

2.28 In relation to the governance within CAA for making decisions it will be important that the CAA Board retains overall responsibility for making key decisions, but we will consider whether there is scope to make better use of a board sub-committee and external advisors to support robust decision making and senior level interactions with stakeholders.

**Lessons learnt:** to support the timely delivery of our work programmes we should have a focused decision making process and stronger expectations around the timely provision of information by licensees and stakeholders.

**Questions for the review:** do you have any views on governance and whether there are examples that the CAA should consider in terms of best practice in making decisions on price controls or similar issues?

2.29 Engagement and taking account of stakeholder views: we intend to review our approach to engaging with stakeholders during the price control process, including regulated companies, airline customers and consumers. This is to

make sure we have a robust and transparent process and can demonstrate how we have considered and where appropriate taken into account consumer and other stakeholder views.

- 2.30 Effective stakeholder engagement also depends on the quality of information that we provide to stakeholders. We will consider the outputs from the recent regulatory reviews, and consider whether these are fit for purpose, transparent and appropriate for the audience. This includes external communications, consultation documents, the licence, price control models and supporting materials.
- 2.31 The regulated companies and airlines are involved in price control reviews in different ways, including constructive engagement as described above, as well as their inputs into and responses to our own regulatory processes. We will aim to take a holistic view of different parties' roles in the reviews, and whether there are opportunities to improve the effectiveness of their input within the overall process.
- 2.32 We will also want to consider how best to ensure that we continue to understand consumers' views and make sure these are appropriately reflected in the business plans of regulated companies and our decisions on price controls.

**Lessons learnt:** we should consider how to best engage with stakeholders during the price control review process and how we reflect consumer views.

**Questions for the review:** how should we ensure that consumer views are understood and reflected in our approach to setting price controls? How effective was the consumer research for H7 and NR23 and what improvements could be made for the next price reviews? How could the CAA improve its engagement with stakeholders for H8 and NR28?

- 2.33 Guidance and information gathering: During recent price controls there have been a number of issues around the quality and timeliness of information provided by stakeholders to support the price review process. We will consider whether there are opportunities to make our guidance more effective and whether there are other measures to secure the provision of high quality business plans and other information in a timely way. We will also consider the potential role of our formal information gathering and related powers.

**Lessons learnt:** we should consider how to improve the quality of information that we receive from stakeholders during the price control review.

**Question for the review:** how should the CAA secure the provision of timely and high quality information to support the H8 and NR28 reviews?

- 2.34 Expert advice and quality assurance: for both H7 and NR23, we used external experts to provide analysis and advice on key areas of the price controls

including cost assessment, pension costs, cost of capital and assurance of price control models. We intend to review lessons from how we use external consultants and advisors for the price controls, to make sure this is appropriately targeted and effective.

**Lessons learnt:** the use of external consultants and advisors provides vital support to our price control reviews and we should consider how to make best use of these resources in the future.

**Questions for the review:** do you have any views on the quality of the reports that we published by our external consultants during H7 and/or NR28 and do you have any suggestions for how we should best use external consultants and advisors in the future?

## Approach to key price control issues and building blocks

- 2.35 Passenger forecasts: even with the introduction of traffic risk sharing arrangements for both HAL and NERL, the passenger/traffic volume forecast remains an important part of the price reviews and has a significant impact on the allowances for costs. It was particularly contentious for the H7 review, in part because many of the external forecasts that are available do not focus on passenger numbers at Heathrow. We will consider whether there are lessons we can learn from the H7 and NR23 review. For NR23, forecasts from external sources are more readily available and their use is broadly supported by stakeholders). One option might be to commission an independent third party to develop a forecast that can be used for the purpose of setting the next price control for HAL.
- 2.36 In considering the approach to volume forecasting it is necessary consider both the frequency and timing of forecasts to use for the price control reviews as it is important to both allow time for consultation and for the forecast to reflect recent market conditions and trends.
- Lessons learnt:** we should consider how best to improve our approach to passenger forecasting for the H8 review.
- Question for the review:** how should we develop passenger forecasts for H8 and what are your views on using external forecasts?
- 2.37 Service quality: the H7 review started a transition towards outcome-based regulation (“OBR”), which was an important evolution of our previous approach to the regulation of service quality at Heathrow. This transition allows for a greater focus on outcomes and overall satisfaction of consumers/passengers at the airport. For NR23, we retained, in broad terms, the same approach from the previous price control for service quality measures and incentives. This is informed by the metrics and targets used across EU air navigation service providers.



2.38 We will consider whether we can improve the incentives on HAL and NERL to provide appropriate levels of service quality to consumers, as well as how we demonstrate consumers are receiving value for money. We have committed to a separate mid-term review of OBR,<sup>4</sup> though we will need to do further work on the approach for the H8 price review.

2.39 For NERL, we will need to consider any recommendations coming out of the independent review of the air traffic systems failure in August 2023. We have also stated in our final decision for NR23 that there should be a wider review of how environmental performance is measured for future price controls.

**Lessons learnt:** there is scope to consider how to further improve the regulation of service quality for both HAL and NERL.

**Question for the review:** are there changes to our overall approach to service quality issues that we should consider for H8 and NR28?

Traffic risk sharing: at the H7 and NR23 price control reviews we put in place traffic risk sharing arrangements. These arrangements share the risk between the licensee and its customers of unexpected variations in passenger volumes / traffic levels. They are designed to protect the regulated business from undue risk and prevent unnecessary increases in its cost of capital that would lead to higher charges for customers. For both NERL and HAL, we will consider how traffic risk sharing arrangements should best evolve. We note that these arrangements are relatively new for HAL and we will want to ensure that they are in the interests of consumers before considering our approach for the H8 price control.

**Lessons learnt:** traffic risk sharing arrangements can provide useful protections for both the regulated business and consumers.

**Question for the review:** are there any changes in our overall approach, or specific factors that we should take into account, when considering whether and how to implement traffic risk-sharing for H8 and NR28?

2.40 Cost assessment: a key part of our work at a price control review involves assessing the efficient level of costs that the regulated business is likely to incur in meeting the needs of consumers and its customers. We will review the lessons learnt in relation to how we have set allowances for opex, capex and non-regulated revenues in respect of H7 and NR23. We will consider how well our existing approach and methods for cost assessment have worked and the opportunities for improvements.

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<sup>4</sup> The scope of this review is set out in paragraph 3.38 of [CAP 2524B](#).

2.41 For H8 and NR28, we will consider our overall approach to cost assessment, including how we reach an independent view of costs, the balance of top-down and detailed assessments and different tools we should use, such as benchmarking, and detailed assessments of productivity and input prices. For capex programmes, we will also need to consider our expectations for justification of capex programmes when setting allowances and whether there is scope to rely more on commercial prices and incentives for large scale capital projects.

**Lessons learnt:** we should consider how best to improve our approach to cost assessment.

**Questions for the review:** what are your views on our approach to cost and commercial revenue assessment for H7 and NR23? How should we change our approach for H8 and NR28?

2.42 Opex and capex incentives: a key objective of the price control review is to provide incentives for efficiency. In the H7 review we introduced a new framework for forward-looking (“*ex ante*”) capex incentives. These will need time to bed in and for us to assess the scope for further improvements. For NR23, we continued to assess the efficiency of capex on a backward-looking (“*ex post*”) basis, but said that we would consider the approach to capex incentives for NR28. For both H7 and NR23, the risk of overspend and underspend on opex continues to be held by HAL and NERL respectively, except for specified types of costs.

2.43 For H8 and NR28 we will consider whether we can further strengthen incentives for efficiency and delivery, while not creating undue risks that would make the financing of capital investment more costly. For NR23, we commissioned Egis to review key capital programmes for NR23. One of the recommendations, which we will consider as part of this work for NR28, is for the CAA to consider “*mechanisms for incentivising efficiency, delivery, and benefits in NERL’s capex programme.*”<sup>5</sup>

**Lessons learnt:** setting incentives for efficiency remains an important part of the price control review process.

**Questions for the review:** what are your views on our existing approach to opex and capex incentives? Are there options we should consider for H8 and NR28 to strengthen incentives for efficiency and service delivery?

2.44 Contributing to the UK aviation sector reaching net zero: during the H7 review we made allowances for HAL to deliver a number of projects that will support the airport’s transition to net zero. The NR23 price control includes incentives for

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<sup>5</sup> Egis, Review of key capital programmes proposed by NERL for the NR23 period, 26 October 2023

NERL to provide air traffic services in a way consistent with the provision of efficient flight paths for the airlines that use its services.

- 2.45 We also address questions relating to the environment in the section on broader strategic issues below, where we consider whether HAL or NERL could play a wider role in the changes needed across the aviation sector in order to achieve net zero.

**Lessons learnt:** the existing price control framework provides a reasonable basis for allowing licensees to contribute towards the UK's legally binding target to reduce all greenhouse gas emissions to net zero.

**Questions for the review:** are there more steps that HAL or NERL could reasonably take during H8 and NR28 to contribute towards net zero? Are there any changes the CAA should make to enable this?

- 2.46 Inflation indexation: we currently estimate the cost of capital and level of return on a real basis and allow for the impact of inflation on returns by indexing the HAL and NERL regulatory asset bases ("RABs") by the retail prices index ("RPI"). Given that there are issues with the reliability of RPI as a price index, the government has set out plans to align RPI with the consumer prices index including owner occupiers' housing costs (CPIH) by 2030, during the future price control periods. Bearing this in mind there may be advantages of using CPI or CPIH indexation for prices, the RAB and the calculation of a real cost of capital for H8 and NR28.

**Lessons learnt:** we should consider how we treat inflation in setting price controls, including with respect to the indexation of the RAB and the cost of capital.

**Questions for the review:** do you have any views on our plan to consider the approach to indexation for H8 and NR28 and our initial view that we should adopt CPI or CPIH indexation?

- 2.47 Cost of capital: in setting price controls we make an estimate of the regulated company's cost of capital and use this to make a projection of the appropriate return for the capital invested in the business. The CMA considered our approach to these matters as part of its work on the appeals of our H7 price control decision and supported the broad approach we had taken. We also adopted a similar approach to setting the cost of capital for NR23 as we did for H7. Bearing these factors in mind we expect to carry forward various aspects of our H7 and NR23 approaches in setting the cost of capital for H8 and NR28 respectively.

- 2.48 Nonetheless, our approach will need to be adapted and improved to keep pace with emerging precedent and changing market conditions. Areas that we will likely consider include alignment with the UKRN's cost of capital guidance; the

treatment of inflation in the estimation of the cost of capital; estimation of the Total Market Return and Equity Risk Premium in light of persistently high interest rates; the appropriate notional gearing assumption; changes to the cost of new debt indexation mechanism; and how we should take account of new market information in estimating asset beta.

**Lessons learnt:** we should build on the CMA's assessment of our work on the cost of capital to inform our approach to these matters at future price reviews.

**Question for the review:** do you have a views on the areas that it will be particularly important to focus on in estimating the cost of capital at H8 and NR28?

2.49 RAB and depreciation: the RAB of each licensee reflects the store of value of capital invested in the business. It is key to providing investors with a reasonable degree of certainty about the future and allowing for the costs of investment to be spread over a number of price control periods. We currently do not plan to change the overall framework for H8 and NR28 of setting price controls based on a single-till RAB framework for a period of five years.

2.50 HAL has a relatively large RAB and the allowances for regulatory depreciation and returns that this creates make significant contributions to the overall level of HAL's airport charges, which are relatively high when compared to other UK and overseas airports. Bearing this in mind there are important questions about the future profile of HAL's regulatory depreciation, its relationship with expected capital expenditure and whether further increases in HAL's RAB would be in the interests of consumers.

2.51 For NERL, there are a number of different incentive mechanisms where adjustments are made to the RAB rather than directly to revenues. In addition to considering the approach to depreciation, we also consider whether there are opportunities to simplify the future price control framework and adjustments to the RAB.

**Lessons learnt:** we should consider the approach to regulatory depreciation and RAB adjustments to ensure that they remain consistent with our statutory duties and continue to support efficient investment.

**Questions for the review:** Do you have any views on the factors we should consider in establishing an approach to regulatory depreciation for H8 and NR28? Are there any changes we should consider to the existing regulatory mechanisms that lead to RAB adjustments?

2.52 Package of incentives and risk sharing arrangements: incentives for efficiency and quality of service and risk sharing arrangements are key to creating a balanced approach to price controls. The incentives should also work together as a package as well as in relation to the specific area of focus. Key considerations

include whether the package is proportionate, appropriately targeted and a 'fair bet' (that is, the expected and allowed returns are broadly equal, and where appropriate there are opportunities for the company to earn financial upside when it outperforms, as well as financial penalties when it underperforms).

**Lessons learnt:** we should consider whether we should increase the focus and transparency we give to the overall package of incentives.

**Questions for the review:** do you have any views on how we should assess the package of incentives and risk sharing arrangements for H8 and NR28?

2.53 Financeability: in setting a price control we test whether an efficiently financed licensee (i.e. with an efficient balance of debt or equity financing, or 'notional' financial structure) can reasonably finance its activities. This is designed to help ensure the business can continue to finance investment in an efficient way and is consistent with our statutory duties to have regard to the financeability. The approach to testing debt financeability is relatively well established and we intend to adopt broadly the same approach at future price control reviews.

2.54 For equity financeability, we have taken somewhat different approaches in the NR23 and H7 price controls and, in each, our approach has evolved over the course of the price control. We intend to further consider our approach to these matters and, if appropriate, consider changes to our approach to take a consistent approach across licensees.

**Lessons learnt:** we should consider further our approach to testing equity financeability.

**Questions for the review:** do you have any views on our approach to assessing equity financeability and any changes we might consider?

2.55 Other regulated charges (ORCs): in setting the H7 price control we took into account the costs of HAL providing a range of services to its customers that are outside the scope of its airport charges. Recognising the importance of these services the H7 decision introduced new rules for the governance of ORCs as well as requiring the conduct of an independent review of HAL's approach to cost allocation which supports it setting charges for these services.

**Lessons learnt:** we intend to let the changes introduced at H7 and for the work of the independent review to conclude before considering any further changes to the regulatory framework for ORCs.

**Questions for the review:** is the approach of waiting to see the impact of changes to governance arrangements and the results of the independent review a reasonable and proportionate way forward?

## Chapter 3

## Broader strategic issues

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- 3.1 In addition to the lessons learnt exercise and considering our approach to the H8 and NR28 review, we will also consider broad longer-term issues around how we set future price controls. This work will be outside the scope of this lessons learnt review, so that this review remains appropriately focused on issues to be considered for the next HAL and NERL price controls (H8 and NR28). The conclusions from work on these broader issues may however inform our approach to H8 and NR28 where it is practicable to do so in the time available.
- 3.2 We set out below our initial views on the broader strategic issues that it will be appropriate to consider. We will want to discuss with DfT to what extent the work on these issues forms part of the CAA's work or is part of any wider DfT review of the basis, scale and scope of all the CAA's economic regulatory activity, as set out in the recommendation from the 2023 ALB review.
- 3.3 We would welcome any early stakeholder views on these issues, if and how they should inform our approaches to H8 and NR28, and whether these issues should be taken forward as part of the CAA's review or any wider DfT review, as set out above.
- 3.4 Form of controls: we intend to consider whether there are opportunities to improve the form of future price controls applied to HAL and NERL respectively. This will incorporate consideration of aspects of the design of the existing controls including the duration of the price controls and the treatment of non-regulated and commercial revenues within these price controls.
- 3.5 We currently do not plan to change the overall framework for H8 and NR28 of setting price controls based on a single-till RAB framework for a period of five years. Nevertheless, we could consider alternative treatments for specific costs or parts of the price control, particularly if there was a strong case that by doing so we could improve incentives for efficient investment and deliver better outcomes for consumers.
- 3.6 Environmental sustainability: we will consider how H8 and NR28 can contribute towards the CAA's wider environmental sustainability strategy<sup>6</sup>. The UK aviation sector is transitioning to net zero carbon emissions by 2050 and Government

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<sup>6</sup> <https://www.caa.co.uk/consumers/environment/environmental-sustainability-strategy/>

recognises that its Jet Zero Strategy<sup>7</sup> will need to be supported by a range of actions, including:

- the delivery of the Airspace Modernisation Strategy (“AMS”); and
- investment in infrastructure at airports<sup>8</sup>.

- 3.7 Our future price control frameworks need to appropriately support HAL’s and NERL’s plans to transition to net zero, for example through business plan and service quality incentives. We will review our price control frameworks to ensure that they do not inadvertently create longer-term barriers to delivering net zero and we will consider whether new policies are needed to support transition of the sector and the environmental sustainability agenda.
- 3.8 Expansion at Heathrow airport: HAL’s plans for capacity expansion with the third runway remain paused and our present assumption is that its H8 business plan will focus on the operation of a two runway airport. However, we will keep this under review, including how best to address issues relating to capacity expansion and in particular a third runway at Heathrow, if they arise again in the future.
- 3.9 Provision and operation of new infrastructure at Heathrow airport: our most recent involvement with expansion plans at Heathrow also involved an early consideration of the potential issues arising from a third party proposal to provide and operate part of the infrastructure at the expanded airport. We will consider how we might approach similar issues in future, including assessing whether a continuation of our largely reactive approach (dealing with the issues associated with a specific proposal) remains appropriate.
- 3.10 Scarcity rents: the existence and implications of scarcity rents were debated extensively during H7, both in the context of expansion and in setting price caps for a two-runway airport from 2020 onwards. We will consider whether there is merit in further examining scarcity rents and relatedly whether and to what extent airport charges are passed through to consumers, noting that a considerable volume of evidence already exists in respect of both questions. We will also consider the implications of this work for the wider regulatory framework for HAL.
- 3.11 Airspace modernisation and new users: our NR23 review considered how best to support airspace modernisation and ensure our decisions did not create barriers relating to the emergence of new types of airspace user. The Airspace Modernisation Strategy covers the period out to 2040, and we will need to consider the Strategy’s Elements as they relate to HAL, NERL, and government policy in developing our approach to H8 and NR28. Alongside this, we will also

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<sup>7</sup> [Jet Zero strategy: delivering net zero aviation by 2050 - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/jet-zero-strategy-delivering-net-zero-aviation-by-2050)

<sup>8</sup> [2040 zero emissions airport target - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/2040-zero-emissions-airport-target)

need to ensure we take account of relevant outputs and outcomes from CAA, government and industry's Future of Flight activities.

- 3.12 Charges and Airport Charges Regulations (ACRs): currently HAL has a relatively high degree of discretion on decisions regarding the structure of its charges, as long as they are compatible with the broad principles set out in the ACRs. We could consider whether to retain the current "ex post" approach to regulating the structure of HAL's charges and compliance with the ACRs, and/or whether there are steps we should take to further other policy objectives, such as on environmental sustainability.



## APPENDIX A

# Abbreviations

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Abbreviations	
ACRs	Airport Charges Regulations
ALB	Cabinet Office Public Bodies review programme (the 2023 arms length body review of the CAA)
AMS	Airspace Modernisation Strategy
CAA	UK Civil Aviation Authority
CAA12	Civil Aviation Act 2012
Capex	capital expenditure
CMA	Competition and Markets Authority
CPI	consumer prices index
CPIH	consumer prices index including owner occupiers' housing costs
DfT	Department of Transport
EU	European Union
GAL	Gatwick Airport Limited
H7	the HAL price control period from 2022 to 2026
H8	the next HAL price control review
HAL	Heathrow Airport Limited
NERL	NATS (En Route) Plc
NR23	the NERL price control period from 2023 to 2027
NR28	the next NERL price control review
OBR	outcome-based regulation for HAL
Opex	operational expenditure
RAB	regulatory asset base
ORCs	other regulated charges

RPI	Retail prices index
TA00	The Transport Act 2000
TSU	Total service unit
WACC	weighted average cost of capital

## APPENDIX B

## H7 and NR23 process

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- 3.13 This appendix sets out, for reference:
- the key documents for each of the H7 and NR23 price control reviews; and
  - the price control building blocks for the H7 and NR23 price control reviews.

### Key documents for H7

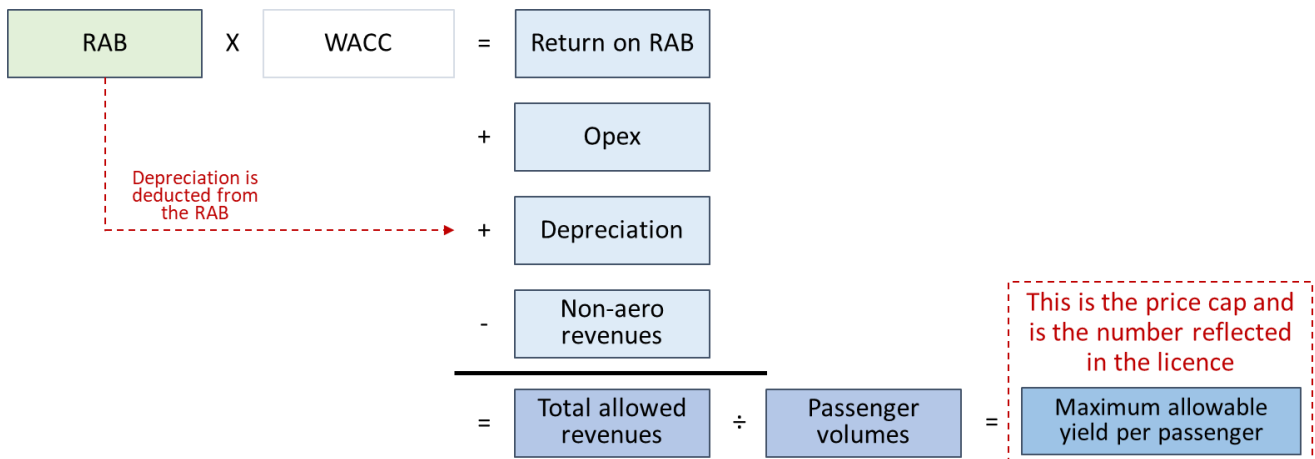
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- 3.14 We set out below a list of the key CAA and CMA documents for the H7 review. This excludes related working papers, consultant reports and documents relating to interim price caps.
- Strategic themes for the review of Heathrow Airport Limited's charges: A discussion document (CAP 1383), March 2016;
  - Discussion papers on: Promoting cost efficiency and financeability; Empowering consumers and furthering their interests; Incentivising the right consumer outcomes; and Increasing airport resilience, April 2016;
  - Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime (CAP1476), December 2016;
  - Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control (CAP1540), April 2017;
  - Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow (CAP1541), June 2017;
  - Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP1610), December 2017;
  - Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP1658), April 2018;
  - Economic regulation of capacity expansion at Heathrow: working paper on the cost of capital and incentives (CAP1674), May 2018;
  - Update on cost of capital for RP3 and H7 (CAP1762), February 2019;
  - Economic regulation of capacity expansion at Heathrow: policy update and consultation (CAP1782), March 2019

- Heathrow expansion – affordability and financeability update (CAP1812), June 2019
- Economic regulation of Heathrow Airport Limited: policy update and consultation on the early costs of capacity expansion (CAP1871), December 2019
- Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues (CAP1876), January 2020
- Economic regulation of Heathrow: programme update (CAP1914), April 2020
- Economic regulation of Heathrow: policy update and consultation (CAP1940), June 2020
- Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment (CAP1966), October 2020
- Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment (CAP2098), February 2021
- Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (CAP2139), April 2021
- Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment (CAP2140), May 2021
- Economic regulation of Heathrow Airport Limited: H7 Initial Proposals (CAP2265), October 2021
- Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Draft Licence Modifications (CAP2275), November 2021
- Economic regulation of Heathrow Airport Limited: H7 Final Proposals (CAP2365), June 2022
- H7 Final Decision (CAP2524), March 2023
- CMA, H7 Heathrow Airport Licence Modification Appeals - Summary of Provisional Determinations, September 2023
- CMA, H7 Heathrow Airport Licence Modification Appeals - Final Determinations, October 2023

## Price control building blocks for H7

- 3.15 The building blocks for the H7 price control are summarised in Figure B.1 below. This summarises the calculation of the maximum allowable yield per passenger from allowances for operating and capital costs, and passenger volumes.

**Figure B.1 – Price control building blocks for H7**

Source: CAA

## Key documents for NR23

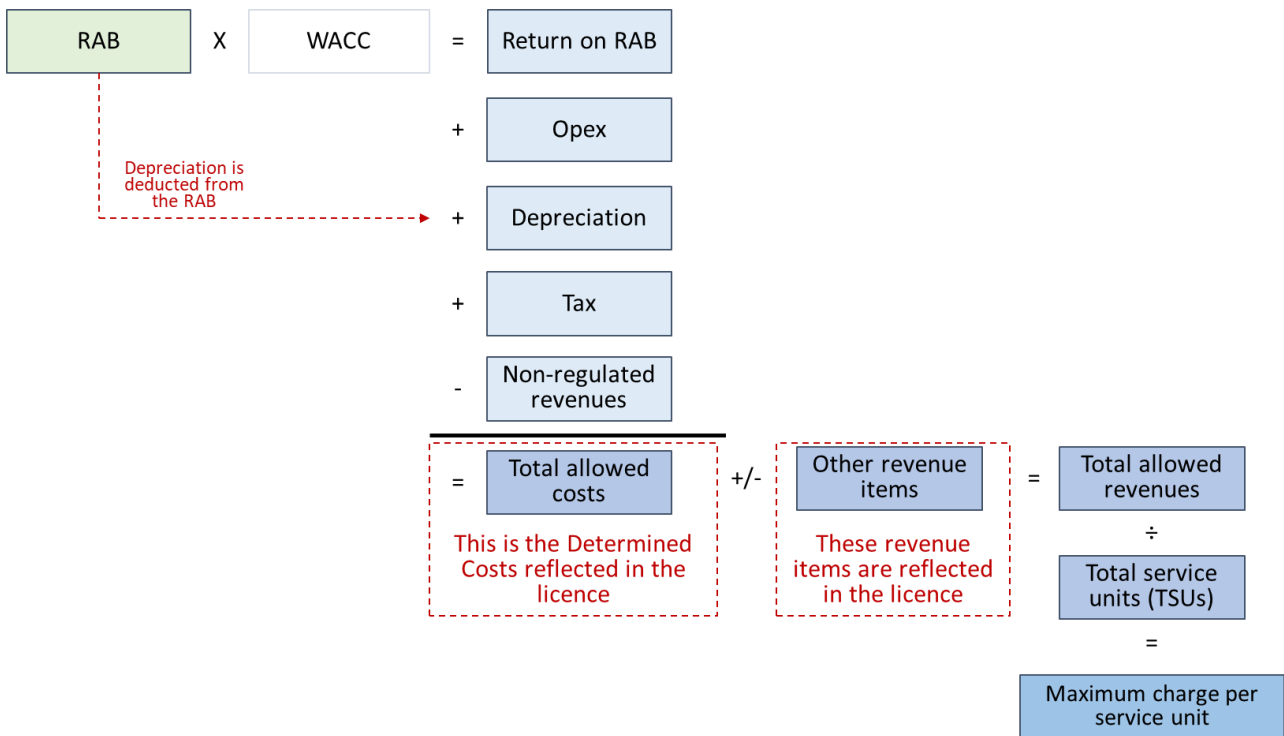
3.16 We set out below a list of the key CAA and CMA documents for the H7 review. This excludes related working papers, letters and consultant reports.

- Economic regulation of NATS En Route plc: Consultation on the approach to the next price control review (CAP1994), December 2020
- Economic regulation of NATS (En Route) plc: Update on approach to the next price control review (CAP2119), March 2021
- Economic regulation of NATS (En Route) plc: further update on approach to the next price control review (NR23) (CAP2160), October 2021
- Economic regulation of NATS (En Route) plc: working paper on the reconciliation review for NR23, including the request for information (CAP2291), November 2021
- Request for information to NERL for the NR23 business plan submission: cost and revenue building blocks (CAP2306), December 2021
- Economic regulation of NATS (En Route) plc: Initial Proposals for the next price control review (NR23) (CAP2394), October 2022
- Economic Regulation of NATS (En Route) plc: Provisional Decisions for the NR23 (2023 to 2027) price control review (CAP2553), July 2023
- Economic Regulation of NATS (En Route) plc: Final Decision for the NR23 (2023 to 2027) price control review (CAP2597), October 2023

## Price control building blocks for NR23

3.17 The building blocks for the NR23 UK en route price control are summarised in Figure B.2 below. This summarises the calculation of the maximum charge per service unit per passenger from allowances for operating and capital costs, and service unit volumes.

**Figure B.2 – Price control building blocks for NR23**



Source: CAA