

Economic regulation of Heathrow airport: H7 final issues - decision

CAP3001

About this document

This document sets out our decisions on the matters that were remitted to us by the Competition and Markets Authority by its Final Determinations of the appeals of our Final Decision on the H7 price control and certain matters that we had highlighted and were not able to resolve prior to making the Final Decision. These matters are:

- the approach to calculating the “AK” adjustment to revenues for 2020 and 2021;
- the “index-linked premium” used to calculate the cost of debt for the H7 cost of capital;
- verification of the “shock factor” used in the H7 passenger forecast;
- the appropriate contributions to the opex allowance “building block” used in the H7 price control for each of pension deficit repair costs and business rates; and
- treatment of HAL’s revenues from its “Pod parking” product.

It also deals with a number of other matters that have been raised with us by stakeholders. This decision sets out our analysis of each of these issues, our decisions on them and the statutory notice of the licence modifications we have decided to make to implement our proposals.

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Contents

About this document	2
Contents	4
Introduction and Summary	8
Introduction	8
Context: The Final Decision and appeals to the CMA	8
Summary	9
Matters remitted to us by the CMA	9
Issues outstanding from the H7 Final Decision	10
Other issues	11
Putting these decisions into effect	11
Our duties as economic regulator of HAL	12
Structure of this document	12
Next steps and Implementation	13
Chapter 1	14
The AK_t adjustment factor	14
Introduction	14
Context	14
The Final Decision and appeals to the CMA	14
The CMA's Final Determination	14
The March 2024 Consultation	15
Stakeholder views	16
Our views	18
Our decision	20
Adjustments in relation to D_t and BR_t	20
Adjustments in respect of the "Passenger mix"	21
Chapter 2	23
Premium applied to index-linked debt costs	23
Introduction	23

Context	23
The Final Decision and appeals to the CMA	23
The CMA's Final Determination	24
The March 2024 Consultation	24
Stakeholder views	25
Our Views	26
Our Decision	27
Chapter 3	28
Shock factor applied to passenger forecasts	28
Introduction	28
Context	28
The Final Decision and appeals to the CMA	28
The CMA's Final Determination	29
The March 2024 Consultation	29
Stakeholder Views	30
Our views and decision	30
Chapter 4	32
Allowance for Pension Deficit Repair Costs in H7	32
Introduction	32
The Final Decision	32
The March 2024 Consultation	33
Stakeholder Views	33
Our Views	34
Our Decision	35
Chapter 5	36
Cost allowance in respect of Business Rates in H7	36
Introduction	36
The Final Decision	36
Subsequent developments	36
The March 2024 Consultation	37
Stakeholder views	38
Our views	39

Our Decision	39
Chapter 6	41
HAL's H7 commercial revenues and "Pod parking"	41
Introduction	41
The March 2024 Consultation	41
Stakeholder views	42
Our Views	42
Our Decision	42
Chapter 7	43
Other issues	43
Introduction	43
Formula error in Condition C1.6	43
Stakeholder views	44
Our views and decision	44
Calculation of charges for 2025 and 2026	44
Stakeholder views	44
Our views and decision	44
Updating energy costs in the opex allowance	45
Stakeholders' views	45
Our views and decision	45
Vehicle queuing times metric	45
Stakeholder views	45
Our views and decision	46
Terminal drop-off charge ("TDOC")	46
Stakeholder views	46
Our views and decision	47
Certificate of adequacy of resources - assurance	47
Stakeholder views	48
Our views	48
Arithmetic error in the March 2024 Consultation	49
Our views and decision	49
Chapter 8	51

Implementation	51
Introduction	51
The March 2024 Consultation	51
Making the adjustments through the RAB or the allowed price cap	51
Treatment of the time value of money	51
One adjustment term or more?	52
The design of the adjustment terms	52
Impact on the allowed price caps for 2025 and 2026	53
The AK_t adjustment	53
The $H7_t$ factor	54
Modifying the Licence	55
Our duties	56
Glossary	58
Further detail on the calculation of the AK_t and $H7_t$ adjustments	61
AK_t factor	61
$H7_t$ factor	63
Overall impact	65
Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence	66
Introduction	66
What the modifications cover	66
Modification of the price control formula in Condition C1.5	68
Modification of the price control formula in Condition C1.6	69
Modification of the definition of the WACC in Condition C1.10(a)	70
Modification of the definition of the AK_t in Condition C1.22	70
Inserting the definition of the $H7_t$ factor at Condition C1.23	72
Clarifying the vehicle queuing times metric	73

Introduction and Summary

Introduction

Context: The Final Decision and appeals to the CMA

1. We issued our Final Decision¹ setting the price control for the “H7” period in March 2023. This was appealed to the Competition and Markets Authority (“CMA”) by HAL and airlines in April 2023. The CMA’s Final Determinations of those appeals in October 2023 found that the CAA had 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.
2. The CMA also found a handful of smaller issues which the CAA needed to look at again and we agreed to do so swiftly. These issues are:
 - the CAA’s approach to setting the level of the additional adjustment factor (“AK”) that reflects the difference between HAL’s actual and allowed revenues per passenger in 2020 and 2021;
 - whether we should have included an uplift for index-linked debt in our calculation of the cost of debt used for the cost of capital for H7; and
 - verification of the calculation of the “shock factor” used for the H7 passenger forecast.
3. Of these, the AK_t adjustment is of the greatest materiality.
4. The H7 Final Decision also left a small number of issues outstanding which we were unable to conclude prior to making that decision. These issues related to the appropriate allowances that should be fed into the price control to deal with:
 - the appropriate contributions to the opex allowance “building block” used in the H7 price control for pension deficit repair costs (“PDRCs”) and business rates; and
 - the appropriate treatment of HAL’s revenues from its commercial “Pod parking” service.
5. We have decided it would be reasonable, proportionate and consistent with the interests of consumers to deal with these issues alongside the issues remitted to us

¹ A glossary of the terms used in this consultation is set out at Appendix B.

by the CMA, as well as addressing a number of issues raised by stakeholders since the Final Decision.

6. We issued a consultation on our proposed approach to these matters in March 2024 (the “March 2024 Consultation”).² This document summarises the responses we received to that consultation and sets out our latest views and final decisions on these matters.

Summary

7. Having considered stakeholders’ views on the proposals set out in the March 2024 Consultation, we have reached the decisions summarised below (all figures in 2020 CPI-real prices unless stated otherwise).

Matters remitted to us by the CMA

8. In respect of the AK_t adjustment factor:
 - We are content that the approach we adopted in the March 2024 Consultation to calculate the contribution to the AK_t adjustment arising from the capex adjustment (“ D_t ”) and business rates (“ BR_t ”) terms was consistent with the reasoning set out by the CMA in its Final Determinations and that stakeholders have not put forward any compelling arguments that would suggest a different approach. As a result, the adjustments we have decided to make in respect of D_t and BR_t are unchanged from the March 2024 Consultation at £20 million in respect of 2020 and £30 million in respect of 2021;
 - We have decided to retain an adjustment to reflect the impact of airlines operating flights with fewer passengers than forecast, but do not consider that we should treat this adjustment in the same way as the D_t and BR_t adjustments as it arose for different reasons. Looking at the similarities and differences between the elements that go to make up the AK_t adjustment in the round, we have decided to adopt the position proposed in the March 2024 Consultation and share the passenger mix adjustment equally between HAL and consumers. As a result, the adjustments we have decided to make in respect of this element of the AK_t adjustment are unchanged from the March 2024 Consultation at £8 million in respect of 2020 and £17 million in respect of 2021; and
 - In total, our decisions on these matters reduces the AK_t adjustment from £253 million (as calculated in accordance with the Final Decision) to £76 million (2020 CPI-real). We have decided that this will be returned to consumers through charges in 2025 and 2026.

² Economic regulation of Heathrow airport: H7 final issues (CAP2980): See: www.caa.co.uk/CAP2980.

9. In respect of the premium we included in the WACC to allow for the costs of index-linked debt, we have decided that the data we have available does not allow us robustly to conclude that we should allow either a positive or a negative premium. So, we have decided that we should remove the index linked premium from the calculation of the WACC. This has the effect of reducing the H7 RPI-real WACC from 3.18% to 3.16%.
10. We applied a “shock factor” to the passenger forecast for H7 to represent the downward impact of the typically occurring, but unforecastable events that it is reasonable to anticipate would be likely to affect the forecast for the H7 period.³ We have concluded that the calculation of the shock factor has not been unduly biased by economic downturns, and that we have no evidence to support the suggestion made by stakeholders that there are significant rebounds in demand (beyond a return to the upward trend and level associated with our underlying forecast) following major demand shocks. We have, therefore, decided to retain a shock factor of 0.87% for the purposes of the passenger forecast for H7.

Issues outstanding from the H7 Final Decision

Contribution to the opex allowance in H7 in respect of PDRCs

11. The advice we have received is that there is no requirement for HAL to remedy any notional pension deficit at present and have, therefore, decided to reduce the opex allowance included in the H7 price control by £84 million to reflect this. We will address any PDRCs actually incurred by HAL in the latter years of the H7 period as part of the H8 price control review.

Contribution to the opex allowance in H7 in respect of business rates

12. There is evidence that HAL is likely to experience a significant increase in the level of business rates it pays in the last year of the H7 period. This increase will likely be greater than the £85 million downward adjustment we might otherwise make to reflect HAL’s current business rates. As a result, we have decided to defer making any adjustment and will assess both (i) the level of business rates payable by HAL from April 2026 and (ii) how best to true-up with the underlying price control allowance as part of our work on the H8 price control.

Contribution to the opex allowance and commercial revenue forecast made by HAL’s “Pod parking” product

13. We have decided that the T5 business car park is the best comparator available and so have retained our approach to estimating the net impact on revenues of Pod parking from the March 2024 Consultation. As a result, we have decided to apply a

³ These asymmetric non-economic downside risks include events such as adverse weather, volcanic eruptions, terrorism or strike action.

net reduction in the commercial revenue forecast of just under £4 million over the H7 period.

Other issues

14. This decision document also addresses a number of other issues that have emerged since the Final Decision, including:
- our decision to correct one of the formulae in the price control in the Licence to that it delivers the price profile intended;
 - confirmation that the “starting point” we used for calculating charges in 2024 was correct;
 - clarifying the definition of the vehicle security post queuing measure used in the performance incentives in Schedule 1 of the Licence; and
 - certain other issues raised by stakeholders in their responses to the March 2024 Consultation.

Putting these decisions into effect

15. We have decided to implement the changes to the calculation of the AK_t adjustment, recalculation of the WACC, the opex allowance in relation to PDRCs and the net adjustment to the commercial revenues forecast in respect of Pod parking by making two adjustments to HAL’s price control:
- To implement our decision in relation to the AK_t adjustment, we have converted the adjustment of £29 million in respect of 2020 and £47 million for 2021 giving a total of £76 million (all 2020 CPI-real) by providing for an indexation uplift to 2025 and 2026 prices and applying the revised pre-tax WACC of 4.01 per cent to 2025 and 2026 and adopting the 2025 and 2026 forecast passenger volumes in the H7 Final Decision. On this basis, we estimate the reduction in the allowed price caps per passenger will be -£0.718 for 2025 and -£0.748 for 2026 (both amounts in nominal terms); and
 - To implement the other adjustments, we have decided to use a separate term (“ $H7_t$ ”) and used the price control model we used for H7 to work out what the allowed revenues over each year of the H7 period should have been and compared them to the amounts we used for the Final Decision to determine the difference (£107.27 million, 2020 CPI-real). Adjusting so that the net present value of the adjustment is the same when spread over 2025 and 2026 leads to an estimated reduction in the allowed price caps as a result of the $H7_t$ adjustment of -£0.798 for 2025 and -£0.825 for 2026 (both amounts in nominal terms).
16. Taken together and when adjusted for the time value of money, the changes we have decided to make will lead to decreases in HAL’s charges of £1.516 in 2025 and

£1.573 in 2026 compared to the charges for H7 we set in the Final Decision (both amounts in nominal terms). On the basis of the nominal price caps set out in the Final Decision,⁴ this would reduce charges from £25.24 in 2025 to £23.73 in 2025 and from £25.28 to £23.71 in 2026 (in each case a reduction of around six percent).

17. To implement these changes, we have decided to modify the price control condition in the HAL's licence to amend the definition of the WACC and adding in these two adjustment terms.
18. To put all of the above into effect, this document includes (at Appendix D), a notice under CAA12 section 22(2) setting out the modifications that we propose to make to the Licence.

Our duties as economic regulator of HAL

19. Our work H7 has been guided by our duties under CAA12. Our primary duty under CAA12 is to further the interests of users regarding the range, availability, continuity, cost and quality of airport operation services, having regard to the matters set out in our "secondary duties" (including having regard to the need to secure HAL's ability to finance its activities). Further details of these duties are set out in Appendix A.

Structure of this document

20. The structure of this decision document is set out below.

Chapters 1 to 3 set out our approach to, and decisions on the matters remitted to the CAA by the CMA's Final Determinations of the H7 appeals as follows:

Chapter 1 - the AK_t adjustment factor;

Chapter 2 – the premium applied to index-linked debt costs; and

Chapter 3 – the shock factor applied to passenger forecasts.

Chapters 4 to 6 set out our approach to, and decisions on, addressing the matters left open by the Final Decision as follows:

Chapter 4 – the cost allowance in respect of Pension Deficit Repair Costs in H7;

Chapter 5 – the cost allowance in respect of Business Rates in H7; and

Chapter 6 – HAL's commercial revenues and "Pod parking".

Chapter 7 discusses the other issues raised by stakeholders since the Final Decision as sets out our decisions on them.

⁴ At Table 8 in the Summary of the Final Decision. See www.caa.co.uk/CAP2524A.

Chapter 8 sets out our decision on how we will implement these changes.

Appendix A sets out a summary of our duties under CAA12;

Appendix B provides a glossary of terms used in this consultation;

Appendix C sets out our calculations supporting the adjustments to HAL's price control we have decided to make; and

Appendix D sets out the notice of the modifications we have decided to make to HAL's licence to implement these decisions.

21. Alongside this decision we are also re-publishing the price control model ("PCM") in support of the analysis set out in chapter 8 (Implementation).

Next steps and Implementation

22. We are issuing a Notice of licence modifications under section 22(6) of CAA12 as set out in Appendix D and providing explanatory text which summarises our reasoning and rationale for the licence modifications we are making to implement our decision on the matters summarised above.
23. HAL, as the licence holder, and any provider of air transport services whose interests are materially affected by the final decision (typically airlines operating from Heathrow), may apply to the CMA within six weeks of the publication of this Final Decision for permission to appeal our decision to modify HAL's licence under section 25 of CAA12.

Chapter 1

The AK_t adjustment factor

Introduction

- 1.1 This chapter addresses the finding in the CMA's Final Determinations⁵ that the CAA should reconsider the calibration of the adjustment we made to HAL's revenues to account for over-recovery in 2020 and 2021.
- 1.2 We start by setting out context and background, discuss stakeholder responses to our March 2024 Consultation, then set out our views on these matters and our final decision.

Context

The Final Decision and appeals to the CMA

- 1.3 Our Final Decision on H7 contained an adjustment term ("AK") intended to "true up" over- or under- recovery of revenues by HAL that had arisen in 2020 and 2021 to align them with the revenues allowed by its price control. Although the number of passengers (and, therefore, HAL's revenues) fell very sharply in 2020 and 2021, we considered that HAL had nonetheless recovered substantially more than was allowed by the price control. The AK_t term was designed to return this sum to airlines. HAL appealed this element of the Final Decision arguing that no adjustment should be made.

The CMA's Final Determination

- 1.4 The CMA determined⁶ that we had not erred in deciding that some adjustment should be made.⁷ We had, however, been wrong, in the exceptional circumstances of the pandemic, to apply the adjustment mechanistically without properly considering:
- the impact of the capex adjustment ("D_t") and business rates ("BR_t") terms in HAL's price control in adjusting HAL's allowed revenue downwards given HAL's capex underspend and lower than expected business rates;⁸ and

⁵ See generally, chapter 10 of the CMA's Final Determinations.

⁶ See the CMA's Final Determinations at paragraphs 10.117 to 10.121.

⁷ *Ibid.* at paragraph 10.63 to 10.71.

⁸ *Ibid.* at paragraphs 10.101 and 10.110.

- over recovery in per passenger charges as a result of airlines operating flights with fewer passengers than forecast.⁹

1.5 The CMA said that, therefore, we had been wrong not to consider these factors and whether HAL had actually over-recovered revenues in 2020 and 2021 to the extent implied by the standard application of the correction factor.

The March 2024 Consultation

1.6 In the March 2024 Consultation, we proposed to adopt an approach based on the CMA's Final Determinations.

D_t and BR_t

1.7 Following the approach set out in the CMA's Final Determinations, by comparing the outturn figures with the relevant forecasts for capex, business rates and passengers, we found that the D_t and BR_t terms led to HAL returning amounts that exceeded the revenues that it had actually earned in relation to those elements of the price control, so increasing its losses.

1.8 To address this, again following the approach set out in the CMA's Final Determinations, we proposed an approach that calculated adjustments consistent with the revenues that would have arisen if the levels of capex and business rates had been accurately forecast.¹⁰ To act consistently with the CMA's findings, we recalibrated these adjustments by applying the proportion of outturn passenger volumes to forecast passenger volume to the original figures, giving adjustments totalling £51 million.

Passenger mix

1.9 The Final Determinations did not point to an alternative means of assessing the appropriate level of the "passenger mix" adjustment. We considered that the justification for making an adjustment to reflect the "passenger mix" was not the same as that for the D_t and BR_t terms because:

- unlike the D_t and BR_t terms, the "passenger mix" adjustment did not arise from a comparison of the actual revenue recovered and that which HAL was entitled to recover under a specific price control term;
- the fact that airlines operated flights with fewer passengers than expected was a direct consequence of the impact of the covid-19 pandemic, rather than a function of the price control formula. Rather, the "passenger mix" appeared to be, at least to an extent, a manifestation of the volume risk allocated to HAL by the price control; and

⁹ *Ibid.* at paragraph 10.118.

¹⁰ *Ibid.* at paragraph 10.94 and 10.109ff.

- much of the difference between the outturn and allowed yield per passenger may also have been a function of HAL's choices in way it structured its charges, which are not mandated by the price control.

1.10 Therefore, we considered the justification for making an adjustment to reflect the "passenger mix" did not appear to be the same as that for the D_t and BR_t terms.

1.11 At the same time, we needed to take appropriate account of the CMA's observations on:

 - the importance of holding HAL to the price control set;¹¹ but
 - that we had not got a reliable basis for treating the differences as arising as a result of a "failure" on the part of HAL in setting charges.¹²

1.12 We also recognised the difficulties of making an accurate passenger forecasts at that time. In this light, we took the view that it would not be appropriate for the CAA to make no adjustment,¹³ but, equally, it would not be appropriate for us to completely remove the passenger mix adjustment and the fact that passenger numbers turned out to be significantly lower than forecast did not itself provide a reason for departing from the expected approach.¹⁴ Having considered the same approach as for the D_t and BR_t , we decided that it would be appropriate to reflect the difference between those adjustments and the passenger mix adjustment by sharing the latter adjustment equally between HAL and consumers, giving adjustments totalling £25 million.

Stakeholder views

- 1.13 HAL's response appears to broadly accept the D_t and BR_t adjustments as they relate to the AK_t term. It agreed that there should be a significant reduction in the adjustment and considered that our proposal represented the "maximum" level for any remaining adjustment.
- 1.14 It said that any upwards adjustment to the level of AK_t would cause consumer harm through reducing resources available. It also agreed with our approach of:
- dealing with the adjustment within H7, not H8, to avoid increased costs to future consumers; and
 - keeping the AK_t adjustment separate from other terms in the price control.
- 1.15 On the "passenger mix" adjustment, HAL expressed concern that the CAA had not undertaken the "detailed analysis" it said was required by the CMA: its

¹¹ See the CMA's Final Determinations at paragraph 10.86.

¹² *Ibid.* at paragraph 10.114.

¹³ *Ibid.* at paragraph 1.116.

¹⁴ *Ibid.* at paragraph 10.114.

position remained that there had been no over-recovery due to impact of the covid-19 pandemic and the significant losses it incurred during 2021 and 2022. HAL considered that our proposal did not align with the CMA's comments because:

- the CAA did not have evidence that the difference between HAL's actual yield per passenger and the amounts allowed under the price control were because of any "failure" by HAL;
- HAL's submissions regarding airlines' decisions to fly with fewer passenger should have attracted further consideration due to the risk of perverse outcomes; and
- the CAA was wrong not to have considered whether it was more appropriate to calibrate each component of the AK_t factor adjustment more closely to HAL's actual over-recovery.

1.16 In that context, HAL requested that the CAA apply the same "scaling" approach as implemented on the D_t and BR_t elements to the passenger mix adjustment.

1.17 The submissions from BA and Virgin were supported by a report from AlixPartners and largely repeated the arguments made in that report.

1.18 BA focussed on the passage in the CMA's Final Determinations that:

"the fact of 2020 and 2021 being exceptional COVID-19 impacted years – in that passenger numbers turned out to be significantly lower than forecast – does not in itself provide a reason for departing from the approach that otherwise would have been expected to apply in relation to identified over-recovery"¹⁵

and did not expect this issue to arise beyond the context of these limited and exceptional circumstances.

1.19 BA acknowledged that the CAA had adopted the CMA's approach to recalibrating the D_t and BR_t adjustments, but argued that for the passenger mix adjustment

"the issue arises not through the recovery of expenditure variances over actual or forecast passenger volumes, but because of variances in HAL's own forecast ... meant that the actual revenue per passenger received by HAL exceeded the regulatory price cap".

1.20 On this basis, it:

¹⁵ *Ibid.* at paragraph 10.114.

- considered that HAL should not get additional compensation for reduced passenger traffic beyond the RAB adjustment;
- argued that the CAA's H7 Final Decision had been correct to treat the additional revenue made by HAL as pure over-recovery; and
- considered that the 50/50 sharing could effectively transfer volume risk from HAL to airlines and allow HAL to benefit from *ex post* windfall revenues, retrospectively undermining the "regulatory contract" without providing any benefit to customers.

1.21 Virgin made similar arguments to those put forward by BA:

- expressly agreeing with the approach of following CMA's approach for recalculating D_t and BR_t elements of AK_t adjustment; but
- strongly disagreeing with CAA's proposed approach to sharing "passenger mix" adjustment, claiming it was, arbitrary, not being supported by evidence or rationale, "unfair", unjustified, and that it would perverse incentives to game forecasting in the future.

1.22 It noted that CMA did not make a definitive finding on whether HAL should be responsible for compensating airlines following variances from forecast and, like BA, took the view that our approach transferred risk from HAL to airlines, undermining the principles of incentive regulation by giving HAL windfall gains and crated the risk of "gaming". It argued that the adjustment was a function of HAL's own forecasting errors, not the pandemic, so that HAL should be required to refund it in full to airlines and consumers.

1.23 Airlines for America supported the CAA's approach, but said the adjustment should be reflected in charges in 2025, not spread over 2025 and 2026.

1.24 The AOC/LACC made similar comments to those made by BA and Virgin. It argued that the calibration of the AK_t factor was fundamentally a "maths question" and that HAL's over-recovery was the amount of additional revenue based on actual volumes/mix. On this basis, it was unclear why HAL should not repay 100% of the over-recovery. It also wanted the return to be effected in 2025, not over 2025 and 2026.

Our views

1.25 We are content that the approach adopted in the March 2024 consultation to the adjustments for AK_t arising from the D_t and BR_t terms was consistent with the reasoning set out by the CMA in its Final Determinations. We also note that stakeholders have not put forward any compelling arguments that would suggest a different approach. Given this, and the importance for the interests of consumers of protecting the integrity of the regulatory regime by acting consistently with the CMA's findings, we intend to retain the approach to these

matters summarised above and explained in more detail in the March 2024 Consultation.

- 1.26 As for the passenger mix adjustment, HAL's argument that the CAA's approach should concentrate on the three elements identified by the CMA and summarised in paragraph 1.15 above does not address the full range of points raised by the CMA. Specifically, HAL's observations do not address the clear statements by the CMA that we had not erred in applying some adjustment. As for "*evidence of failure on the part of HAL*", while it is arguable that, at least in relation to 2020, the divergence between HAL's forecast and the actual number of passengers was mostly driven by circumstances it could not reasonably foresee, it is not clear that this applies to 2021 and, in any case, HAL's arguments do not appear to take sufficient account of the comments by the CMA that:
- the exceptional nature of 2020 and 2021 did not in itself provide a reason for departing from the normal means of calculating the adjustment;¹⁶
 - holding HAL to the price control conditions that applied in 2020 and 2021 was an important consideration;¹⁷ and
 - it was a natural response to the pandemic for airlines to operate flights with fewer passengers (and passengers would have been worse off if airlines had instead cancelled more flights).¹⁸
- 1.27 Having given these matters further consideration, when looked at in the round, we consider that the proper response to the overall impact of these considerations is that we should retain an adjustment to reflect the impact of airlines operating flights with fewer passengers than forecast.
- 1.28 We do not consider that we should treat the passenger mix adjustment in the same way as the D_t and BR_t adjustments. As we set out in the March 2024 Consultation,¹⁹ the passenger mix adjustment arose for different reasons from those in relation to D_t and BR_t . It would, therefore, not be appropriate for us to adopt the same approach to recalculation of the passenger mix adjustment as for the other elements when the underlying positions are not consistent.
- 1.29 Nonetheless, we consider that it would not be appropriate for us to accept airlines' submissions that the CAA should apply the passenger mix element of the AK_t adjustment in full. We consider that such an approach would create the very risk we identified in the March 2024 Consultation of undermining the

¹⁶ *Ibid.* at paragraph 10.114.

¹⁷ *Ibid.* at paragraph 10.86

¹⁸ *Ibid.* at paragraph 10.115

¹⁹ At paragraph 1.31ff

credibility of the regulatory regime as a whole and, therefore, would be contrary to the interests of consumers.

- 1.30 Looking at the similarities and differences between the elements that go to make up the AK_t adjustment in the round, we consider that the approach we set out in the March 2024 Consultation represents a reasonable and proportionate exercise of our discretion to further the interests of consumers as it:
- has appropriate regard to the need for us to act consistently with the CMA's findings; while also
 - reflects the differences between the different elements of the AK_t adjustments; and
 - takes a proportionate and reasonable approach to the sharing of costs and risks.

Our decision

- 1.31 For the reasons set out above, we have decided to retain the approach set out in the March 2024 Consultation to the calibration of the AK_t term. We are firmly of the view that the AK_t adjustment will be a "one-off" to take account of the specific circumstances of the Covid-19 pandemic. Our approach to addressing the CMA's findings is confined to responding appropriately to the Final Determinations in the context of the facts prevailing in 2020 and 2021. As such, we do not consider that this decision sets any wider precedent.
- 1.32 We recognise that making an adjustment that is lower than that implied by the mechanistic application of the AK_t term will lead to charges being higher than they would have been had the AK_t term been applied mechanistically. While this would not normally be in the interests of consumers:
- the clear finding by the CMA that our approach to determining the size of the AK_t adjustment was flawed; and
 - the damage to the credibility of the regulatory regime as a whole that would be caused by the CAA not giving due weight to the CMA's findings would act contrary to consumers' interests by making it harder for HAL to seek efficient finance in the long run and make financing more expensive, so increasing costs for future consumers.
- 1.33 The above factors outweigh the short-term detriment that consumers face from increasing airport charges during H7.

Adjustments in relation to D_t and BR_t

- 1.34 The adjustments in respect of D_t and BR_t are unchanged from those we proposed in the March 2024 Consultation and are set out in Table 1.1 below.

Table 1.1: Recalibration of capex and business rates components of the AK_t factor. Figures calculated in accordance with the Final Proposals in brackets

Adjustment (£ million, 2020 CPI-real prices)	2020	2021	Total
Over-recovery due to the development capex term D _t	11 (40)	21 (89)	32 (129)
Over-recovery due to the business rates term BR _t	9 (35)	9 (40)	19 (74)
Total (may not sum due to rounding)	20 (75)	30 (129)	51 (204)

Source: CAA calculation

Adjustments in respect of the “Passenger mix”

- 1.35 This adjustment is also consistent with that set out in the March 2024 Consultation, as set out in Table 1.2 below.

Table 1.2 Recalibration of pax mix component of the AK_t factor. Figures calculated in accordance with the Final Decision in brackets

Adjustment (£ million, 2020 CPI-real prices)	2020	2021	Total
Over-recovery due to the passenger mix element	8 (17)	17 (33)	25 (50)

Source: CAA calculation

- 1.36 The combined effect of these adjustments is set out in Table 1.3 below. On this basis, we have decided to recalibrate the AK_t adjustment at £76 million (2020 CPI-real) instead of the £253 million calculated in accordance with the Final Decision.

Table 1.3 Proposed recalibration of all components of the AK_t factor

Adjustment (£ million, 2020 CPI-real prices)	2020	2021	Total
Over-recovery due to the development capex term D _t	11	21	32

Over-recovery due to the business rates term BR _t	9	9	19
Over-recovery due to the passenger mix element	8	17	25
Total (may not sum due to rounding)	29	47	76

Source: CAA calculation

- 1.37 Having considered the representations of Airlines for America and the AOC, we are not persuaded that this adjustment should be returned through charges in a single year, given that this is a shorter period than envisaged in the Final Decision. So, we have decided that this adjustment should feed into HAL's charges equally in 2025 and 2026. This and other implementation issues are discussed in more detail in chapter 8 (Implementation).

Chapter 2

Premium applied to index-linked debt costs

Introduction

- 2.1 This chapter addresses the finding in the CMA's Final Determinations that the CAA should reconsider the allowance that we made in the Final Decision for the costs of index-linked debt²⁰ as part of the calculation of the WACC for H7.
- 2.2 We start by setting out context and background, discuss stakeholder responses to the March 2024 Consultation, then set out our views on these matters and our final decision.

Context

The Final Decision and appeals to the CMA

- 2.3 The approach we adopted to estimating the overall WACC for the Final Decision included, within the calculation of HAL's the cost of debt, an "index linked premium" to reflect the additional costs incurred by HAL in issuing index-linked debt. The index-linked premium we used was intended to reflect the difference in the cost of such instruments compared to the cost of equivalent debt with a fixed coupon, when the cost of each type of instrument is expressed on a comparable basis.
- 2.4 In the Final Decision, we took the view that index-linked debt would be 15 basis points ("bps") more expensive for HAL than fixed-rate debt on a nominal basis.²¹ We based this approach on an estimate set out by HAL in its Revised Business Plan,²² supported by our own assessment of five of HAL's Class A bonds. This fed through into an increase in the estimate of the WACC that we used for the Final Decision of two basis points (from 3.16% to 3.18%).
- 2.5 This element of the Final Decision was appealed by airlines on the grounds that the CAA had made errors in its approach to and calibration of the index-linked premium.²³

²⁰ Index-linked debt represents debt whose yield is dependent on outturn inflation.

²¹ See the Final Decision at paragraph 9.142.

²² See: HAL (2020), "*H7 Revised Business Plan (Detailed)*", December, p412.

²³ The appeals were dealt with at paragraphs 7.257ff of the CMA's Final Determination, summarised in the March 2024 Consultation at paragraphs 2.3ff

The CMA's Final Determination

- 2.6 In its Final Determination, the CMA agreed with the Airlines that it would typically expect index-linked bonds to exhibit lower yields than fixed-rate debt due to the absence of an inflation risk premium (that is, that a negative premium could be appropriate²⁴). However, the CMA also noted that there was some merit to our view that this would be offset by lower liquidity in corporate index-linked markets. Overall, the CMA said that, while we might have had grounds for applying a premium for the costs of index-linked debt, as economic theory suggested a discount was more appropriate, we should have had a more substantial evidential basis for finding that a premium existed.
- 2.7 As a result, the CMA concluded overall that we erred in fact and law that in concluding a 15bps index-linked premium in the calculation of the WACC on the basis of the evidence we considered and, as the error was material (having the potential to have a significant impact on the overall level of the price control and future controls), remitted this determination to us for reconsideration.

The March 2024 Consultation

- 2.8 In response to the CMA's findings, the March 2024 Consultation considered afresh whether we should apply any premium to reflect the costs of index-linked debt. In support, we commissioned our advisors, Centrus, to examine whether issuers pay an additional issuance premium when issuing index-linked bonds compared with fixed-rate nominal bonds.
- 2.9 Having considered Centrus's analysis (which showed a small weighted average premium of 10-20 bps), our view was that the small size of the dataset and the constraining factors identified by Centrus (for example the difficulties in reliably comparing bonds with different issue dates) were cause for concern, given the CMA's feedback in respect of the evidentiary threshold needed to conclude on the existence of an index-linked premium.
- 2.10 Furthermore, there were several examples of index-linked bonds being issued at a discount to their fixed-rate counterparts. This undermined confidence that we could robustly conclude that an index-linked premium exists.
- 2.11 We also noted that the decrease in the liquidity of the index linked bond market and the existence of an active index-linked swap market also suggested that issuers may have the option of achieving more cost-effective results by issuing a combination of fixed rate debt and inflation swaps.
- 2.12 On this basis, we considered that there was insufficient evidence to conclude that was a systematic index-linked premium and proposed to remove the

²⁴ See the CMA's Final Determinations at para 7.306

premium from our WACC estimate, reducing the H7 RPI-real cost of debt allowance from 0.80% to 0.62% and the H7 RPI-real WACC from 3.18% to 3.16%.

Stakeholder views

- 2.13 HAL did not agree with the removal of the index linked premium from our WACC estimate and argued that we had not properly considered the evidence from our advisors, Centrus, which showed a positive weighted average premium.
- 2.14 Referring to the CMA's Final Determination that the data set relied upon by the CAA was too limited, HAL argued that we had failed to set out the appropriate sample size which we considered would be required to prove the existence of an index linked premium.
- 2.15 HAL observed that the data set considered had increased since the Final Decision (from 5 bond pairs to 17) and argued that the small size of the dataset was a result of lack of liquidity, which results from an illiquidity premium. HAL also said there are more bonds that could have been explored by Centrus.
- 2.16 It also stated that Centrus had made errors in its analysis in relation to cases where it had found there to be a negative index-linked premium. HAL also queried the period between the issuance of some of the bond issues compared by Centrus and the adjustment method used.
- 2.17 Overall, HAL said that the evidence suggested that the application of a negative premium would not be credible, and that Centrus' analysis pointed to an average positive index-linked premium of 10-20bps.
- 2.18 While HAL acknowledged the CAA's commentary regarding the use of inflation linked swaps, it said that the use of these swaps did not have a zero cost and so did not support a conclusion of a zero premium for index linked debt.
- 2.19 On this basis, HAL said the CAA should revisit its approach as well as clarifying whether it intended to carry out similar work for the H8 price control review.
- 2.20 The submissions from BA and Virgin agreed with the proposed removal of the index linked premium in the calculation of the WACC and restated the case they had already argued for during the appeal process that there should be a negative premium. To support this, they referred to a report commissioned from AlixPartners, submitted alongside their responses.
- 2.21 They also said that the Centrus Report had:
- failed to consider the full scope of the index-linked premium by not accounting for the negative premium arising from the protection against inflation; and
 - overlooked the potential for a negative premium as it incorrectly incorporates the higher yields of nominal Gilts compared to index-linked Gilts.

- 2.22 The Airlines' responses highlighted that the AlixPartners report indicated that there is evidence:
- from the gilts market showing that investors require a lower return for inflation index linked bonds rather than equivalent fixed bonds, implying a negative premium; and
 - for a negative premium in the corporate bond market, especially for regulated companies, which could issue index-linked debt based on their index linked RAB.
- 2.23 Airlines said that the CAA should have considered this evidence and applied a negative index linked premium of at least 10bps and said that this would be in the interests of consumers.

Our Views

- 2.24 Having considered stakeholders' views on these matters and reflected further on the information and commentary in the Centrus report our view remains that the dataset analysed by Centrus does not allow us robustly to conclude that we should allow a premium for index linked debt.
- 2.25 We note that, while HAL raised points regarding some of the specific bonds analysed by Centrus, it also highlighted some of the difficulties in working with a limited dataset, such as the time elapsing between bond issuances making direct comparison challenging.
- 2.26 The evidence cited by airlines from AlixPartners drawing on the gilts market is also not conclusive. The relevance of gilts markets was considered by the CMA which noted that government bond markets are different from corporate bond markets in important respects (in particular, their relative depth and liquidity).²⁵
- 2.27 We acknowledge the point made by AlixPartners that the inflation risk premium implies that index-linked bonds should exhibit a lower cost. However, this assessment omits consideration of the lower liquidity of corporate index-linked bonds compared with their fixed-rate counterparts. We also note that Centrus's Report did explore the possibility of a negative index premium and noted that the evidence in support of a negative premium for corporate debt is limited.
- 2.28 While we note HAL's comment that issuing swaps is not a "cost free" activity, our commentary on using combinations of fixed debt and inflation-linked swaps did not intend to imply that any particular instrument was available at zero cost. Rather, we were highlighting the existence of other financing strategies that may be more cost effective in overall terms than issuing index linked debt.

²⁵ See the CMA's Final Determination, para 7.302

- 2.29 In this light, we do not consider that, on the evidence available, we can robustly conclude that there is either a positive or a negative premium for index-linked debt.

Our Decision

- 2.30 The dataset we have available for analysing index-linked premiums remains limited. The small number of index-linked bonds in the market, as well as the other constraining factors identified by Centrus, makes it challenging to draw definitive conclusions from this dataset. While we have considered both HAL's and airlines' views, we must exercise caution due to these limitations. We are also mindful that the CMA stated remittals should be completed in a timely manner and this limits the scope for use to conduct extensive further analysis on this issue at this stage.
- 2.31 On this basis, our decision is to retain our position from the March 2024 Consultation, that we should remove the index linked premium from the calculation of the WACC. Our approach to implementing these changes is set out in chapter 8 (Implementation).
- 2.32 We note that this is consistent with the guidance provided by the CMA in its Provisional and Final Determinations that the CAA should 'not apply an index-linked premium to the cost of debt, if the CAA decides upon further consideration that the available evidence is insufficient to constitute robust evidence for the calculation of an appropriate level of indexed-linked premium'.²⁶
- 2.33 Nonetheless, will continue to consider issues around the existence and extent of any premium for index-linked debt in our work on the H8 price control review, with a view to reaching more definitive conclusions on these matters.

²⁶ See the CMA's Final Determinations at para 16.10

Chapter 3

Shock factor applied to passenger forecasts

Introduction

- 3.1 This chapter addresses our approach to verifying the calculation of the “shock factor” applicable to the passenger forecast for H7.
- 3.2 We start by setting out context and background, discuss stakeholders’ responses to our March 2024 Consultation, then set out our views on these matters and our final decision.

Context

The Final Decision and appeals to the CMA

- 3.3 As the final step in the process we used to develop the passenger forecast for H7, we applied a “shock factor” to represent the downward impact of the typically occurring, but unforecastable events that it is reasonable to anticipate would be likely to affect the forecast for the H7 period. These asymmetric non-economic downside risks include events such as adverse weather, volcanic eruptions, terrorism or strike action.
- 3.4 We had previously applied an adjustment of this kind in the Q6 price control. At that time, we applied a “shock factor” calibrated to match the average annual loss of volumes that HAL had experienced over the period from 1991 to 2012 as a result of “one-off” events (which included the Gulf War, the 9/11 terrorist attacks, SARS and the disruption caused by the eruption of the Eyjafallajökull volcano).
- 3.5 In the Final Decision, we applied a shock factor only to the remaining years of the H7 period (2023 to 2026), rather than for 2022 (where the outturn number of passengers was already known).
- 3.6 The magnitude of the shock factor we applied was 0.87% which was consistent with the updated estimate that HAL had applied to the forecasts in its RBP Update.²⁷

²⁷ See the Final Decision at footnote 3.

- 3.7 Airlines appealed our use of the shock factor on the grounds that it double counted downside risks, should not have applied to all of 2023 and because the magnitude of the adjustment applied was arbitrary.²⁸

The CMA's Final Determination

- 3.8 The CMA's Final Determination found that:
- the use of the shock factor did not constitute double counting with other elements of the passenger forecast; and
 - applying the shock factor to the entirety of the passenger forecasts for 2023 was not wrong as that forecast was not based on actual data, but forward-looking booking data.
- 3.9 However, the CMA did find an error on our part. This was that we had failed to properly assess HAL's calculation of the 0.87% figure for the shock factor. As a result, the CMA remitted calculation of the shock factor to us.

The March 2024 Consultation

- 3.10 In response to the CMA's Final Determination, we assessed HAL's calculation of the 0.87% shock factor. Our verification process involved checking the calculations and the underlying method used by HAL in its RBP to estimate the shock factor.
- 3.11 We found that:
- the chosen start and end dates for each shock appear reasonable and consistent with our understanding of the chronology; and
 - HAL's approach to estimating counterfactual passenger numbers during a shock period (averaging pre- and post-shock months) was reasonable and did not appear to be subject to any systematic bias.
- 3.12 Based on these findings, we were able independently to replicate HAL's estimate of the shock factor (0.87%). We also established that the reduction in the shock factor since Q6 was due to a lower prevalence of downside shocks since 2014. If this trend continues, it implies an even lower shock factor would be applied in H8.
- 3.13 Considering these observations, we concluded that HAL's calculation of the shock factor was reasonable and proposed to retain HAL's estimate of 0.87% and make no further adjustments to HAL's price control based on these findings.

²⁸ See the CMA's Final Determinations at para 9.270ff and summarised in the March 2024 Consultation at paragraph 3.5ff

Stakeholder Views

- 3.14 HAL noted that the CMA had not found that HAL's calculation of a shock factor of 0.87% was incorrect. It supported the CAA's analysis and the confirmation of this level of shock factor for 2023-2026.
- 3.15 The submissions made by airlines (supported by a report from AlixPartners) disagreed with the CAA's proposal to retain the 0.87% shock factor on the grounds that:
- the shock factor is intended to account for non-economic shocks not economic downturns. However, HAL's shock model erroneously includes economic downturns such as in 1991, leading to an overestimation of the shock factor. Economic shocks are already considered in econometric models used for forecasting, so this double counting is problematic;
 - there is insufficient evidence to support the assumption that base traffic forecasts are unshocked. If HAL's econometric models used raw traffic data that included shocks, applying the shock factor could lead to double counting; and
 - HAL's method overlooked the possibility of positive rebounds following negative shocks (for example through rebooked flights after cancellations) and that it would be reasonable to assume that a rebound of 100% would take place after any given shock.
- 3.16 Airline submissions also proposed licence modifications to address these issues and suggested a thorough review of passenger forecasting for H8.

Our views and decision

- 3.17 In response to the points raised by airlines, we note that the CMA did not find that we had been wrong to include the shock factor or find that there had been any material double counting within our passenger forecasts. We also note that the CMA did not find any error with our use of external forecasts. As such, these points appear to seek to reopen matters already considered by the CMA and outside the scope of the limited matter (calculation of the level of the shock factor) remitted to us by the CMA .
- 3.18 As for the calculation of the shock factor itself, while AlixPartners draw attention to one "shock" (Desert Storm in 1991) that coincided with an overall downturn in UK GDP and sought to argue that this meant that the calculation of the shock factor was "contaminated" by economic downturns, having reviewed UK GDP data for the whole of the period covered by the calculation, we observe that this is the only year in which a "shock" coincided with a fall in UK GDP.

- 3.19 As a result, we can see no credible evidence of a systematic correlation between “shocked” years and years in which there was an economic downturn such that would cause us to question whether the calculation of the shock factor had indeed been “contaminated” by economic downturns. Save for this one example, they all correlate with increasing GDP.
- 3.20 We also do not have any evidence that supports the suggestion that there are significant rebounds of demand (that is, over and above the restoration to normal levels of demand) following major demand shocks.
- 3.21 As a result, we are satisfied that the analysis we undertook for the March 2024 Consultation that verified HAL’s calculations was robust and met the requirements set out by the CMA. We have, therefore, decided to retain a shock factor of 0.87% for the purposes of the passenger forecast for H7.

Chapter 4

Allowance for Pension Deficit Repair Costs in H7

Introduction

- 4.1 As part of the H7 price control, we made an allowance to support HAL's efficient operating expenditure (opex). This allowance was designed to ensure that airport charges are calculated efficiently, having regard to users' reasonable demands for airport operation services ("AOS") and the need to promote economy and efficiency in HAL's provision of AOS.
- 4.2 As part of this, we considered whether HAL should be allowed to recover defined benefit pension costs relating to the BAA Pension Scheme (the "Scheme") during H7, including any payments needed to address an actuarial deficit in the longer-term pension scheme funding (known as pension deficit repair costs or "PDRCs").
- 4.3 In our Final Decision we said these matters required further consideration. This chapter addresses these issues. We start by summarising our Final Decision on these matters, then go on to summarise our proposed approach as set out in the March 2024 Consultation, stakeholders' responses and our views on these matters and final decision.

The Final Decision

- 4.4 The Final Decision included an allowance of £99m for PDRCs within the overall opex allowance.²⁹ However, we:
- made clear that this approach was subject to us conducting a detailed review of HAL's proposals in relation to PDRCs which we had not, at the time of the Final Decision, been able to undertake as a result of the late provision of information by HAL; and
 - if required, would bring forward proposals for a licence modification to put any required changes into effect.³⁰

²⁹ CAP2365, Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks, paragraph 4.72.

³⁰ CAP2524C, Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks paragraph 4.51.

The March 2024 Consultation

- 4.5 To support the March 2024 Consultation, we commissioned a report from the Government Actuary's Department (the "GAD Report")³¹ reviewing the position in relation to HAL's PDRCs in more detail. The GAD Report considered the evidence provided by HAL to support its request for the opex allowance to continue to support HAL making £99 million of PDRCs during H7.
- 4.6 The GAD Report came to the following conclusions:
- the Scheme was in surplus at the 2021 valuation, so there is no current requirement for HAL to pay PDRCs;
 - without formal "sectionalisation" arrangements in place, there is no requirement for PDRCs to be paid to remedy a notional deficit in any putative "HAL share" of the Scheme; and
 - there is uncertainty surrounding what the position will be following the 2024 valuation, which is likely to conclude late 2025, so a degree of flexibility within the regulatory framework may be appropriate.
- 4.7 Having considered the GAD report and its recommendations, in the March 2024 Consultation we proposed to reduce HAL's opex allowance by £84 million, in line with the findings of the GAD Report but retaining the allowance for £15 million of PDRCs relating to the 2018 actuarial review that was payable in 2022.
- 4.8 While we also recognised that there is some uncertainty surrounding the need for PDRCs for the rest of the H7 period, we said we would assess any:
- (i) PDRCs incurred in 2026 as a result of the 2024 valuation, and
 - (ii) other PDRCs incurred between now and 2025
- as part of our H8 review.

Stakeholder Views

- 4.9 HAL observed that, for Q6, we had specified that the relevant pension scheme for regulating HAL was the Heathrow section of the Scheme only, and the performance of the other section was considered a shareholder risk. HAL said it had consistently referred to the Q6 approach as relevant precedent and shared information with the CAA based in this context to assess an appropriate PDRC allowance.

³¹ <https://www.caa.co.uk/media/22bknuul/hal-pdrc-analysis.pdf>

- 4.10 HAL said it had clearly expressed its concern that there is a risk PDRCs may be required to recommence from 2026 onward and argued for reinstatement of the opex allowance given the GAD Report's:
- acknowledgement of uncertainty over the 2024 valuation; and
 - suggested flexibility within the regulatory framework.
- 4.11 It also highlighted the risk of funding levels dropping below a specified threshold, potentially leading to PDRCs recommencing before the 2024 valuation concludes.
- 4.12 If the CAA was not to reinstate the allowance, it wanted the CAA to commit to allowing cost pass through in H8 programme and that any such recovery should not be affected by any delay to the H8 price control.
- 4.13 Airlines' submissions supported our proposals to remove the allowance for PDRCs and allow HAL to recover any PDRCs incurred in the latter years of H7 through the H8 price control.

Our Views

- 4.14 We note HAL's comments on the treatment of pension costs at the Q6 price control review. It is not clear that HAL has provided a balanced view of the treatment of pension costs at previous price control reviews. In our February 2014 document that granted HAL's licence we explained that in 'the Q5 November 2007 proposals for Heathrow and Gatwick, the CAA stated that BAA's pension costs should be capped "on the basis of cash contributions to the pension fund each year" and that these should be capped at an appropriate level, to ensure airport users are not disadvantaged by the relative generosity of the scheme'.³² We note that the corollary of this would be that a proportion of scheme deficits should be for shareholders to manage, given the previous conclusions about the undue generosity of the pension arrangements.
- 4.15 Specifically in relation to pension deficit contributions, we noted the 'incremental deficit method developed by Ofgem whereby the pension liabilities are split between those accrued before and after a cut-off point. Any scheme deficit is then split between these portions with customers paying for the former, and the company for the latter. The CAA stated that it intended to consult stakeholders on potential changes to the treatment of HAL's deficit at the next price control review based on the issues described above'.³³

³² Economic regulation at Heathrow from April 2014: Notice granting the licence (CAP1151) at paragraph E27. See: www.caa.co.uk/CAP1151.

³³ Ibid, para E50

- 4.16 Bearing the above in mind we see no real issue of inconsistency with the approach set out in our March 2024 Consultation and our previous decisions. We have clearly signalled that HAL may not recover all the pension costs it considers that it has incurred and that we may reasonably limit the recovery of pension deficit costs.
- 4.17 We also consider that the advice from GAD is clear that, without formal sectionalisation, there is no requirement for PDRCs to be paid to remedy a notional deficit in any putative “HAL share” of the Scheme. In the light of all of the above, we consider that it is in the interests of consumers to reduce the opex allowance included in the H7 price control to reflect GAD’s findings.
- 4.18 Nonetheless, we recognise that there remains a risk that HAL will be required to incur PDRCs during the remaining years of the H7 Period (particularly 2026). Our view remains that this can satisfactorily be addressed by considering any PDRC’s actually incurred by HAL in the latter years of the H7 period, as part of the H8 price control review.

Our Decision

- 4.19 We have decided to retain our position from the March 2024 Consultation and reduce HAL’s opex allowance by £84 million, in line with the findings of the GAD Report. Our approach to implementing these changes is set out in chapter 8 (Implementation).
- 4.20 We continue to recognise that there is still some uncertainty surrounding PDRCs for the rest of the H7 period. We will assess (i) any PDRCs incurred in 2026 as a result of the 2024 valuation, and (ii) any other PDRCs incurred between now and 2025, as part of our H8 review.

Chapter 5

Cost allowance in respect of Business Rates in H7

Introduction

- 5.1 This chapter sets out our decision on the contribution to the overall operating expenditure (opex) allowance for H7 that we should make to account for HAL's liability for business rates. As noted in chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in H7), the opex allowance was designed to ensure that airport charges are calculated efficiently, having regard to users' reasonable demands for AOS and the need to promote economy and efficiency in HAL's provision of AOS.
- 5.2 In our Final Decision we said that our allowance for business rates required further consideration. This chapter addresses these issues. We start by summarising our Final Decision on these matters, subsequent developments, our proposed approach as set out in the March 2024 Consultation, stakeholders' responses and our views and final decision.

The Final Decision

- 5.3 As part of the H7 price control, we included in the opex allowance for H7 an amount to recognise the level of business rates that HAL would be required to pay. However, during much of the period of the H7 price control review, HAL was in still in discussions with the Valuation Office Agency ("VOA") about its latest business rates valuation and the costs that would apply from 2023 onwards.
- 5.4 HAL substantively concluded its negotiations with the VOA over the business rates that it would pay from 2023 at a level around £80 million lower than the figure that we had included in the Final Proposals.³⁴ While our view at the time of the Final Decision was that this was a reasonable basis to support the business rates element of the opex allowance, we said we would carry out a proportionate review and, should any adjustment to the H7 price control be required to reflect the outcome of this review, we would bring forward proposals for a licence modification to put the required changes into effect.

Subsequent developments

- 5.5 Following the Final Decision, we reviewed HAL's commitment to pay business rates which indicated that its liability was £85 million lower than the figure used

³⁴ The Final Decision set an allowance of £593 million for business rates within the overall opex allowance, and a separate non-airlines business rates forecast of £5.6 million relating to Other Regulated Charges.

for opex allowance in the Final Decision. However, during this review, it also became clear that the VOA intended to review airport business rates again during H7, with new rates to be payable from April 2026 for the final nine months of the period. We understood that the VOA was changing the method it used to calculating business rates and that the next revaluation could increase HAL's business rates liability. We noted this prospect should be considered alongside the £85 million opex allowance reduction when we engaged with HAL and airlines.

- 5.6 HAL told us that it expected its business rates liability to rise significantly from April 2026 and to a level that had the potential to exceed the allowance made in the Final Decision.

The March 2024 Consultation

- 5.7 While noting our assessment that a downward adjustment to the H7 opex allowance may be appropriate, the March 2024 Consultation said that we should take account of:
- the planned revaluation by the VOA to come into effect towards the end of the H7 period; and
 - the material increase to the rates payable in 2026 that this seemed likely to bring.
- 5.8 We outlined a proposal that sought to address the planned revaluation and avoid a situation in which HAL would have a significant business rates liability towards the end of H7 that was not addressed through the opex allowance. Our proposal was:
- not to make a downwards adjustment to the H7 business rates;
 - to “log up” the £85 million reduction against 2026 business rates increase; and
 - to “true-up” this £85 million against HAL's actual business rates liability during H7 as part of the H8 review as, by then, the result of the revaluation would be known.
- 5.9 We considered this to be in the interests of both present and future consumers by reducing volatility in airport charges, and through HAL facing less exposure to the need to finance increased rates that had not been taken account of in setting the H7 price control, while also allowing prompt resolution of the final position as part of the H8 price control review.

Stakeholder views

- 5.10 HAL supported our proposal to not make the £85 million adjustment to the H7 opex allowance in order to mitigate the risk from the revaluation which, in HAL's view, could increase its costs very significantly and create financing issues.
- 5.11 HAL proposed that a material increase over a certain level should be reflected in the RAB to allow additional amounts to be financed. In support of this, it cited our high-level approach that HAL should neither lose nor gain from matters that are largely beyond its control.³⁵
- 5.12 HAL also:
- said that, if the H8 review is delayed, then any substantial increase in rates should be reflected in its price control revenue for 2027 and beyond and not be deferred; and
 - asked the CAA to clearly state that additional business rates will be subject to cost pass-through into H8.
- 5.13 Airlines criticised our proposed approach with both Virgin and BA suggesting that the rateable value increase could be less than £85 million or may not happen in H7.
- 5.14 BA stated that our proposal lacked transparency and consistency regarding the recovery of costs within the regulatory period in which they are incurred, arguing this was a fundamental principle of good regulation and that it would be best regulatory practice and consistent with the requirement for the CAA to carry out our regulatory activities in a transparent, accountable, proportionate and consistent way to make the reduction now.
- 5.15 Virgin proposed that deferring an H7 business rates increase into the H8 price control period would allow higher H8 passenger numbers to generate a lower unit rate cost reducing the consumer impact.
- 5.16 Airlines for America also argued that the £85 million reduction in the H7 opex allowance should be made now to benefit consumers.
- 5.17 The AOC/LACC contrasted our proposals for business rates with our proposals for PDRCs, arguing that it showed a lack of consistency with our findings on and approach to this similar issue. It also said that it was not clear how this different approach would better serve consumers' interests.

³⁵ See the Introduction and summary to the March 2024 Consultation at paragraph 18.

Our views

- 5.18 While airlines have contrasted our approach to business rates with that we proposed to take to PDRCs, the difference in approach we are taking is driven by different evidence in respect of each. While:
- on the one hand, as discussed in chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in H7), we have no information that suggests that HAL will have any liability for PDRCs during H7;
 - on the other hand we have clear evidence (i) from the VOA that its next revaluation will take place by April 2026 and will reflect the economic conditions prevailing in 2024 which have improved compared to those used in HAL's current valuation which took account of the prevailing travel constraints in 2021 and (ii) from HAL's rates advisors that the level of rates is likely to increase.
- 5.19 Following the March 2024 Consultation we have been informed by the VOA that the timing of the revaluation process remains unchanged and that the process is now underway. On this basis a significant increase in business rates remains likely before the end of H7. No evidence has been provided to us to support suggestions that the increase in business rates could be less than £85 million.
- 5.20 We consider that the approach set out in the March 2024 Consultation is more likely to lead to the greatest proportion of H7 costs being met within H7. We consider that this approach is appropriate in the interests of consumers and will best reflect the change to HAL's business rates liability from 2026 without seeking to "second guess" the outcome of the VOA's revaluation. On this basis, we view the policy as having appropriate regard to the regulatory principles of being transparent, accountable, proportionate and consistent based on the evidence available to us. We do not consider that there is any inconsistency with our position on PDRCs as the factual background is different for each issue.
- 5.21 That said, we would need to address our wider policy on business rates in the event of a delay to the H8 period. Our expectation would be to continue to treat business rates as a cost pass-through subject to our view of the efficiency of these costs following HAL and VOA engagement.

Our Decision

- 5.22 We have decided to retain our position from the March 2024 Consultation. We have, therefore, decided to defer the downward adjustment to HAL's opex allowance by £85 million and "log up" this sum pending the outcome of the next business rates revaluation. We will assess the level of business rates from April 2026 in conjunction with the deferred £85 million downward adjustment for the H7 business rates allowance as part of setting the operating costs allowance for

the H8 price control and true-up the HAL's business rates liability over the H7 period as part of our work on the H8 price control.

Chapter 6

HAL's H7 commercial revenues and "Pod parking"

Introduction

- 6.1 HAL's commercial revenues include income from various activities at Heathrow airport, including car parks. Projections of these commercial revenues are incorporated into the "single till" calculations used to set the price control for HAL's airport charges. The goal is to create incentives for HAL's efficiency and protect consumers' interests in both the short and long term. An issue arose late in the H7 process relating to assumptions about a specific category of HAL's car parking revenue known as "Pod parking" revenue and how this should contribute to the single till.
- 6.2 During Q4 and Q5 price control reviews, the decision was made not to include the capital expenditure ("capex") associated with Pod parking in the Regulatory Asset Base ("RAB"). Pod parking was considered a novel project with technical and commercial development risks, that lacked support from airlines. Excluding the project from the RAB prevented users from underwriting this risk. This approach was maintained in Q6, and operating costs and revenues related to Pod parking were also excluded from the single till calculations. Consequently, the development and operation of the Pod parking product fell outside the single till price control arrangements.
- 6.3 Relatively late in the H7 process we realised that we had not made an adjustment to HAL's single till revenues to take account of Pod parking and we said we would deal with these matters during the H7 period.
- 6.4 This chapter summarises what we said on these matters in the March 2024 Consultation, stakeholder responses, and our views and final decision.

The March 2024 Consultation

- 6.5 Following the Final Decision we wrote to HAL explaining that we intended to take a proportionate approach to estimating incremental revenues from Pod parking and said that we intended to adopt an approach broadly consistent with that used at the Q6 price control review.
- 6.6 With support from CEPA, we completed analysis of incremental costs and revenues of Pod parking based on information provided by HAL and took the view that the Pod parking product is likely to command a premium of 50% over other parking products. To recognise that Pod parking was not within the single till, we proposed to remove £14.5 million from the commercial revenue forecast and £10.5 million from the opex allowance. This would lead to a net reduction in

HAL's allowed revenues of £4 million (2020, CPI) over H7 (£14.5 million minus £10.5 million).³⁶

Stakeholder views

- 6.7 HAL disagreed with our assessment of the premium that Pod parking generates in comparison to other parking services, but broadly supported our analysis supporting a net reduction of just under £4 million in the commercial revenue forecast. It also suggested better engagement on these issues at future price control reviews.
- 6.8 Airlines questioned whether Pod parking really commanded a premium and noted that the business car park was further from T5 and suggested this might be responsible for some or all of the price differential. They said that a thorough evaluation of Pod parking costs should be conducted during the H8 process.

Our Views

- 6.9 Our view is that it the T5 business car park is the best comparator available and so have retained our approach to estimating the net impact on revenues of Pod parking.
- 6.10 We will look at commercial revenues as part of the H8 process. However, we note that the revenues associated with the Pod parking product are relatively modest and that we should adopt a proportionate approach to assessing these issues.

Our Decision

- 6.11 We propose to retain our position from the March 2024 Consultation and apply a net reduction in the commercial revenue forecast of just under £4 million (in 2020 prices over the H7 period). Our approach to implementing these changes is set out in chapter 8 (Implementation).

³⁶ The precise figure is set out in Appendix C at Table C.3.

Chapter 7

Other issues

Introduction

7.1 The March 2024 Consultation addressed a number of issues that have arisen since our Final Decision in addition to the issues remitted to us by the CMA, including:

- a manifest formula error in condition C1.6 of the Licence;
- a potential issue with the calculation of charges for 2025 and 2026; and
- HAL's request that we should update the H7 opex allowance in respect of energy costs.

7.2 This chapter also addresses a number of additional issues raised by HAL, including:

- the definition of the queuing times metric for vehicles at security posts;
- the application of the Terminal Drop-Off Charge ("TDOC") recovery mechanism; and
- the certification of the adequacy of HAL's operational resources.

7.3 This chapter address each of these issues in turn, setting out the background to each issue, a summary of the views of stakeholders and the course of action we have decided to take in relation to each issue.

Formula error in Condition C1.6

7.4 Condition C1.6 of the Licence sets out the formula for calculating the average revenue yield per passenger for the given Regulatory Year and is a key element of the price control. As discussed in the March 2024 Consultation,³⁷ we had identified that the inadvertent omission of the subscript "-1" from the algebra would mean that the reference to year " X_t " in the formula would "point" at the wrong Regulatory Year, leading to a profile of charges that is very different from our policy intent of having a "flat price profile" for the price control. This omission would generate an increase in the allowed yield per passenger of £6.28 in 2025 and £6.30 in 2026.

7.5 To address this, we proposed to amend the formula in Condition C1.6 to insert the subscript "-1" that had been omitted in error. We considered that it was more appropriate to do this my means of a formal licence modification than the use of an "erratum notice" as had been suggested by stakeholders.

³⁷ See the March 2024 Consultation at paragraphs 7.3ff

Stakeholder views

7.6 HAL and airlines agreed that this was a “manifest error” but maintained their support for it being addressed through an “erratum notice”.

Our views and decision

7.7 Stakeholders’ responses were agreed that this is a “manifest error” and were keen that this should be corrected quickly. While it might be possible to use an “erratum notice” to address such an issue, as we have decided to make a number of changes to the Licence, we consider that the best way to do this is to include this change alongside the other modifications as part of a set of formal licence modifications. As a result, we have decided to make this amendment as part of the modifications set out in Appendix D to this decision.

Calculation of charges for 2025 and 2026

7.8 The March 2024 Consultation discussed how Table 8 in the “Summary” document for the Final Decision³⁸ contained a figure for the price caps for 2023 of £31.32, while Condition C1.1 of the Licence specified a maximum yield per passenger of £31.57 for 2023. Airline stakeholders had expressed concern that the inclusion of the difference (£0.25), which related to capital triggers and service quality bonuses for previous years, could lead to an overstatement of the charge for 2024. We acknowledged the potential for confusion, but made clear that this had been addressed in the calculation of the charges for 2024.

Stakeholder views

7.9 HAL reiterated the view noted in the March 2024 Consultation that the figure of £31.57 in Condition C1.1 is correct and supported our position that no further action is needed.

7.10 Airline stakeholders noted the lack of transparency around this issue and the potential for it to create confusion. They did not, however, indicate that they thought that the CAA’s analysis of this issue was incorrect.

Our views and decision

7.11 We recognise that the apparent inconsistency between the figures set out in the Final Decision and the Licence had the potential to create confusion, despite the fact that the Final Decision did explain the difference in a footnote. While we do not consider that action is appropriate now, we are mindful of the need for transparency in all our work and will seek to avoid similar confusion arising in the future.

³⁸ Economic regulation of Heathrow Airport: H7 Final Decision (CAP2524A). See: www.caa.co.uk/CAP2524A

Updating energy costs in the opex allowance

7.12 The March 2024 Consultation addressed HAL's contention that we should update the opex allowance for energy costs used for the H7 price control alongside the allowances for PDRCs and business rates.

Stakeholders' views

7.13 HAL did not make further representations on this issue, while airlines stakeholders opposed a reopening of the price control on this issue.

Our views and decision

7.14 Having considered stakeholders' views, we have decided not to reopen the H7 price control on this issue. HAL had the opportunity to raise this issue in its extensive appeals to the CMA but chose not to do so. Reopening this issue now would not be appropriate in the context of incentive regulation and would not be in the interests of consumers.

Vehicle queuing times metric

7.15 This issue concerns the definition of the performance target metric for vehicle queuing times at control posts used as part of the service quality "Measures, Targets & Incentives" (the "MTI scheme") set out in Schedule 1 of the Licence.

Stakeholder views

7.16 HAL raised this issue, noting that it had, through engagement with the airline community, agreed a per-vehicle measure and an updated definition of the metric used for the MTI scheme. HAL was concerned that the wording used in the Licence was insufficiently clear to reflect the agreed position and was concerned that the Licence might be interpreted incorrectly.³⁹ It proposed specific wording to remove the ambiguity.

7.17 Virgin and Airlines for America agreed with the proposed changes, while the AOC/LACC stated that it was "not opposed" to the change. We wrote to HAL and the AOC/LACC in May proposing that we should use the "self-modification procedure" set out in the Licence to resolve this issue and seeking written agreement to both the use of the self-modification procedure⁴⁰ and the text of the clarifying modifications.

7.18 Each of HAL and the AOC/LACC have confirmed their support for this approach.

³⁹ HAL said that the agreed methodology should be to measure the average number of vehicles at each control post group which have a waiting time of less than 15 minutes in each 15-minute period.

⁴⁰ Conditions D1.6 to D1.8 of the Licence set out this procedure.

Our views and decision

7.19 While this issue was not raised in the March 2024 Consultation, we consider that the “self-modification” procedure for the MTI scheme set out in Licence conditions D1 is both available and an appropriate mechanism for effecting this change in a timely manner. We see the proposed amendment as being a clarification of the Licence, rather than a modification of the incentive in question.

7.20 We have, therefore, decided to modify the licence in accordance with the self modification procedure. The modifications to the licence are set out in Appendix D.

Terminal drop-off charge (“TDOC”)

7.21 HAL considers that the Final Decision makes it clear that the differential between the total TDOC revenue forecast by the CAA and the actual/forecast TDOC revenues should be subject to a sharing factor that shares 65% of any profit or loss with the airline community through charges from the year 2022.

7.22 However, the licence drafting (set out in Condition C1 of the price control⁴¹) only applies from 2024 and does not address differences between forecasts and outturns in 2022 and 2023, in HAL’s view creating an inconsistency in policy between the Final Decision and the Licence. In addition, HAL has said that the mechanism should also include an inflation adjustment and that these matters should be addressed through a licence change.

Stakeholder views

7.23 BA and Virgin supported by the AlixPartners report, consider that the CAA is best placed to clarify its Final Decision including whether it was intended to cover the risk of shortfalls in 2022 and 2023, but noted that the CAA should take an incentive based approach so that HAL is only exposed to risks beyond its control. Further, HAL should be expected to take a commercial approach and any shortfall arising from HAL’s pricing decisions or inefficiency should not be included in any true-up.

7.24 They also said that:

- this may be an attempt to reopen the price control and the CAA should resist this; and
- these matters should be reviewed in the context of the review that the CAA said in the Final Decision that it would carry out.

7.25 Airlines for America said that the CAA should first establish whether any true-up was required and then consult on the matter.

⁴¹ See condition C1.18 and C1.19 of the Licence.

7.26 The AOC/LACC said it was not of the view that the CAA's policy was designed to cover shortfalls but would welcome clarity from the CAA as well as further engagement and appropriate consultation before any amendments are made and these matters would be best addressed by the review the CAA proposed in the Final Decision.

Our views and decision

7.27 This is a matter that the CAA did not consult on as part of the March 2024 Consultation and, therefore, no changes to Condition C1 can be made at this stage as we would need to adhere to the licence modification process set out in CAA12, which requires consultation on licence changes. Nonetheless, given that this issue has been raised by stakeholders, we make the following observations.

7.28 We remain of the view that the Final Proposals and the Final Decision set out an appropriate approach to these matters. The Final Proposals explained our concerns about both the TDOC being a new revenue stream and HAL's ability to significantly increase the charge and retain the extra profits. To address this, we built on a proposal from the Initial Proposals that there be a 65%:35% risk sharing arrangement so that, if the revenue from this charge were to be greater than forecast, airport charges would reduce by approximately two thirds of the difference.⁴²

7.29 The Final Decision retained this approach and the associated provision for a review by the CAA during 2024 as a proportionate way of dealing with the uncertainties in this area.⁴³

7.30 On this basis, we consider that the approach set out in the Final Decision was designed to address the risk of revenues from TDOC being higher than forecast, not lower as has turned out to be the case. That said, as noted above, we intend to conduct a review of our allowance for revenue from TDOC later in 2024. The position outlined above will be the starting point for that review.

7.31 As for HAL's request for an inflation adjustment, we do not intend to make this change now but will consider as part of our review of the TDOC mechanism and there seems no compelling case to reopen this issue ahead of this review. Reopening this issue now would not be appropriate in the context of incentive regulation and would not be in the interests of consumers.

Certificate of adequacy of resources - assurance

7.32 HAL's licence condition E2.5 of the Licence provides that HAL must obtain and submit to the CAA with each of the (i) financial and (ii) operational, certificates of sufficient resources a report prepared by its auditors stating whether the auditors are

⁴² See The Final Proposals at paragraphs 5.16 and 5.74

⁴³ See the Final Decision at paragraph 5.40

aware of any inconsistencies between, on the one hand, those certificates and, on the other, the information they obtained during the audit.

7.33 In March 2024, HAL told us it would be unable to provide us with the required report in relation to the certificate of operational resources it would give under Condition C2.3. This was because HAL's auditors had taken the view that this would lie outside the scope of the audit.

7.34 We acknowledged at the time that HAL would not be able to provide the report but indicated that HAL should seek to provide alternative assurance in the interests of consumers. Although this situation may constitute a breach of HAL's licence, we considered that it would not be proportionate for us to seek to investigate these matters while HAL was seeking to identify what alternative assurance it could provide in the interests of consumers.

Stakeholder views

7.35 HAL has proposed an approach under which it provides further assurance signed by its Chief Operating Officer and a nominated board member confirming that HAL has reviewed the requirement and that it has sufficient resources to provide AOS in accordance with the Licence for the next two years. It proposed that the Licence should be amended to reflect this approach on an enduring basis.

7.36 BA's response drew comparison with the issuance of Air Operators Certificates which mandates a rigorous process for applicants including a thorough assessment to verify that the applicant meets the relevant requirements, including financial requirements. It said that the CAA should adopt a similar approach to verifying that HAL has sufficient operational resources to check that HAL's self-assessment aligns with the standards required.

7.37 Airlines for America considered that assurances from HAL's Chief operating Officer and a nominated board member would not provide sufficient assurance as it would allow HAL to "correct its own homework", Instead, it suggested that HAL should provide independent assurance. The AOC/LACC took a similar view.

Our views

7.38 This issue has arisen as a result of HAL's auditors taking the view that, despite the fact that they had, in previous years, considered it appropriate for them to provide assurance in relation to the "combined" certificates of financial and operational resources, it would not be appropriate for them to give assurance in relation to a "separate" certificate of operational resources.

7.39 We acknowledge that the assurance that the auditors' report gave in previous years was limited by the fact that it sought to provide assurance in relation to operational resources by highlighting any inconsistency between HAL's *operational* resources

certificate and information they had obtained during their audit of the relevant year-end accounts which are, of their nature, focussed on HAL's *financial* position.

- 7.40 Having considered HAL's proposed approach, of "*producing a signed declaration from the Chief Operating Officer and a nominated board member that they have reviewed the Licence requirement and that the Licensee has available sufficient operational resources*", we consider that this does not provide materially more assurance than the existing obligation in Condition E2.3 which requires that the certificate itself be "*approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution*".
- 7.41 We acknowledge that stakeholders have proposed external assurance and drawn parallels with the approach taken to Air Operators Certificates. We are not immediately persuaded that taking a significantly more intrusive approach would be proportionate, not least as the more natural parallel with the oversight of Air Operators Certificates for HAL appears to be the ongoing oversight arrangements the CAA has in place as a result of Heathrow being a certificated aerodrome.
- 7.42 That said, we continue to regard an appropriate form of further assurance in relation to this certificate to be important as it relates to HAL's ability to meet the reasonable demands of consumers at the airport in the coming years. As a result, we do not consider that it would be appropriate for us to accept HAL's approach at this stage. We will continue to engage with HAL in developing an appropriate approach in the interests of consumers, with a view to bringing forward a suitable licence modification in due course.

Arithmetic error in the March 2024 Consultation

- 7.43 The March 2024 Consultation set out in detail how we had calculated the AK(t) and H7(t) amounts.⁴⁴ The AlixPartners report referred to by BA and Virgin notes that there appears to be an arithmetic error in paragraph D9 of Appendix D of the March 2024 Consultation that leads to an understatement of the value of our calculation of the H7(t) adjustment term. Specifically, AlixPartners highlight that the two sides of these equations do not agree. BA requested that this issue be reviewed.

Our views and decision

- 7.44 We have reviewed the calculations set out in Appendix D of the March 2024 Consultation, and especially those set out in both Table D.4 and paragraph D9. The issue that AlixPartners have identified has arisen because, in the calculations in paragraph D9, we used RPI indices on the left-hand side of the equations, but CPI indices to calculate the result on the right-hand side of the equation.

⁴⁴ See the March 2024 Consultation at Appendix D.

- 7.45 Our review has concluded that this was a transposition error in the drafting of paragraph D9 that arose because, while in Table D.4 the description of the inflation index (“L”) used in the calculations in D9 was for the “ONS CPI Index”, we had inadvertently inserted RPI index numbers in that line of the table.
- 7.46 While the March 2024 Consultation did not discuss in detail the inflation index to be used for each of the AK_t and $H7_t$ adjustments, paragraph 8.7 of the March 2024 Consultation made clear that the approach for each adjustment we proposed was to follow the approach to the time value of money used in the Final Decision.⁴⁵ This approach was taken forward by the clear reference to CPI in the description of “L” in Table D.4 of Appendix D of the March 2024 Consultation. The use of this measure of inflation is appropriate because the $H7_t$ term adjusts the opex and commercial revenue allowances which were indexed by CPI in the Final Decision. As such, Table D.4 and the calculations in paragraph D9 should contain CPI indices and the references in the calculations paragraph D9 should have consistently been to CPI.
- 7.47 In practice, we had used CPI indices to undertake the underlying calculations in paragraph D9 of the March 2024 Consultation and, therefore, this issue does not affect the output of those calculations. On this basis, we are satisfied that the right-hand side of the equation is correct. As this is the figure which is carried forward into the calculation of $H7(t)$, we have decided that there is no error in the calculation of $H7(t)$.
- 7.48 A corrected version of the calculations (using CPI values for “L” in Table C4) is set out in Appendix C.

⁴⁵ As discussed in chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in $H7$) and chapter 6 (HAL’s commercial revenues and “Pod parking”), the $H7(t)$ factor adjusts the opex and commercial revenues building blocks. The approach we took to each of these in the Final Decision was to index each of these building blocks by CPI.

Chapter 8

Implementation

Introduction

8.1 This chapter sets out how we have decided to implement the changes to HAL's allowed revenues for H7 arising from the matters discussed in the preceding chapters.

The March 2024 Consultation

8.2 The March 2024 Consultation considered:

- making the adjustments through the RAB or the allowed price cap,
- the treatment of the time value of money;
- whether to use one adjustment term or more; and
- the design of the adjustment terms.

Making the adjustments through the RAB or the allowed price cap

8.3 We considered that it would be in consumers' interests to make the relevant adjustments within H7 by adjusting the allowed price cap, rather than more slowly through the RAB. This would also reduce the number of issues outstanding for the H8 price control process. To do this, we proposed to amend the price control condition in the Licence.⁴⁶ Only where the position is too uncertain to be addressed now did we propose to defer implementing the adjustment.⁴⁷

Treatment of the time value of money

8.4 To be consistent with the approach taken in the Final Decision, we proposed to follow the approach to the time value of money used in the Final Decision for each adjustment to ensure that there is no gain or loss to consumers resulting from this. On this basis:

- we used the recalculated WACC to recalibrate the AK_t factor, using RPI and the pre-tax WACC uplift to account for the time value of money; and

⁴⁶ Condition C1 (Price Control).

⁴⁷ This higher level of uncertainty applies to the truing up of HAL's business rates expenditure during H7 and addressing any PDRCs that might arise in H7.

- we re-ran the PCM using the updated WACC to identify the appropriate figures for the PDRC and Pod parking adjustments.⁴⁸

8.5 We considered that this was a reasonably clear and transparent approach which is consistent with that used for the calculations in the Final Decision.

One adjustment term or more?

8.6 We proposed two adjustment factors to achieve a suitable balance between transparency and simplicity:

- a recalculated AK_t factor for the adjustments for 2020 and 2021; and
- a new adjustment factor for the H7 period (“H7_t”), to account for the other adjustments we are making.

The design of the adjustment terms

8.7 Our starting point was the design of the AK_t factor we included in the Final Decision because:

- it allows adjustments to be made to the allowed price cap over more than one year, with appropriate uplifts for indexation and for the time value of money; and
- the structure of the AK_t term (rather than how the underlying adjustment was derived) was not a matter of contention before the CMA.

8.8 However, given the time elapsed since the Final Decision, we proposed to make two changes to the approach used for the Final Decision:

- to specify the amounts of the adjustments (in 2020 prices) as they are now known; and
- to require HAL to return the adjustment through charges equally in 2025 and 2026⁴⁹ to reduce charge volatility.

8.9 We proposed to adopt the same structure for both adjustments as these issues were relevant to each of them.

8.10 We did not receive significant comments on these matters, apart from airlines and their representatives who favoured the adjustment being made in one year (2025). While we note that stakeholders did suggest licence drafting in relation to these adjustments, those suggestions were designed to reflect their comments

⁴⁸ See the discussion in chapter 7 (Other Issues) on the use of CPI and RPI indexation.

⁴⁹ The amounts will be equal in net present value terms, which means that the nominal amount in 2026 will be slightly larger.

that we should make different adjustments. For the reasons set out in the preceding chapters, we have decided not to adopt these suggestions.

Impact on the allowed price caps for 2025 and 2026

8.11 Having considered stakeholders' representations, we have decided that the most appropriate approach is to make the adjustments required by our decisions in chapters 1 to 7 in the manner set out in the March 2024 Consultation. We consider that this approach is most consistent with the approach used in the Final Decision for the AK_t adjustment, and will be in the interests of present and future consumers over the remainder of H7 by contributing to a lessening of charge volatility in that period. The adjustments we have decided to make are set out below.

The AK_t adjustment

8.12 On the basis of the analysis that we set out in chapter 1 (The AK_t adjustment factor), we have decided that the appropriate amount of the AK_t adjustment is £29 million in respect of 2020 and £47 million for 2021, giving a total of £76 million (2020 CPI-real prices).⁵⁰

8.13 To convert these amounts into the changes to be made in the 2025 and 2026 allowed price caps we have:

- provided for indexation uplift to 2025 and 2026 prices through the formulae in the Licence;
- applied the revised real pre-tax WACC of 4.01% to 2025 and 2026;
- spread the adjustment equally across in 2025 and 2026; and
- adopted the 2025 and 2026 forecast passenger volumes in the H7 Final Decision.

8.14 Following these calculations steps, the estimated reduction in the allowed price caps per passenger will be -£0.718 for 2025 and -£0.748 for 2026. These figures have been calculated in the manner set out in Appendix C.⁵¹

⁵⁰ The detail of the recalculation of these figures is set out in Appendix C at Tables C.1 (2020 CPI-real prices) and C.2 (rebased to current prices).

⁵¹ To ensure a consistent approach with the H7 Final Decision, we have used the inflation data that was available at the time of publication the H7 Final Decision (March 2023), that is, outturn inflation figures published by the ONS up to 2021, and inflation forecasts published by the OBR (November 2022 edition) from 2022 onwards.

The H7_t factor

8.15 For the adjustments to the H7 price control, we have employed the PCM to work out what the allowed revenues over each year of the H7 period should have been and compared them to the amounts we used for the Final Decision, to determine the difference. The PCM takes the inputs relating to all five years of the H7 period and calculates a profile of charges for that period, albeit that for the first two years the level of the charge was specified by means of a holding cap. We have made the equivalent NPV adjustment for the years 2024 to 2026. These differences are set out in Table 8.1.

Table 8.1 Total amount of adjustment for the H7_t factor

£ million 2020 CPI-real prices	2024	2025	2026	Total
Removal of index-linked debt premium	-8.19	-8.37	-8.44	-24.99
Changing Pensions Deficit Repair Costs allowance	-28.25	-28.88	-29.12	-86.26
Changing Pod parking allowance	+1.31	+1.33	+1.35	+3.99
Total H7 _t adjustment	-35.13	-35.92	-36.21	-107.27

Source: CAA analysis. Numbers may not add up due to rounding.

8.16 Since charges for 2024 are already being levied, it is not appropriate to seek to change them. While this does increase the adjustment to charges in 2025 and 2026, the net present value of the adjustment will remain the same. The estimated reduction in the allowed price caps as a result of the H7_t adjustment will, therefore, be -£0.798 for 2025 and -£0.825 for 2026 as calculated in Appendix C and set out in Table 8.2.

Table 8.2 Estimated reduction in the allowed price cap in (H7_t)

Estimated reduction in the allowed price cap in £ per passenger current year prices	2025	2026
Removal of index-linked debt premium	-0.186	-0.192
Pensions Deficit Repair Costs	-0.642	-0.663
Pod parking	+0.030	+0.031
Total	-0.798	-0.825

Source: CAA analysis. Numbers may not add up due to rounding.

8.17 Taken together and when adjusted for the time value of money, we estimate that the changes set out in this consultation will lead to decreases in HAL's charges of £1.516 in 2025 and £1.573 in 2026 compared to the charges for H7

we set in the Final Decision.⁵² This size of reduction is the result of having two years to apply the reduction in allowed revenues that corresponds to a period of seven years (from 2020 to 2026) to which the underlying adjustments relate.

Modifying the Licence

- 8.18 For the reasons set out above and in chapters 1 to 7, we have decided to implement these changes through modifications to Condition C.1 (Price Control) of the Licence. HAL will give effect to the adjustments in relation to both the AK_t and $H7_t$ in its charges for 2025 and 2026. These modifications are set out in the Notice under section 21(2) CAA12 which accompanies this consultation at Appendix D.
- 8.19 For the reasons set out in chapter 7 (Other Issues), we have also decided to modify the licence using the “self-modification procedure” set out in Condition D1 of the Licence to clarify the “Vehicle queuing times metric” used as part of the service quality “Measures, Targets & Incentives” (the “MTI scheme”) set out in Schedule 1 of the Licence. These modifications are set out in Appendix D.

⁵² Estimates of the charges we set for H7 were set out in Table 8 of the Final Decision. That table did not include the impact of the AK_t adjustment as this relates to the period 2020 and 2021 (that is, prior to the H7 period). The decreases in HAL’s charges of £1.516 in 2025 and £1.573 in 2026 set out in paragraph 16 above are as compared to the estimated charges set out in Table 8 of the Final Decision.

APPENDIX A

Our duties

- A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.
- A2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.
- A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.
- A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.
- A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:
- the need to secure that each licensee is able to finance its licensed activities;
 - the need to secure that all reasonable demands for AOS are met;
 - the need to promote economy and efficiency on the part of licensees in the provision of AOS;
 - the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
 - any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
 - the “Better Regulation” principles.
- A6 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.
- A7 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent

CAP3001

determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

APPENDIX B

Glossary

B1 The terms used in this document are arranged in the following groups:

- legislation and regulatory processes;
- price controls; and
- other terms.

Legislation and regulatory processes

Acronym / term	Description
AOS	Airport operation services, defined in section 68 CAA12
CAA12	The Civil Aviation Act 2012
CMA	The Competition and Markets Authority
Final Proposals	CAP2365 “Economic regulation of Heathrow Airport Limited: H7 Final Proposals” June 2022. See: www.caa.co.uk/CAP2365
Final Decision	CAP2524 “Economic regulation of Heathrow Airport: H7 Final Decision” March 2023. See: https://www.caa.co.uk/commercial-industry/airports/economic-regulation/h7/consultations/final-and-initial-proposals-for-h7-price-control/
The CMA’s Final Determinations	CMA Final Determinations of the appeals against the CAA’s decision on H7 dated 17 October 2023. See: https://assets.publishing.service.gov.uk/media/652fe1e4d06662000d1b7cc0/3_H7_Appeal_Final_Determinations_Non-Sensitive.pdf
Consumers	“Users” are defined in section 69 CAA12 as passengers and those with “a right in property” (cargo) carried by air transport services and include future users.
The Licence	The licence granted to Heathrow Airport Limited by the Civil Aviation Authority under section 15 CAA12 on 13 February 2014.
The March 2024 Consultation	CAP2980 “Economic regulation of Heathrow airport: H7 final issues”. See www.caa.co.uk/CAP2980
Virgin	Virgin Atlantic Airways Ltd

Price controls

Acronym / term	Description
Q5	Q5 was the price control for the period from 2008 to 2013, the approach to which was subsequently extended to cover January to March 2014.
Q6 / Q6 price control	Q6 was the price control for the period from 2014 to 2018, the approach to which was successively extended to cover 2019 and 2020 to 2021.
H7	The price control period for Heathrow from 1 January 2022 until 31 December 2026.
iH7	The interim H7 price control, running from 1 January 2020 until 31 December 2021.
H8	The price control for Heathrow following H7.

Other

Acronym / term	Description
AOC/LACC	Airline Operators' Committee (for Heathrow) / London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport.
BA	British Airways plc
Building blocks	Price control building blocks, including passenger numbers, operating costs, capital expenditure and commercial revenues
CAA ("us"/"we")	The Civil Aviation Authority
Capex	Capital Expenditure
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport.
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport.
Opex	Operational Expenditure

Acronym / term	Description
ORCs	Other Regulated Charges, which are for specified services and facilities that are collected separately from the general regulated airport charges and are, in general, levied on a “user-pays” basis).
Price Control Model	The financial model developed by the CAA to calculate HAL’s revenue requirements for H7.
RAB	Regulatory Asset Base
RBUpdate2	HAL’s publication, Updated Revised Business Plan submitted to the CAA in December 2021.
Shock factor	A downward adjustment to volume forecasts to address the asymmetry of risks.
WACC	Weighted average cost of capital

APPENDIX C

Further detail on the calculation of the AK_t and H7_t adjustments

AK_t factor

C1 Table C.1 sets out how we have recalculated the value of AK_t in £ million, 2020 CPI-real prices in the manner described in chapter 8 (Implementation).

Table C.1: Total adjustment amount

£ million, 2020 CPI-real prices	2020	2021	Total
<u>Original calculation</u>			
Original Dt ("A")	-40	-89	-129
Original BR _t ("B")	-35	-40	-74
Original Pax mix ("C")	-17	-33	-50
Original AK _t factor ("D"=A+B+C)	-91	-162	-253
<u>Passenger figures used to recalibrate D_t and BR_t</u>			
Forecast passenger volume (million) ("E")	81.5	82.0	
Outturn passenger volume (million) ("F")	22.1	19.4	
Outturn passenger volume as a percentage of forecast passenger volume (%) ("G"= F/E)	27.1%	23.6%	
<u>Recalculation of AK_t factor</u>			
Recalculated Dt ("H"= A x G)	-11	-21	-32
Recalculated BR _t ("I" = B x G)	-9	-9	-19
Recalculated Pax mix ("J" = C x 50%)	-8	-17	-25
Recalculated AK _t factor ("AK" = H + I + J)	-29	-47	-76

Source: CAA calculation. Numbers may not add up due to rounding

C2 Table C.2 sets out how we have rebased the AK_t adjustment into current year prices for 2025 and 2026 using (i) ONS inflation data and forecasts⁵³ and (ii) the recalculated WACC in accordance with our proposals in chapter 2 (The Premium applied to index-linked debt costs). This table sets out how we have translated

⁵³ We used the ONS outturn inflation figures up to the end of 2021, and OBR inflation forecasts from 2022 onwards. This is the same information set available to us when we published the H7 Final Decision in March 2023.

this adjustment into an estimate of the change in the per passenger allowed price cap using the passenger forecast used in the Final Decision.

Table C.2: AKt: Estimated changes to the allowed price cap to account for inflation, the WACC and the H7 passenger forecast

1.		2020	2021	2025	2026	Total
	<u>Inflation, WACC and passenger forecast inputs</u>					
2.	ONS CPI index (D7BT index) ("L")	108.75	111.56			
3.	ONS RPI index (CHAW index) ("M") ⁵⁴	293.14	305.00	381.25	384.94	
4.	Pre-tax real WACC (%) ("N")					4.01%
5.	H7 forecast passengers (million) ("P")			80.70	81.30	
6.						
7.	<u>Calculation (all in current year prices)</u>					
8.	Recalculated AKt factor (£ million) ("AK' ", calculated by applying CPI inflation uplift to "AK" from Table 1 above) – for detail, see paragraph C3 below	29	48			77
9.						
10.	2020 allowed revenues adjustment (reduction) in 2025 and 2026 (£ million) ("Q" calculated in accordance with paragraph C4 below)			22.63	23.76	46.39
11.	2021 allowed revenues adjustment (reduction) in 2025 and 2026 (£ million) ("R" calculated in accordance with paragraph C5 below)			35.30	37.07	72.37
12.	Changes (reduction) to allowed price cap in 2025 and 2026 (£ per passenger) ("S" = (Q + R) / P)			0.718	0.748	

Source: CAA calculation. Numbers may not add up due to rounding.

C3 We have used the inflation figures set out in Table C.2 to re-base the recalculated AKt factor in 2020 CPI-real prices to current prices as follows (see line 8 of Table C.2):⁵⁵

$$AK'_{2020} = AK_{2020} \times \frac{L_{2020}}{L_{2020}} = 29m \times \frac{108.75}{108.75} = 29m$$

$$AK'_{2021} = AK_{2021} \times \frac{L_{2021}}{L_{2020}} = 47m \times \frac{111.56}{108.75} = 48m$$

⁵⁴ See paragraphs 12.40-12.41 of our Final Decision (www.caa.co.uk/CAP2524D) for a discussion of why we use both RPI and CPI in different parts of the H7 price control.

⁵⁵ The term L has the meaning shown in the tables in this Appendix

C4 Adopting the calculation steps described in paragraph 8.13 of chapter 8 (Implementation) we have calculated the AK_t adjustment in respect of 2020 allowed revenues to be applied in 2025 and 2026 (see line 10 of Table C.2):⁵⁶

Q₂₀₂₅

$$\begin{aligned}
 &= \text{Recalculated AKt factor (rebased) for 2020} \times 50\% \times \frac{\text{RPI index for 2025}}{\text{RPI index for 2020}} \times (1 + \text{WACC})^{(2025-2020)} \\
 &= K'_{2020} \times 50\% \times \frac{M_{2025}}{M_{2020}} \times (1 + N)^{(2025-2020)} \\
 &= 29\text{m} \times 50\% \times \frac{381.25}{293.14} \times (1 + 4.01\%)^5 \\
 &= 22.63\text{m}
 \end{aligned}$$

Q₂₀₂₆

$$\begin{aligned}
 &= \text{Recalculated AKt factor (rebased) for 2020} \times 50\% \times \frac{\text{RPI index for 2026}}{\text{RPI index for 2020}} \times (1 + \text{WACC})^{(2026-2020)} \\
 &= K'_{2020} \times 50\% \times \frac{M_{2026}}{M_{2020}} \times (1 + N)^{(2026-2020)} \\
 &= 29\text{m} \times 50\% \times \frac{384.94}{293.14} \times (1 + 4.01\%)^6 \\
 &= 23.76\text{m}
 \end{aligned}$$

C5 By adopting the same calculation steps as paragraph C4 above, we have calculated the AK_t adjustment in respect of 2021 allowed revenues to be applied in 2025 and 2026 (see line 11 of Table C.2):

$$\begin{aligned}
 R_{2025} &= 48\text{m} \times 50\% \times \frac{381.25}{305.00} \times (1 + 4.01\%)^5 = 35.30\text{m} \\
 R_{2026} &= 48\text{m} \times 50\% \times \frac{384.94}{305.00} \times (1 + 4.01\%)^6 = 37.07\text{m}
 \end{aligned}$$

H7_t factor

C6 For calculating the H7_t adjustment, as discussed in chapter 8 (Implementation), we employed the PCM to work out what the allowed revenues over each year of the H7 period should have been. We compared these to the amounts we used for the Final Decision to determine the difference. These differences are set out in Table C.3 below.

⁵⁶ The terms M and N have the meanings shown in the tables in this Appendix

Table C.3 Total amount of adjustment for the H7_t factor

£m, 2020 CPI-real prices	2024	2025	2026	Total
Removal of the index linked debt premium ("T")	-8.19	-8.37	-8.44	-24.99
Changing PDRC allowance ("U")	-28.25	-28.88	-29.12	-86.26
Changing pod parking allowance ("V")	+1.31	+1.33	+1.35	+3.99
Total H7 _t adjustment ("W" = T + U + V)	-35.13	-35.92	-36.21	-107.27

Source: CAA calculation. Numbers may not add up due to rounding.

C7 Table C.4 sets out how we have rebased the H7_t adjustment into current year prices for 2025 and 2026 using ONS inflation data and forecasts⁵⁷ and the recalculated WACC in accordance with our proposals in chapter 2 (The Premium applied to index-linked debt costs). This table sets out how we have translated this adjustment into an estimate of the change in the per passenger allowed price cap using the passenger forecast used in the Final Decision. As noted in chapter 7 (Other Issues), the figures for "L" in this table have been changed from those set out in the equivalent table in the March 2024 Consultation as these figures should have been for CPI, not RPI.

Table C.4: H7_t: Estimated changes to the allowed price cap to account for inflation, the WACC and the H7 passenger forecast

	2022	2023	2024	2025	2026	Total
<u>Inflation, WACC and passenger forecast inputs</u>						
ONS CPI index (D7BT index) ("L")	121.77	130.72	131.54	130.52	130.75	
Pre-tax real WACC (%) ("N")						4.01%
H7 forecast passengers (million) ("P")				80.70	81.30	
<u>Calculation (all in current year prices)</u>						
Present value of change as at 2022 ("X" calculated in accordance with paragraph C8 below)			-31.22	-30.69	-29.75	-91.67
NPV (as at 2022) to be recovered ("Y") = X _{total} x 50%				-45.83	-45.83	-91.67
Nominal amount to be recovered (£ million) ("Z" calculated in accordance with paragraph C9 below)				-64.379	-67.076	
Changes to allowed price cap in 2025 and 2026 (£ per passenger) AA = Z / P (see paragraph C10 below)				-0.798	-0.825	

Source: CAA calculation. Numbers may not add up due to rounding.

⁵⁷ See footnote 54 above.

C8 We have calculated the net present value of the required changes to the allowed price cap as follows:⁵⁸

$$\text{Net present value} = \frac{\text{present value of change}_{2024}}{(1 + \text{WACC})^3} + \frac{\text{present value of change}_{2025}}{(1 + \text{WACC})^4} + \frac{\text{present value of change}_{2026}}{(1 + \text{WACC})^5}$$

$$X_{\text{total}} = \frac{W_{2024}}{(1 + N)^3} + \frac{W_{2025}}{(1 + N)^4} + \frac{W_{2026}}{(1 + N)^5} = \frac{-35.13}{(1 + 4.01\%)^3} + \frac{-35.92}{(1 + 4.01\%)^4} + \frac{-36.21}{(1 + 4.01\%)^5} = -91.67$$

C9 We have calculated the estimates of the nominal amount to be recovered as follows:⁵⁹

$$\text{Nominal amount}_{2025} = \text{NPV to be recovered}_{2025} \times \frac{\text{CPI index for 2025}}{\text{CPI index for 2020}} \times (1 + \text{WACC})^4$$

$$Z_{2025} = Y_{2025} \times \frac{L_{2025}}{L_{2020}} \times (1 + N)^4 = -45.83 \times \frac{130.52}{108.75} \times (1 + 4.01\%)^4 = -64.379$$

$$Z_{2026} = Y_{2026} \times \frac{L_{2026}}{L_{2020}} \times (1 + N)^5 = -45.83 \times \frac{130.75}{108.75} \times (1 + 4.01\%)^5 = -67.076$$

Overall impact

C10 Taking the above analysis together, we set out in Table C.5 the estimated overall impact on the allowed price cap.

Table C.5: Estimated overall impact on the allowed price cap

£ per passenger, current year	2025	2026
AK _t	-0.718	-0.748
H7 _t	-0.798	-0.825
Total	-1.516	-1.573

⁵⁸ The terms W,X and N have the meanings shown in the tables in this Appendix

⁵⁹ The terms Z, Y and N have the meanings shown in the tables in this Appendix. The numbers shown may not agree due to rounding.

APPENDIX D

Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

Introduction

- D1 This Appendix constitutes a notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) (“Notice”) that the CAA has decided to modify the licence granted to HAL by the CAA under section 15 CAA12 on 13 February 2014 (“the Licence”) to implement the policy proposals set out in chapters 1 to 7 of this decision. These modifications address the issues which:
- the CMA remitted to the CAA as part of its Final Determination; and
 - the CAA left outstanding in the Final Decision.
- D2 The modifications are set out below and are mostly set out in full in “tracked change” format in red compared to the current version of the Licence, which took effect on 1 May 2023.
- D3 Where the reasons for, and effects of, the modifications set out in this Notice are set out in other chapters of this decision, the reasons for, and effects of the modifications set out in those other chapters are deemed to be incorporated in this Notice. This notice sets out where those reasons and effects are to be found. Those chapters also set out how we have taken account of stakeholders’ responses to the March 2024 Consultation and the notice under section 22(2) contained in it. The modifications we have decided to make under section 22(5) CAA12 are unchanged from those set out in that earlier notice.
- D4 In addition to these changes effected through the licence modification procedure set out in CAA12, this Appendix sets out the changes that we have decided to make under the “self-modification” procedure set out in Condition D1 of the Licence in relation to the vehicle queuing times metric discussed in chapter 7 (Other Issues).
- D5 All the modifications set out in this Appendix will take effect on 1 September 2024.

What the modifications cover

- D6 Key areas that are addressed by the modifications set out below are:

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

- the CAA’s approach to setting the level of the additional correction factor (“AK_t”) that reflects the difference between HAL’s outturn and allowed revenues per passenger in 2020 and 2021 (see chapter 1 (The AK_t adjustment factor));
- whether the CAA should have included an uplift for index-linked debt in the calculation of the cost of debt used for the WACC for H7 (see chapter 2 (The Premium applied to index-linked debt costs));
- the appropriate contributions to the opex allowance “building block” used in the H7 price control for “PDRCs (see chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in H7));
- the appropriate treatment of HAL’s revenues from its commercial “Pod parking” service (see chapter 6 (HAL’s commercial revenues and “Pod parking”)); and
- addressing the manifest error the CAA has identified in the drafting of the Licence modifications that the CAA used to implement the Final Decision (see chapter 7 (Other Issues)).

D7 These modifications are not extensive. The most significant substantive changes are addressed through:

- the modification of the “AK_t” term used in the formula for the price control set out in Condition C1.5 and defined in Condition C1.22. While the CMA quashed our previous decision to introduce an AK_t term, it remitted these issues to us for reconsideration and did not rule out the use of such a term in the circumstances where we had considered further the appropriate approach to these matters and the calibration of the term. As explained in more detail in chapter 1 (The AK_t adjustment factor) and chapter 8 (Implementation)), we have now decided that an AK_t term remains appropriate, albeit at a significantly reduced level than that implied by our Final Decision. The modification is shown is a track change version of the licence as modified in 2023, and its effect is to reintroduce a modified version of the AK_t term to address the CMA’s decision to quash and remit these matters to us for further consideration;
- the introduction of a new “H7_t” term into the formula for the price control set out in Condition C1.5 and defined in Condition C1.23 to implement the adjustments to the Price Control in respect of:
 - (i) the removal of the index linked debt premium from the calculation of the WACC (the reasons for and effects of which are discussed in chapter 2 (The Premium applied to index-linked debt costs));

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

- (ii) the adjustment in respect of PDRCs in H7 (the reasons for and effects of which are discussed in chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in H7) and 8 (Implementation)); and
- (iii) the adjustment in respect of Pod parking (the reasons for and effects of which are discussed in chapter 6 (HAL’s commercial revenues, and “Pod parking”) and 8 (Implementation)).

D8 The modifications we have decided to make are set out in turn below.

Modification of the price control formula in Condition C1.5

D9 The CAA has decided to modify Condition C1.5 in the manner set out below to introduce a new “H7_t” adjustment term:

“C1.5 On each occasion on which the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in each of the subsequent Regulatory Years starting on 1 January 2025 and ending on 31 December 2026, the Licensee shall fix those charges at the levels best calculated to secure that, in each Regulatory Year, total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the amount set in accordance with the formula below:

$$M_t = Y_{t-1} \times (1 + \text{CPI}_t + X_t + B_{t-2}) + \frac{AC_t}{Q_t} - \frac{T_t}{Q_t} + \frac{TDO_t}{Q_t} + \frac{TRS_t}{Q_t} - AK_t + H7_t - K_t$$

where:

- (a) M_t is the maximum revenue yield per passenger using the Airport in Regulatory Year t expressed in pounds sterling;
- (b) Y_{t-1} is the average revenue yield per passenger in Regulatory Year $t - 1$, as defined in Condition C1.6;
- (c) CPI_t is the percentage change between:
 - (i) the average value of the Office for National Statistics monthly D7BT Consumer Price Index over Regulatory Year t ; and
 - (ii) the average value of the Office for National Statistics monthly D7BT Consumer Price Index over Regulatory Year $t - 1$;
- (d) $X_t = 0$;
- (e) B_{t-2} is the bonus factor in Regulatory Year t , based on the Licensee's service quality performance in Regulatory Year $t - 2$, as defined in

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

Condition C1.9;

- (f) AC_t is the Licensee’s allowed capex adjustment in the Regulatory Year t , as defined in Condition C1.10 to C1.15;
- (g) Q_t is the number of passengers using the Airport in the Regulatory Year t ;
- (h) T_t is the capital trigger factor in the Regulatory Year t , as defined in Condition C1.16 to C1.17;
- (i) TDO_t is the terminal drop-off charge factor in Regulatory Year t , as defined in Condition C1.18 to C1.19;
- (j) TRS_t is the traffic risk sharing factor in Regulatory Year t , as defined in Condition C1.20 to C1.21;
- (k) AK_t is the additional correction factor for Regulatory Year t , as defined in Condition C1.22 ~~to C1.23; and~~
- (l) $H7_t$ is the H7 factor for Regulatory Year t , as defined in Condition C1.23; and
- (m)(#) K_t is the correction factor in Regulatory Year t , as defined in Condition C1.24.”

Modification of the price control formula in Condition C1.6

D10 The CAA has decided to modify Condition C1.6 in the manner set out below to remove the manifest error in the formula discussed in chapter 7 (Other Issues) by inserting “-1” after “ X_t ” as follows:

“Average revenue yield per passenger Y_{t-1}

C1.6 Y_{t-1} is the average revenue yield per passenger in Regulatory Year $t - 1$ calculated in accordance with the following formula:

$$Y_{t-1} = Y_{t-2} \times (1 + CPI_{t-1} + X_{t-1}) + S_{t-1}$$

where:

- (a) $Y_{2023} = £31.570 + S_{2023}$
- (b) CPI_{t-1} is the percentage change between:
 - (i) the average value of the Office for National Statistics monthly D7BT Consumer Price Index over Regulatory Year $t - 1$; and

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

- (ii) the average value of the Office for National Statistics monthly D7BT Consumer Price Index over Regulatory Year $t - 2$;
- (c) X_t has the same value as in Condition C1.5(d), except that in respect of Regulatory Year 2024, X_{2024} has the same value as in Condition C1.4(d); and
- (d) S_{t-1} is the allowable security and/or health and safety cost per passenger in Regulatory Year $t - 1$, as defined in Condition C1.7 to C1.8.”

Modification of the definition of the WACC in Condition C1.10(a)

D11 The CAA has decided to modify the definition of the WACC set out in Condition C1.10(c) in the manner set out below to implement the recalibration of the WACC as discussed in chapter 2 (The Premium applied to index-linked debt costs):

- “(c) RWACC is the pre-tax RPI-real weighted average cost of capital which shall have a value of ~~4.01%~~4.04%”

Modification of the definition of the AK_t in Condition C1.22

D12 The CAA has decided to modify the definition of the AK_t factor set out in Condition C1.22 in the manner set out below to implement the recalibration of the WACC as discussed in chapter 2 (The Premium applied to index-linked debt costs) and chapter 8 (Implementation).

“Additional correction factor AK_t

C1.22 AK_t is the additional correction factor to be made in Regulatory Year t to return in full during Regulatory Years ~~2025~~2024 to 2026 the Licensee’s over recovery of revenue from airport charges compared with M_{2020} and M_{2021} . AK_t is calculated as follows:

$$AK_t = \frac{0.51}{Q_t} \times \left[\text{OR}_{2020} \times \text{WR}_{2020,t} \times (R_{2020} - Q_{2020} \times M_{2020}) \times \frac{P_t}{P_{2020}} \times (1 + RWACC)^{t-2020} + \text{OR}_{2021} \times \text{WR}_{2021,t} \times (R_{2021} - Q_{2021} \times M_{2021}) \times \frac{P_t}{P_{2021}} \times (1 + RWACC)^{t-2021} \right]$$

where:

- (a) Q_t bears the same meaning as in Condition C1.5(g);
- (b) OR_t is the over-recovered airport charges revenue and has the following values:
 - (i) OR_{2020} is equal to £29 million in 2020 RPI-real prices; and

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

(ii) OR_{2021} is equal to £48 million in 2021 RPI-real prices;

~~(b) — $wR_{2020,t}$ is the proportion of the Licensee’s over-recovery of revenue from airport charges in Regulatory Year 2020 to be included in the adjustment of the maximum allowable yield for Regulatory Year t and shall be subject to:~~

~~$$\sum_{t=2024}^{t=2026} wR_{2020,t} = 1$$~~

~~$$0 \leq wR_{2020,2024} \leq 1$$~~

~~$$0 \leq wR_{2020,2025} \leq 1$$~~

~~$$0 \leq wR_{2020,2026} \leq 1$$~~

~~(i) — The Licensee shall publish the value of $wR_{2020,t}$ in the annual consultation for setting charges for Regulatory Year t .~~

~~(c) — $wR_{2021,t}$ is the proportion of the Licensee’s over-recovery of revenue from airport charges in Regulatory Year 2021 to be included in the adjustment of the maximum allowable yield for Regulatory Year t and shall be subject to:~~

~~$$\sum_{t=2024}^{t=2026} wR_{2021,t} = 1$$~~

~~$$0 \leq wR_{2021,2024} \leq 1$$~~

~~$$0 \leq wR_{2021,2025} \leq 1$$~~

~~$$0 \leq wR_{2021,2026} \leq 1$$~~

~~(i) — The Licensee shall publish the value of $wR_{2021,t}$ in the annual consultation for setting charges for Regulatory Year t .~~

~~(d) — R_t is the total revenue from airport charges in respect of relevant air transport services levied at the Airport in Regulatory Year t expressed in pounds sterling;~~

~~(e) — M_t bears the same meaning as in Condition C1.5(b);~~

~~(c)(f) P_t bears the same meaning as in Condition C1.10(a);~~

~~(d)(g) P_{2020} is the average value of the Office for National Statistics monthly CHAW Retail Price Index over Regulatory Year 2020 and is equal to 293.14;~~

CAP3001 Notice under section 22(5) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the Licence

- (e)(h) P_{2021} is the average value of the Office for National Statistics monthly CHAW Retail Price Index over Regulatory Year 2021 and is equal to 305.00; and
- (f)(i) RWACC bears the same meaning as in Condition C1.10(c).

Inserting the definition of the $H7_t$ factor at Condition C1.23

D13 As a result of the modification to the text of Condition C1.22, the text currently set out at Condition C1.23 will no longer be required. The CAA has decided to delete that text and replace it with the text set out below. This text inserts the definition of the factor as Condition C1.23 to implement adjustments discussed in chapter 2 (The Premium applied to index-linked debt costs), chapter 4 (Cost allowance in respect of Pension Deficit Repair Costs in H7) and chapter 6 (HAL’s commercial revenues and “Pod parking”) in the manner discussed in chapter 8 (Implementation).

“H7 adjustment factor $H7_t$

C1.23 $H7_t$ is the H7 adjustment factor to be made in Regulatory Year t to adjust in full during Regulatory Years 2025 to 2026 the Licensee’s allowed revenue to reflect the CAA’s decisions in 2024 on the exclusion of the index-linked debt premium from the calculation of the weighted average cost of capital, and the revisions to the Licensee’s revenues in relation to pension deficit repair costs and pod parking revenues. $H7_t$ has the following values:

- (a) for 2025, $H7_{2025} = -0.798$; and
- (b) for 2026, $H7_{2026} = -0.825$.

~~For the purposes of Condition C1.22, the values of $R_{\bar{t}}$, $Q_{\bar{t}}$ and $M_{\bar{t}}$ shall be calculated in accordance with the price control conditions applicable to the Licensee in this licence as they were in each of the Regulatory Years 2020 and 2021.”~~

Clarifying the vehicle queuing times metric

D14 For the reasons set out in chapter 7 (Other Issues), we have decided to modify the Licence using the “self-modification procedure” set out in Condition D1 to clarify the “Vehicle queuing times metric” used as part of the service quality “Measures, Targets & Incentives” (the “MTI scheme”) set out in Schedule 1 of the Licence.

D15 The modifications we have decided to make are as follows:

Schedule 1, Paragraph 3.14, Table at line F8:

Control posts vehicle queuing times (percentage of ~~vehicle queuing times at each control post group that are~~ vehicles at each control post group, measured as the average queue time for all vehicles arriving in each 15 minute period, which have a waiting time of less than 15 minutes)

Schedule 1, paragraph 3.20:

“3.20 Queuing times shall be recorded by the Licensee using an automatic number plate recognition (ANPR) system. The ANPR system used by the Licensee for this purpose must be able to determine the percentage of vehicles ~~at each control post group measured as the average queue time for all vehicles arriving in each 15 minute period, which have a waiting time equal to or greater less~~ than 15 minutes”

Schedule 1, section 8 (Tables), Table 2, Metrics

Percentage of vehicles at each control post group, ~~measured as the average queue time for all vehicles in each 15 minute period,~~ which have a waiting time of less than 15 minutes