

NON-SENSITIVE

BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MATTER OF AN APPEAL UNDER SECTION 25 OF THE CIVIL AVIATION
ACT 2012

B E T W E E N :

DELTA AIR LINES, INC.

Appellant

and

THE CIVIL AVIATION AUTHORITY

Respondent

NOTICE OF APPEAL
AIRPORT LICENCE CONDITION
H7

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SECTION 1: INTRODUCTION

A. Overview

- 1.1 Delta Air Lines, Inc. (**Delta** or the **Appellant**) is a major United States airline based in Atlanta, Georgia. Delta holds a Foreign Carrier Permit issued by the Civil Aviation Authority (the **CAA**) under Article 250 of the Air Navigation Order 2016, with London Heathrow Airport (**Heathrow Airport**) a key UK gateway for its global customer base.
- 1.2 Under the Civil Aviation Act 2012 (the **Act** or **CAA12**), the CAA can regulate an airport operator by means of an economic licence if the market power test is met. On 10 January 2014, the CAA made a market power determination in respect of Heathrow Airport Limited (**HAL**) under section 7 of the Act¹, with the result that HAL requires a licence to levy charges for airport operation services (**AOS**) at Heathrow Airport.² In February 2014, the CAA granted a licence to HAL (the **Licence**) under section 15 of the Act which includes price control conditions on airport charges at Heathrow Airport.³
- 1.3 This appeal concerns the final decision made by the CAA to modify the conditions of HAL's Licence to give effect to the CAA's Final Decision for the H7 price control review which will operate from 1 January 2022 to 31 December 2026, contained in a notice under section 22(6) of the Act published on 8 March 2023 (the **H7 Final Decision**).⁴
- 1.4 The H7 price control review sets the airport charges that HAL may impose on airlines, including Delta, that operate passenger services to and from Heathrow Airport. These airport charges apply on a per passenger basis and, as acknowledged by the CAA, are among the highest in the world.⁵ In the H7 Final Decision, the CAA explained that HAL has significant market power which, if left unconstrained, has the potential to damage consumers' interests for example through higher prices, lower quality services and facilities and inefficiencies.⁶ The CAA stated that to further the interests of consumers it had sought to ensure that HAL's charges will be "no higher than necessary".⁷ Delta considers that the CAA has failed to meet this objective for three key building blocks of the H7 price control where its decision was wrong, as explained in sub-section D.

B. Application for permission to appeal

- 1.5 The Appellant seeks permission from the Competition and Markets Authority (the **CMA**) under section 25(3) of the Act to bring an appeal (and, if permission is granted, to appeal) against the CAA's H7 Final Decision.
- 1.6 Section 25(2)(b) of the Act provides that a "*provider of air transport services whose interests are materially affected by a decision*" may bring an appeal. 'Air transport service' is defined in section 69 of the Act as "*a service for the carriage by air of passengers or cargo to or from an airport in the United Kingdom*". 'Provider' in relation to an air transport service is defined in the same provision as, "*a person who has the management of the aircraft used to provide the service*".

¹ The CAA determined that HAL is the operator [Vol A / Tab 11] of a dominant airport area at a dominant airport [Vol A / Tab 12].

² AOS are defined in section 68 of the Act as services provided at an airport for the purposes of: (a) the landing and taking off of aircraft; (b) the manoeuvring, parking or servicing of aircraft; (c) the arrival or departure of passengers and their baggage; (d) the arrival or departure of cargo; (e) the processing of passengers, baggage or cargo between their arrival and departure; or (f) the arrival or departure of persons who work at the airport. They include, in particular, the provision at an airport of groundhandling services, facilities for car parking, and facilities for shops and other retail businesses. They do not include air transport services, air traffic services, or services provided in shops or as part of other retail businesses. [Vol A / Tab 13 / p 1000].

³ [Vol A / Tab 14].

⁴ Available in the "Decision" bundle.

⁵ CAA, Economic regulation of Heathrow Airport Limited: H7 Final Proposals Summary (CAP2365A) (**H7 Final Proposals Summary**) [Vol A / Tab 1 / p.9 / para 27].

⁶ CAA, H7 Final Decision: Summary (CAP2524A) (**H7 Final Decision Summary**) [Decision / Tab 1 / p.6 / para 4].

⁷ H7 Final Decision Summary [Decision / Tab 1 / p.6 / para 5].

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- 1.7 Dealing with each of these requirements in turn, and as more particularly described in Section B of the Witness Statement of Christopher Allen Walker, Director of Regulatory Affairs at Delta, (CW1):
- (a) As an airline providing passenger services to and from Heathrow Airport, Delta is a provider of air transport services as defined in the Act:
 - (i) Delta holds an air carrier certificate issued by the Federal Aviation Administration of the US Department of Transport and a Foreign Carrier Permit issued by the CAA. The permitted services specified in Delta's Foreign Carrier Permit include passenger services to and from Heathrow Airport, which is the UK's only long-haul international hub airport.
 - (ii) Delta has a significant presence at Heathrow Airport, being one of the largest long-haul international partner hubs in Delta's global network. Heathrow Airport is strategically important for Delta, due to its central role in Delta's joint venture with Virgin Atlantic Airways (VAA) and maintaining Delta's presence on transatlantic routes.
 - (iii) Delta and VAA cooperate in respect of their transatlantic operations, such that all Delta operated flights to Heathrow Airport are within the scope of the joint venture. Together, Delta and VAA operate daily flights from Heathrow Airport to 15 destinations in the United States.
 - (b) Delta's interests are materially affected by the CAA's H7 Final Decision:
 - (i) The H7 Final Decision sets the airport charges that HAL may impose on Delta – and other airlines – in relation to the operation of its passenger services to and from Heathrow Airport. Delta is therefore directly and materially affected by the increase in the maximum allowable airport charge for HAL in the H7 Final Decision. Chris Walker provides information about these charges in Section C of CW1.
 - (ii) In addition, Delta will seek to expand its international network during the H7 price control period and consider adding new transatlantic flights to Heathrow Airport (exceeding pre-pandemic levels). Airport charges will, however, be a key factor for Delta when making decisions about which routes to serve and pricing.
- 1.8 Based on the above, Delta has standing to bring an appeal against the H7 Final Decision.
- 1.9 By virtue of section 30 of the Act, in deciding this application for permission to appeal, the CMA must have regard to the matters in respect of which duties are imposed on the CAA by section 1 of the Act. These matters and duties are addressed in Section 2.

C. Legal framework

- 1.10 Whilst the CMA has not previously heard an airport licence condition appeal under section 25 of the Act, the Appellant notes that the CMA has experience of determining a number of licence modification appeals in the energy sector which are acknowledged to have a similar legal framework.
- 1.11 With this in mind, the Appellant seeks to summarise the relevant legal framework to determine the appeal as succinctly as possible in Section 2.

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D. Scope of the appeal

- 1.12 The H7 price control process was, as the CAA has acknowledged, an “*extended price control review process*”⁸ spanning the period 2016 to 2023. Relevant aspects of this chronology are more fully detailed in Section 3 and in Section G of CW1.
- 1.13 In bringing this appeal, the Appellant has carefully considered the H7 Final Decision and the overriding objective for the CMA to dispose of appeals fairly, efficiently and at proportionate cost within the time limits prescribed by the Act.⁹
- 1.14 The Appellant has accordingly confined its appeal to three discrete issues where the H7 Final Decision is wrong:
- (a) **Ground 1** concerns the CAA’s errors in setting the passenger forecast for the H7 period too low, which is addressed in Section 4;
 - (b) **Ground 2** concerns the CAA’s errors in setting the Weighted Average Cost of Capital (**WACC**) for the H7 period too high, which is addressed in Section 5; and
 - (c) **Ground 3** concerns the CAA’s errors in making a £300 million upward adjustment to the regulated asset base (**RAB**) of HAL, and in failing to review, reverse or reduce that adjustment, which are addressed in Section 6.
- 1.15 These decisions are “*wrong*” within the meaning of section 26 of the Act for the reasons explained in Sections 4 to 6, and as more particularly described in Annexes 1 to 3.
- 1.16 These errors are also material because of their harmful impact on consumers, their financial impact on Delta over the period covered by the H7 price control, the potential impact on future price controls, and for reasons of regulatory and economic principle. Delta is also materially affected by virtue of its stake in Virgin Atlantic Limited.
- 1.17 Details of the relief sought by the Appellant are set out under each ground of appeal and more fully described in Section K of CW1.

E. Key documents

- 1.18 The grounds of this appeal, reasons and supporting evidence are contained in this Notice of Appeal (**NOA**), and accompanying exhibits and in expert and witness evidence (including exhibits).
- 1.19 Delta has provided written evidence for this appeal in the form of:
- (a) Witness Statement of Chris Walker, Director of Regulatory Affairs at Delta, dated 18 April 2023 (**CW1**);
 - (b) ‘Cost of capital issues raised by the Heathrow Airport H7 Price Control’, an Expert Report prepared by AlixPartners LLP dated 17 April 2023 (the **WACC Report**);¹⁰ and
 - (c) ‘Assessment of the CAA’s H7 RAB Adjustment’, an Expert Report by prepared by AlixPartners LLP dated 17 April 2023 (the **RAB Report**).¹¹
- 1.20 A list of other key CAA documents and an indication of relevant sections of such documents, is provided in Section 7.

⁸ H7 Final Proposals Summary [**Vol A / Tab 1 / p. 20 / para 43**].

⁹ CMA, Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) (**CMA Rules**) [**Vol A / Tab 15 / p.1,096 / Rule 4.1**].

¹⁰ See **Vol A / Tab 123**.

¹¹ See **Vol A / Tab 122**.

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- 1.21 A chronology of the key steps the CAA took in setting the H7 price control, culminating in the H7 Final Decision, is provided in Section 8.
- 1.22 A glossary of terms used in this NOA is provided in Section 9, which reflects abbreviations and definitions in the CAA's glossary (at Appendix B to the H7 Final Decision) to the greatest extent possible.
- 1.23 The Appellant has endeavoured to provide all of the facts, reasons, documentary evidence and witness statements in support of its appeal within this NOA. However, it may be necessary for the Appellant to apply to the CMA for permission to make further submissions or provide supplementary evidence during the course of the appeal, e.g. following receipt of the CAA's response and any disclosure.¹²

F. Request for appeals to be considered together

- 1.24 If the CMA grants the Appellant permission to appeal against the H7 Final Decision, and also grants permission to appeal against that decision to any other airlines, the Appellant requests that those appeals be considered together for the reasons further explained in Section D of CW1.
- 1.25 The Appellant notes in this regard that paragraph 2(3) of Schedule 2 to the Act permits the CMA to grant permission to appeal subject to conditions, including conditions requiring the appeal to be considered together with other appeals, including appeals brought by different persons. The Appellant considers that consolidation of appeals by airlines against the H7 Final Decision would be appropriate and consistent with the overriding objective because the appeals are related and it will allow a more streamlined and efficient process. Moreover, to the extent HAL also appeals on common grounds, or on different grounds relying on common facts, the Appellant considers that such appeals should be heard together.
- 1.26 The Appellant further notes that, in the event of multiple appeals against the H7 Final Decision, it would have no objection to the CMA extending the appeal period under section 28(3) of the Act given the additional CMA time, resource and case management which would be required.

G. Contact details

- 1.27 Appellant:
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¹² CMA Rules [Vol A / Tab 15 / p.1112 / Rule 12.5].

¹³ A US registered company, with Companies House number FC005586.

SECTION 2: LEGAL FRAMEWORK

A. Overview

- 2.1 In this section, the Appellant describes the legal framework governing this appeal in six parts:
- (a) the statutory grounds of appeal;
 - (b) the CMA rules regulating the conduct and disposal of airport licence condition appeals;
 - (c) the CAA's statutory duties;
 - (d) the relevant public law principles;
 - (e) the standard of review to be applied by the CMA; and
 - (f) the CMA's powers when allowing an appeal.

B. Statutory grounds of appeal

- 2.2 Under section 26 of the Act, having granted permission, the CMA may allow an appeal only to the extent it is satisfied that the decision appealed against was "*wrong*" on one or more of the following grounds:
- (a) that the decision was based on an **error of fact** (section 26(a) of the Act); and/or
 - (b) that the decision was **wrong in law** (section 26(b) of the Act); and/or
 - (c) that an **error was made in the exercise of discretion** (section 26(c) of the Act).
- 2.3 In determining an appeal, including taking decisions and giving directions, the CMA must, as required by section 30 of the Act, have regard to the matters in respect of which duties are imposed on the CAA by section 1 of the Act. These matters and duties are addressed in Section C below.
- 2.4 The CMA must not, however, in accordance with paragraph 23(2) and (3) of Schedule 2 to the Act, have regard to any matter, information or evidence which was not considered by the CAA in making the H7 Final Decision unless the CMA considers that:
- (a) the CAA could not reasonably have been expected to consider the matter, information or evidence, or the relevant person could not reasonably have raised the matter with the CAA or provided the information or evidence to the CAA during the period in which the CAA was making that decision; and
 - (b) the matter, information or evidence is likely to have an important effect on the outcome of the appeal, either by itself or taken together with other matters, information or evidence.

C. CMA rules regulating the conduct and disposal of appeals

- 2.5 Paragraph 31 of Schedule 2 to the Act provides that the CMA Board may make rules regulating the conduct and disposal of appeals.
- 2.6 The Appellant notes that the CMA Board has recently published the Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) (the **CMA Rules**) and issued an accompanying guide entitled Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) (the **CMA Guide**), both dated 27 October 2022 (which supersede

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the previous rules and guide governing airport licence condition appeals which had effect from 12 February 2014).¹⁴

- 2.7 The CMA Rules provide (rule 4.1) that their overriding objective is to enable the CMA to exercise its appeal functions fairly, efficiently and at proportionate cost in accordance with the time limits prescribed by the Act, and that all parties to an appeal must assist the CMA to further this overriding objective (rule 4.2).
- 2.8 The CMA Guide describes the CMA Rules as seeking “*to ensure that the [CMA] has flexibility to manage appeals fairly and expeditiously and at proportionate cost, having regard to the interests of the parties to the appeal and interested third parties and the statutory time frames*” and notes that this “*sentiment is reflected in the overriding objective*”.¹⁵
- 2.9 The Appellant notes that, following determination of an appeal, the CMA may have regard to – among other things – the extent to which each party has assisted the CMA to meet the overriding objective in deciding what (if any) inter partes costs order to make under the CMA Rules (rule 19.3 and 19.5).

D. The CAA’s statutory duties

- 2.10 Section 1(1) of the Act provides that the **CAA’s general duty**¹⁶ in relation to the economic regulation of AOS is to carry out its statutory functions 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**. As explained above, users of air transport services are defined in section 69 of the Act as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). The CAA collectively refers to them as ‘consumers’.
- 2.11 Under section 1(2) of the Act, the CAA must further the interests of consumers, where appropriate, by carrying out its functions in a manner which it considers will **promote competition in the provision of AOS**.
- 2.12 Section 1(3) of the Act provides that, when performing its statutory duties under subsections (1) and (2), the CAA must have regard to:
- (a) the need to secure that each licence holder is able to **finance** its provision of AOS in the area for which the licence is granted (section 1(3)(a))¹⁷;
 - (b) the need to secure that all **reasonable demands** for AOS are met (section 1(3)(b))¹⁸;
 - (c) the need to promote **economy and efficiency** on the part of each licence holder in its provision of AOS at the airport to which the licence relates (section 1(3)(c))¹⁹;

¹⁴ CMA Rules [Vol A / Tab 15] and CMA, Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) (CMA Guide) [Vol A / Tab 16].

¹⁵ [Vol A / Tab 16 / p.1121 / para 1.4].

¹⁶ Section 1(7) of the Act provides that section 4 of the Civil Aviation Act 1982 (CAA’s general objectives) does not apply in relation to the carrying out by the CAA of its functions under this Chapter of the Act [Vol A / Tab 13 / p.902].

¹⁷ Civil Aviation Act 2012, Explanatory Notes (Explanatory Notes) state: “*Whilst this should require the CAA to encourage efficient and economic investment by allowing a reasonable return over time, the financing duty does not require the CAA to ensure the financing of regulated airports in all circumstances, for example the CAA would not be required to adjust regulatory decisions in order to take account of an operator’s particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator’s financing decisions*” [Vol A / Tab 18 / p.1214 / para 36(a)].

¹⁸ See footnote 21 below.

¹⁹ Civil Aviation Act 2012, Explanatory Notes (Explanatory Notes) state, with regard to the need to secure that reasonable demands for AOS are met and the need to promote economy and efficiency in the provision of such services: “*One would expect both of those needs to be met in a competitive airports market where airport operators provide the services demanded by passengers at minimum cost. The requirement to have regard to those needs reflects the fact that the ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market*” [Vol A / Tab 18 / p.1214 / para 36(b)].

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- (d) the need to secure that each licence holder is able to take reasonable measures to reduce, control or mitigate the adverse **environmental effects** of the airport to which the licence relates, facilities used or intended to be used in connection with that airport (referred to as 'associated facilities') and aircraft using that airport (section 1(3)(d));²⁰
 - (e) any relevant **guidance** issued to the CAA by the Secretary of State (section 1(3)(e)). In this regard, it should be noted that the Secretary of State for Transport sent an open letter to the CAA on 1 December 2020 entitled 'Secretary of State Priorities for the Civil Aviation Authority'.²¹ The first priority – and "*most important immediate task*" set out in that letter was "*supporting the recovery and growth of the aviation industry*";
 - (f) any relevant **international obligation** of the UK notified to the CAA by the Secretary of State (section 1(3)(f)); and
 - (g) the **better regulation** principles, namely that regulatory activities should be carried out in a way that is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed (sections 1(3)(g) and 1(4)). These principles are more particularly defined by the Better Regulation Task Force as follows:²²
 - (i) Transparent: Regulators should be open, and keep regulations simple and user-friendly.
 - (ii) Accountable: Regulators must be able to justify decisions, and be subject to public scrutiny.
 - (iii) Proportionate: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.
 - (iv) Consistent: Government rules and standards must be joined up and implemented fairly. This includes the principle that regulation should be predictable in order to give stability and certainty to those being regulated.
 - (v) Targeted: Regulation should be focused on the problem, and minimise side effects.²³
- 2.13 Section 1(5) of the Act provides that if, in a particular case, the CAA considers there is a conflict between the interests of different classes of user of air transport services, or between the interests of users of air transport services in the range, availability, continuity, cost and quality of AOS, the CAA's duty is to carry out its functions in a manner which it considers will further such of those interests as it thinks best.
- 2.14 Under section 22 of the Act, the Appellant notes that the CAA also has a number of specific procedural obligations with which it must comply in order to make a lawful licence modification decision. Of relevance to this appeal, section 22(7) of the Act provides that the CAA is not to be treated as having complied with the necessary procedural requirements in relation to a

²⁰ Section 1(6) of the Act states that the environmental effects of the airport, associated facilities and aircraft include: substances, energy, noise, vibration or waste, including emissions, discharges and other releases into the environment; visual or other disturbance to the public; effects from works carried out at the airport or the associated facilities or to extend the airport or the associated facilities; and effects from services provided at the airport or the associated facilities [**Vol A / Tab 13 / p.901**].

²¹ Letter from Department of Transport to the CAA 'Secretary of State Priorities for the Civil Aviation Authority' [**Vol A / Tab 129**].

²² Better Regulation Task Force, Principles of Good Regulation [**Vol A / Tab 19**]. These principles are further enshrined in the Department for Business, Innovation & Skills, Better Regulation Delivery Office - Regulators' Code [**Vol A / Tab 20**].

²³ The Appellant also notes that the Government has consulted on "Reforming the Framework for Better Regulation" [**Vol A / Tab 21**] and indicated an intention to reform the Better Regulation Framework in the summary to the consultation [**Vol A / Tab 22**] and in "The Benefits of Brexit: How the UK is taking advantage of leaving the EU" [**Vol A / Tab 23 / p.1374 - 1383**] (setting out proposals under five new regulatory principles including 'proportionality' ("*we will pursue non-regulatory options where we can*", and "*will act decisively to put [strong rules] in place and enforce them vigorously*" where they are needed) and 'recognising what works' (regulations will be thoroughly analysed to ensure they work in the real world). Next steps are currently awaited.

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modification of a licence if the modification “*differs significantly*” from the modification proposed in the notice.

E. Relevant public law principles

- 2.15 As a public body exercising its public function, the CAA must also act in accordance with relevant public law principles when making a licence modification decision. These include acting within its powers (*intra vires*), rationally and in a procedurally fair manner (including meeting the requirements of proper and fair consultation, including re-consultation).
- 2.16 The starting point in determining the duty to re-consult is an evaluation of the differences, taking account of their nature and extent, between the CAA’s proposal and the decision which the CAA in fact made. The duty to re-consult arises:
- (a) where it has been determined that it is necessary to re-open key decisions in a staged decision-making process which had already been settled prior to consultation occurring; or
 - (b) where the key criteria set out for determining the decision and against which the consultation occurred have been changed; or
 - (c) where a central or vital evidential premise of the proposed decision on which the consultation was based has been completely falsified.²⁴
- 2.17 As set out in paragraph 2.13 above, the CAA must carry out its functions in a manner which it considers will further such interests as it thinks best, if the CAA considers that there is conflict between different users, or classes of users, of air transport services. Antecedent to this discretion are the principles set out in section 1(4) of the Act, including the principle of proportionality. This precludes the CAA from intervening where unnecessary, or where less intrusive alternatives are available.
- 2.18 Any failure to act in accordance with these public law principles will be an error of law.

F. The standard of review to be applied by the CMA

- 2.19 The Appellant notes that this is the first airport licence condition appeal to the CMA. However, the CMA’s experience in determining energy licence modification appeals²⁵ will be of assistance as there are similarities between the airport licence condition appeal regime under section 25 of the Act and the CMA’s energy licence modification appeal regime under section 23B of the Gas Act 1986, section 11C of the Electricity Act 1989, The Gas (Northern Ireland) Order 1996 and The Electricity (Northern Ireland) Order 1992.
- 2.20 This similarity was recognised explicitly by the CMA in its open letter on the CMA’s licence modification appeal rules and guidance, dated 7 December 2021, in which it noted: “*The existing sectors where there are the most directly comparable appeals regimes covering the same or similar grounds of appeal are energy and airports*”.²⁶

²⁴ *Keep Wythenshawe Special Limited v NHS Central Manchester CCG and others* [2016] EWHC 17 (Admin) Dove J at paragraph 75 [Vol A / Tab 24 / p.1485 / para 75].

²⁵ Namely, *British Gas Trading v The Gas and Electricity Markets Authority - Final Determination (BGT v GEMA [2015])* [Vol A / Tab 25] *Northern Powergrid (Yorkshire) Plc v The Gas and Electricity Markets Authority (NPG v GEMA [2015])* [Vol A / Tab 26] in respect of GEMA’s RIIO-1 electricity distribution price control, the subsequent appeals by *Firmus Energy (Firmus Energy (Distribution) Limited v NIAUR* [2017] (*Firmus v NIAUR (2017)*) [Vol A / Tab 27]) under The Gas (Northern Ireland) Order 1996 and, most recently, the appeals brought by Cadent Gas, National Grid Electricity Transmission, National Grid Gas, Northern Gas Networks, Scottish Hydro Electric Transmission, Southern Gas Networks and Scotland Gas Networks (jointly), SP Transmission and Wales and West Utilities in relation to Ofgem’s RIIO-T2 and RIIO-GD2 price control determinations.

²⁶ CMA, Open letter on the CMA’s licence modification appeal rules and guidance [Vol A / Tab 99].

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- 2.21 Based on the Act, the CMA Rules, the CMA Guide and previous energy licence modification appeals before the CMA,²⁷ the CMA's approach to the standard of review can be summarised as follows:
- (a) The CMA is not limited to reviewing the decision under appeal on conventional judicial review grounds. The standard of review goes further than this. The key question for the CMA to determine is whether the decision was, on the balance of probabilities, wrong on one or more of the prescribed statutory grounds. In order to do that, the merits of the CAA's decision must be taken into account.
 - (b) In relation to the CAA's exercise of discretion, it is not the CMA's role to substitute its judgment simply on the basis that it would have taken a different view of the matter. The statutory test clearly admits of circumstances in which the CMA might reach a different view from the CAA, but in which it cannot be said that the CAA's decision was wrong on one of the statutory grounds. In relation to questions of regulatory judgment, the CAA will be afforded a margin of appreciation as an expert regulator, and its margin of appreciation will be greatest where all that is impugned is an overall value judgment based upon competing considerations in the context of a public policy decision. However, that margin of appreciation is not unbounded. In circumstances where the CAA has exercised its judgment in reaching a decision on a specific issue, the CAA cannot ignore relevant evidence or base its decision(s) on unreliable data, and the CMA will find an error where there is sufficiently persuasive evidence that an alternative approach is clearly superior. On the other hand, where the alternative options each have competing advantages and disadvantages, and none is clearly superior, the CMA will be unlikely to find that the CAA has made an error.
 - (c) The CMA must determine whether a finding of fact or inference is wrong where that is in issue. The CMA will assess evaluations of fact by the CAA in the same way as the exercise of discretion (i.e. not substituting its judgment for that of the CAA simply on the basis that it would have taken a different view, but only if it is satisfied that the conclusion lies outside the bounds within which reasonable disagreement is possible). The CMA will afford the CAA no margin of appreciation where plain errors of primary fact (or inferences from such primary facts) are identified.
 - (d) The CMA, in assessing errors of law, will evaluate whether the CAA has misdirected itself on its legal obligations in making its decision or reached a conclusion which was substantively or procedurally unlawful. A decision is also "*wrong in law*" where it contravenes the principles applicable in judicial review, including that a decision is unlawful where it falls outside "*the range of responses which a reasonable decision-maker might have made in the circumstances*" (i.e. it is irrational in the public law sense).²⁸ For example, whether the CAA has failed to take proper account of relevant considerations, acted in defiance of logic, failed properly to inquire, acted disproportionately or in a discriminatory manner with no good reason, reached conclusions without adequate supporting evidence, placed reliance on evidence or assumptions which are flawed, failed to discharge its statutory duties under the Act, made methodological errors and/or made procedural errors (e.g. whether the CAA has consulted with an open mind and taken conscientious account of representations received). A decision may also be wrong in law on the basis of an arithmetic error.²⁹ As regards errors relating to procedure, however, the CMA will only take into account procedural deficiencies if they are so serious that the CMA cannot be assured that the decision was not wrong.³⁰
 - (e) The CMA's review is distinct from a *de novo* consideration of the merits, but must consider the merits to the extent necessary to determine whether the challenged decision is wrong under the statutory ground(s) relied upon in the appeal. The CMA will review the CAA's

²⁷ See footnote 23 above.

²⁸ *Soomatee Gokool & Ors v Permanent Secretary of the Ministry of Health and Quality of Life & Anor* [2008] UKPC 54 [Vol A / Tab 28 / p.2023 / para 18]

²⁹ *Danae Air Transport v Air Canada* [2000] 1 WLR 395 [Vol A / Tab 29 / p.2037].

³⁰ *Cadent Gas Limited and Others v Gas and Electricity Markets Authority, Final Determinations, Volume 1 (Energy Licence Modification Appeals 2021 – Volume 1)* [Vol A / Tab 30 / p.2089, para 3.54].

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decision through the prism of the specific errors that are raised. Where no errors are pleaded, the decision to that extent will not be the subject of specific review.

- (f) The CMA will only interfere if it considers that an error is material. Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. However, in previous cases the bar for materiality has been low. For example, in its RIIO-2 decision,³¹ the CMA found an error amounting to an uplift of only 0.2% to be “*clearly material*”. There is therefore no bright-line test for materiality. Relevant factors for determining materiality in each case would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle. This is not an exhaustive list.³² The CMA will also consider, where appropriate, whether the cumulative effect of immaterial errors could have a highly significant impact on the price control.³³

- 2.22 Taking into account the above, and having regard to the CMA’s overriding objective, the Appellant has limited its appeal against the H7 Final Decision to areas where that decision was wrong and the errors made are material.

G. The CMA's powers when allowing an appeal

- 2.23 By virtue of section 27(2) of the Act, if the CMA allows an appeal against a decision by the CAA to modify a licence condition under section 22 of the Act, it must do one or more of the following:

- (a) quash the decision;
- (b) remit the matter back to the CAA for reconsideration and decision in accordance with any directions given by the CMA;
- (c) substitute the CMA's own decision for that of the CAA and give directions to the CAA or HAL.³⁴

- 2.24 Under section 27(4) of the Act, where the CMA substitutes its own decision for that of the CAA, it may give directions to the CAA and HAL. Section 27(5) of the Act provides that the CMA must not give a direction that requires a person to do anything that the person would not have power to do apart from the direction, and section 27(6) of the Act provides that a person to whom a direction is given must comply with it. Section 27(7) of the Act provides that any direction given to HAL is enforceable in England as if it were an order of the High Court.

- 2.25 The CMA must, in accordance with section 29 of the Act, determine an appeal by publishing an order containing its decision, with reasons. Where the CMA is considering appeals or parts of appeals together, it may elect to make a single final determination in relation to two or more appeals in part or in their entirety.³⁵

- 2.26 The CMA’s determination will take effect at the time specified in the order or determined in accordance with the order.³⁶

³¹ *Cadent Gas Limited and Others v Gas and Electricity Markets Authority, Final Determinations, Volume 2B* [Vol A / Tab 31 / p.2,366 / para 7.804].

³² See *BGT v GEMA* (2015) [Vol A / Tab 25 / p.1,531 – 1,532 / para 3.57 – 3.61]. See also *Firmus v NIAUR* (2017) [Vol A / Tab 27 / p.1,226 / para 3.24].

³³ See *Energy Licence Modification Appeals 2021 – Volume 1* [Vol A / Tab 30 / p.2,097 – 2,098 / para 3.89 – 3.97].

³⁴ Civil Aviation Act 2012, Part 1 [Vol A / Tab 13 / p.940].

³⁵ CMA Rules [Vol A / Tab 15 / p.1,115 / Rule 17.2].

³⁶ Section 29(1)(1) of the Act [Vol A / Tab 13 / p.944].

SECTION 3: BACKGROUND

A. Overview

- 3.1 In this section, the Appellant describes the relevant factual background to the H7 price control and this appeal in two parts:
- (a) the Q6 price control; and
 - (b) the H7 price control and the Covid-19 pandemic.

B. The Q6 price control

- 3.2 In February 2014, the CAA determined that HAL was the operator of a “dominant airport” and granted it a Licence in relation to Heathrow Airport pursuant to its powers and duties under the Act.³⁷ The CAA’s market power assessment was based on (i) HAL’s position as the operator of the United Kingdom’s only long-haul international hub airport; (ii) airline network effects available at Heathrow Airport which limit the ability of airlines to switch capacity and to constrain HAL’s charges; (iii) Heathrow Airport’s good surface access options and (iv) the attractiveness of the London market to airlines.³⁸ The Licence came into force on 1 April 2014, and originally included a price control on airport charges for the period 1 April 2014 to 31 December 2018 inclusive (the **Q6 price control** or **Q6**).
- 3.3 The Q6 price control review took place after a period in which traffic volumes had been adversely affected by a number of downside events (e.g. the 2010 volcanic eruption in Iceland). HAL therefore asked the CAA to consider the regulatory treatment of traffic risks during the Q6 review.³⁹
- 3.4 During the Constructive Engagement (**CE**) process, the CAA asked HAL and the airlines if they thought there was merit in introducing a traffic risk sharing (**TRS**) mechanism⁴⁰ (similar to that introduced by the CAA in relation to its regulation of NATS En-route Limited (**NERL**)).⁴¹ The introduction of such a mechanism was not supported by HAL or any other stakeholders, and the preferred option was to consider and address traffic risk through traffic forecasts and the WACC instead.⁴²
- 3.5 In the Q6 Final Proposals, the CAA included a shock factor in its Q6 passenger forecasts on the basis of evidence from the preceding two decades which indicated that HAL was exposed to risks relating to external downside shocks. The CAA stated that the financial consequences that could arise from differences between actual and forecast volumes would sit with HAL’s shareholders, and that it had reflected this risk in the WACC:

“The allowances for demand shocks in the traffic forecasts and in the cost of capital are two different concepts. The CAA does not, therefore, consider that its proposals constituted double-counting. For example, the CAA may set the price control on the basis of a forecast level of shocks of 1% per annum. However, there could be a 10% chance that the out-turn level of shocks exceeds the forecast level by one percentage point of more. The risk that the out-turn is different is borne by the company and the shareholders.”

³⁷ CAA, Market Power Determination in relation to Heathrow Airport – Statement of Reasons (CAP 1133) [Vol A / Tab 12].

³⁸ *Ibid.*, [Vol A / Tab 12 / p.863 / para 2.4].

³⁹ CAA, Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues (CAP2365D) (**H7 Final Proposals Section 3**) [Vol A / Tab 4 / p.333 / para 10.27].

⁴⁰ CAA, Economic regulation of Heathrow: policy update and consultation (CAP 1940) [Vol A / Tab 74 / p. 8221 / para 1.10 – 1.11] and CAA, Economic regulation at Heathrow from April 2014: Final Proposals (CAP 1103) [Vol A / Tab 63 / p.6612 / para 2.58].

⁴¹ CAA, Economic regulation of NATS (En Route) Plc: decision on licence modifications to implement exceptional measures (CAP 2279) Chapter 1 [Vol A / Tab 62 / p.6530].

⁴² CAA, Economic regulation at Heathrow from April 2014: Notice granting the licence (CAP1151) [Vol A / Tab 39 / p.3204 / para A57].

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The CAA therefore allows a higher rate of return for the company than would otherwise be the case to compensate for this risk.” (emphasis added).⁴³

- 3.6 The Licence does not include any specific reopener mechanism or specific criteria by which a request to reopen the price control would be assessed. This was considered at the time of granting the Licence, and the CAA declined to include this in the Licence (despite submissions from HAL requesting a prescribed trigger point with established consequences). Rather, the CAA stated: “*HAL may request that its price control be reopened at any time. The CAA would consider such a request in the light of its statutory duties under the circumstances prevailing at the time*”.⁴⁴
- 3.7 Following the Government’s 2016 announcement that Heathrow Airport was its preferred location for the development of a new runway in the south-east of England⁴⁵ and an extensive period of regulatory development work by the CAA to determine how best to adapt the regulatory framework to accommodate this proposed expansion, the Q6 price control was extended by the CAA (following consultation) twice:
- (a) first in December 2016 for one year, such that the Q6 price control would expire on 31 December 2019;⁴⁶ and
- (b) subsequently in November 2019 for a two year period, up to 31 December 2021 (iH7).⁴⁷
- 3.8 These extensions were intended to align the start of the H7 regulatory period with the period during which it was anticipated that construction work for the third runway at Heathrow Airport would take place.

C. The H7 price control and the Covid-19 pandemic

- 3.9 On 31 December 2019 – consistent with this revised timing – HAL submitted its Initial Business Plan (IBP) to the CAA in respect of the years 2022-2036 and on the basis that the expansion of Heathrow Airport was proceeding.⁴⁸
- 3.10 However, in February 2020, the Court of Appeal held that the Airports National Policy Statement – which set out the Government’s plans in relation to developing the third runway at Heathrow Airport – was unlawful.⁴⁹ In light of that decision, HAL paused its plans for expansion.⁵⁰ Although the Supreme Court subsequently overturned the Court of Appeal’s judgment in December 2020,⁵¹ by that point HAL’s expansion plans had already been overtaken by the impact of the Covid-19 pandemic. Plans for the construction of a third runway at Heathrow Airport remain paused to date (although it is expected that HAL’s expansion programme will remobilise again in the future).⁵²
- 3.11 In April 2020, the CAA published an update on its programme for the development of economic regulation at HAL (the **April 2020 Update**),⁵³ outlining the fundamental impact of the Covid-19 pandemic on Heathrow Airport and the aviation sector more widely. The April 2020 Update confirmed that the CAA would focus its H7 price control review on the operation of a two-runway

⁴³ CAA, Economic regulation at Heathrow from April 2014: Final Proposals (CAP 1103) [Vol A / Tab 63 / p.6621 - 6622 / para 3.14].

⁴⁴ CAA, Economic regulation at Heathrow from April 2014: Notice of the proposed licence (CAP1138) [Vol A / Tab 38 / p.2777 / para A12].

⁴⁵ Department for Transport, Increasing airport capacity in the south-east of England (webpage), accessed 6 April 2023 [Vol A / Tab 64 / p.6934].

⁴⁶ CAA, Notice in relation to a modification of Heathrow Airport Limited’s Licence made under section 22(6) of the Civil Aviation Act 2012 [Vol A / Tab 65 / p.6948].

⁴⁷ CAA, Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications (CAP1852) [Vol A / Tab 66 / p.6958].

⁴⁸ Heathrow, Initial Business Plan - Detailed Plan [Vol A / Tab 67 / p.7024].

⁴⁹ *R. (on the application of Plan B Earth) and others v Secretary of State for Transport* [2020] EWCA Civ 214 [Vol A / Tab 68 / p.7423].

⁵⁰ Heathrow Airport, H7 Revised Business Plan (Detailed) [Vol A / Tab 69 / p.7777 – 7778 / para 7.2.1.2].

⁵¹ *R. (on the application of Friends of the Earth Ltd) v Heathrow Airport Ltd* [2020] UKSC 52 [Vol A / Tab 70 / p.8106].

⁵² Heathrow, Heathrow Expansion (webpage), accessed 6 April 2023 [Vol A / Tab 71 / p.8165].

⁵³ CAA, Economic regulation of Heathrow: programme update (CAP 1914) [Vol A / Tab 72 / p.8169].

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airport at Heathrow Airport, with the intention of having a new price control in place with effect from 1 January 2022. In its response to the April 2020 Update, HAL noted that passenger numbers at Heathrow Airport had, at that point, fallen by c.97% as a result of the Covid-19 pandemic.⁵⁴

- 3.12 On 5 June 2020, Lord Paul Deighton (the Chairman of HAL) wrote to Dame Deirdre Hutton (the Chair of the CAA) requesting that the CAA reopen the Q6 price control “to recalibrate Heathrow’s incentives” on the basis that the current settlement was “unsustainable”.⁵⁵ Lord Paul Deighton referred to the “unprecedented challenges” the aviation industry was experiencing as a result of the Covid-19 pandemic, and concluded that HAL would “separately set out more details of [its] request and potential mechanisms for a reopener to [the CAA’s] Chief Executive” and it was seeking “discussions on how we can urgently move to implementation as delay is not in the interests of consumers or other stakeholders.”
- 3.13 On 23 June 2020, the CAA published a consultation entitled ‘Economic regulation of Heathrow: policy update and consultation’ (the **June 2020 Consultation**).⁵⁶ The CAA noted that HAL’s IBP had been published in December 2019 on the basis that the construction of a third runway at Heathrow Airport was proceeding. However, on account of Heathrow Airport’s expansion now being paused, and given the changed circumstances in light of the outbreak of Covid-19, the CAA concluded that the IBP was substantially out of date, and set out its expectation and guidance for HAL to produce a revised business plan towards the end of 2020. More specifically, the CAA stated:
- “We do not currently expect construction for expansion to restart during H7. If expansion restarts, we will treat it as an add-on to the price control. This, and the impact of the covid-19 pandemic on traffic volumes, means that several key assumptions used to construct the IBP are no longer appropriate. These include assumptions on traffic forecasts, the capex plan, financing and financeability and several other key building blocks”.*⁵⁷
- 3.14 The CAA stated that HAL’s revised business plan should capture, among other things: (i) the outcomes of CE; (ii) HAL’s latest thinking on traffic scenarios and efficient levels of cost; and (iii) HAL’s views on the form and duration of price control arrangements best suited to dealing with any remaining uncertainty.
- 3.15 In response to the June 2020 Consultation, HAL issued a revised financial forecast and accompanying narrative in July 2020 (referred to as its building block update (**BBU**)).⁵⁸ Following HAL’s BBU, a period of CE between HAL and its airline customers began, running between August and October 2020. HAL issued its revised business plan (**RBP**) on 18 December 2020.⁵⁹ HAL’s RBP “base case” implied a substantial increase in airport charges compared to the iH7 charge (c. £30 per passenger (in 2018 prices) compared to an average of c.£22 for 2020 (in nominal prices)).
- 3.16 Meanwhile, in July 2020, HAL had also sent the CAA a request that it should reopen the Q6 price control by making an upward adjustment to HAL’s RAB of £1.7 billion to address the shortfall in revenue it expected to recover in 2020 and 2021 due to the impact of the Covid-19 pandemic (**HAL’s Application**).⁶⁰
- 3.17 Specifically, HAL requested:
- (a) a depreciation holiday for 2020 and 2021;

⁵⁴ HAL, Economic regulation of Heathrow: programme update (CAP 1914), Heathrow’s Response [Vol A / Tab 73 / p.8195 / para 2].

⁵⁵ Letter from Heathrow Airport Holdings Limited to Chair of CAA dated 5 June 2020 [Vol A / Tab 125].

⁵⁶ CAA, Economic regulation of Heathrow: policy update and consultation (CAP 1940) [Vol A / Tab 74 / p.8205].

⁵⁷ CAA, Economic regulation of Heathrow: policy update and consultation (CAP 1940) [Vol A / Tab 74 / p.8233 / para 2.7].

⁵⁸ CAA, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Summary (CAP2265A) (**H7 Initial Proposals Summary**) [Vol A / Tab 8 / p.633 / para 16].

⁵⁹ Heathrow Airport, H7 Revised Business Plan (Detailed) [Vol A / Tab 69].

⁶⁰ HAL, Application for Covid-related RAB Adjustments – Final Submission (**HAL’s Application**) [Vol A / Tab 32 / p.2490].

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- (b) an upward adjustment to the starting RAB in the H7 determination of £1.7 billion (based on the actual revenue outturn for 2020 and the forecast revenue for 2021 to correct for any difference between the RAB change and that implemented through the depreciation holiday);
- (c) no depreciation to be applied to this element of the RAB for H7, but return to be included in prices from 2022 in H7; and
- (d) a final adjustment to the RAB to be made at the end of 2022, reflecting actual outturn revenue for 2021 and prices for 2023 onwards adjusted accordingly.⁶¹
- 3.18 Both HAL's BBU and the RBP were based on the assumption that HAL could recover the full Covid-19 related RAB adjustment that it had requested (£1.7 billion).
- 3.19 The CAA consulted on HAL's Application in October 2020 (the **October 2020 Consultation**)⁶² and February 2021 (the **February 2021 Consultation**)⁶³ before issuing a decision to make an upward adjustment of £300 million (in 2018 prices) to HAL's RAB in April 2021 (the **April 2021 RAB Adjustment Decision**). These consultation exercises and the April 2021 RAB Adjustment Decision are addressed more fully in Ground 3 (at Section 6) below.
- 3.20 On 5 May 2021, Helen Stokes (Head of Legal, Regulation and Operations at HAL) wrote to the CAA, seeking to clarify the formal status and effect of the April 2021 RAB Adjustment Decision.⁶⁴ More specifically, HAL sought clarification as to whether the April 2021 RAB Adjustment Decision was a final decision as to any aspect of the regulatory package that would apply during the H7 Price Control. In its response dated 11 May 2021,⁶⁵ the CAA clarified that the April 2021 RAB Adjustment Decision was a decision by the CAA only on the package of measures that would apply pending the start of the H7 Price Control, and that the appropriate forum for oversight of the April 2021 RAB Adjustment Decision would be as part of any appeal to the CMA. The CAA noted that, in the event of such appeal, the CAA "*will not seek to argue that HAL (or airlines) should be precluded from challenging any aspect of the CAA's H7 licence modifications on the basis that it reflects a decision already taken in the [April 2021 RAB Adjustment Decision] that ought to have been challenged by way of judicial review.*"^{66 67}
- 3.21 On 27 April 2021, the CAA published a consultation entitled 'Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (the **April 2021 Way Forward Document**)'.⁶⁸ In the April 2021 Way Forward Document, the CAA: (i) recognised the ongoing difficulties associated with traffic forecasting in uncertain circumstances, (ii) set out its initial assessment of HAL's RBP, and (iii) outlined the CAA's proposed next steps.
- 3.22 HAL subsequently issued an updated revised business plan (**RBP Update 1**) at the end of June 2021.⁶⁹ HAL's RBP Update 1 stated that the lower passenger numbers expected over the H7

⁶¹ HAL's Application [Vol A / Tab 32 / p.2493 - 2494].

⁶² Heathrow, Quality Rebate and Bonus Scheme (webpage), accessed 17 March 2023 [Vol A / Tab 34, p.2569] and CAA, Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment – Appendices (CAP1966A) [Vol A / Tab 75 / p.8322].

⁶³ CAA, Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098) (**CAA February 2021**) [Vol A / Tab 53 / p.5754] and CAA, Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment - Appendices (CAP2098A) [Vol A / Tab 48 / p.5219].

⁶⁴ Letter from HAL to the CAA regarding CAP 2140: Status of the CAA's document [Vol A / Tab 130].

⁶⁵ Letter from CAA to HAL regarding the Status of CAP2041 [Vol A / Tab 131].

⁶⁶ *Ibid.*

⁶⁷ See also H7 Final Proposals Section 3 at Vol A / Tab 4 / p.341 – 342 / para 10.61-10.62 which states: "*For the avoidance of doubt, the April 2021 RAB Adjustment Decision was intended to be our final decision to give effect to the inclusion of the £300m in HAL's opening RAB for H7 RAB. ... Nonetheless, this change will be put into effect through the same licence modifications that will introduce the H7 price control. As such, airline stakeholders will be able to appeal this decision to the CMA if they disagree with our reasoning and approach to these matters.*" In addition, the Holding Price Cap 2023 Decision states: "*In due course, this process will provide key stakeholders with the right to appeal the licence modification, which will encompass our decisions on HAL's regulatory asset base (including in relation to the interim RAB adjustment).*"

⁶⁸ CAA, Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (CAP 2139) [Vol A / Tab 76 / p.8361].

⁶⁹ Heathrow Airport, H7 Revised Business Plan – Update 1 [Vol A / Tab 60 / p.6041].

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period (due to the impact of the Covid-19 pandemic) meant airport charges would need to be increased beyond the level HAL had previously set out. It included two scenarios: one implying average charges over H7 of c.£32 per passenger and the other implying average charges over H7 of £43 per passenger (both in 2018 prices).

- 3.23 During the period from June 2021 to January 2022, HAL submitted evidence which was critical of the CAA and its April 2021 RAB Adjustment Decision to the House of Commons Committee of Public Accounts ‘Principles of Effective Regulation’ inquiry⁷⁰ and to the House of Commons Transport Committee inquiry to plot the aviation sector’s route to recovery following the Covid-19 pandemic.⁷¹
- 3.24 The CAA issued its initial proposals in respect of the H7 price control period (the **H7 Initial Proposals**) in October 2021. These set a wide range for the regulated airport charge (£24.50 to £34.40 per passenger, in 2020 prices) to reflect the uncertain circumstances prevailing at that time due to the ongoing Covid-19 pandemic.⁷² The CAA set out its views on the way forward for dealing with HAL’s airport charges from 31 December 2021 (when the Q6 price control expired) until the H7 price control arrangements were due to come into effect (at that time, predicted to be early 2022). The CAA proposed to put in place a licence condition to regulate HAL’s prices in 2022 – a £29.50 “*holding price cap*” – and it published a notice of such licence modification in Appendix C to the H7 Initial Proposals. The indicative timetable published in the Initial Proposals provided for responses to the proposed licence modification in November 2021 and to the H7 Initial Proposals by December 2021, followed by the CAA’s final proposal (March/April 2022) and final decision (May/June 2022), with the licence modification taking effect in July/August 2022.⁷³
- 3.25 The CAA received “*detailed responses*” to the Initial Proposals, which included responses from HAL and the airlines,⁷⁴ including Delta and VAA. In their joint response to the CAA’s consultation on the Initial Proposals, Delta and VAA stated that the delay in the CAA’s process had “*left airlines and consumers in the dark as to what level of charges will be ultimately levied. As an airline, we are therefore unable to take informed commercial decisions as to how to approach charges going forward. This issue affects all tickets being sold for flying at any point in 2022*”.⁷⁵ In addition to delay, Delta and VAA expressed concern that the CAA had provided its price control model to consultation respondents only after the consultation period had already begun.⁷⁶
- 3.26 Alongside its response to the H7 Initial Proposals in December 2021, HAL submitted a second update to its RBP (**RBP Update 2**)⁷⁷ which was stated to provide key updates to its H7 building block forecasts to reflect new market data and evidence that had become available since the publication of RBP Update 1 in June 2021.
- 3.27 In December 2021, the CAA issued its decision to impose a holding price cap for 2022 at the mid-point of the range set out in its H7 Initial Proposals (£29.50 per passenger (in 2020 prices)) (the **Holding Price Cap 2022**).⁷⁸ The Holding Price Cap 2022 (£30.19 in 2022 prices) was in effect between 1 January 2022 and 31 December 2022. The CAA stated that it intended the Holding Price Cap 2022 to be ‘trued up/down’ in the light of its Final Decision for the H7 period.

⁷⁰ Public Accounts Committee, Principles of effective regulation (webpage), accessed 6 April 2023 [Vol A / Tab 97 / p.8445] and Heathrow Airport Limited, Written evidence submitted by Heathrow Airport (PER006) [Vol A / Tab 78 / p.8447].

⁷¹ Airlines and airports: supporting recovery in the UK aviation sector - Written evidence - Committees - UK Parliament (webpage), accessed 6 April 2023 [Vol A / Tab 79 / p.8452].

⁷² H7 Initial Proposals Summary [Vol A / Tab 8 / p.645 – 646 / Table 3].

⁷³ H7 Initial Proposals Summary [Vol A / Tab 8 / p.647 / para 77 / Table 4].

⁷⁴ H7 Final Proposals Summary [Vol A / Tab 1 / p.20 / para 44].

⁷⁵ VAA and Delta, Response to 2022 Charges Consultation (CAP2265) [Vol A / Tab 107 / p.10093 / para 3.1].

⁷⁶ VAA and Delta, Response to 2022 Charges Consultation (CAP2265) [Vol A / Tab 107 / p.10090 / para 1.12].

⁷⁷ HAL, A20. RBP Update 2 [Vol A / Tab 80 / p.8454].

⁷⁸ CAA, Economic regulation of Heathrow Airport Limited: Notice of licence modifications (CAP 2305) (**CAA Holding Price Cap 2022**) [Vol A / Tab 81 / p.8573].

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- 3.28 Although the final proposals were timetabled for March/April 2022 (see paragraph 3.24 above),⁷⁹ the CAA published its final proposals for H7 on 28 June 2022 (the **H7 Final Proposals**).⁸⁰ The CAA's H7 Final Proposals were based on retaining the Holding Price Cap 2022 for 2022, with the price cap for subsequent years reducing each year over the H7 period to £21.75 in 2026 (in 2020 prices). The CAA confirmed its £300 million ex post RAB adjustment in the H7 Final Proposals, but concluded that any further RAB adjustment would not further the interest of consumers regarding the range, availability, continuity, cost and quality of AOS, nor be necessary to support the efficient financing of HAL. The H7 Final Proposal stated that the final decision, originally timetabled for May/June 2022, was intended to be published "*in the Autumn of 2022*".⁸¹
- 3.29 After publication of the H7 Final Proposals, the CAA received "*a large number of detailed responses*";⁸² including consultation responses from HAL, eleven airlines (including Delta), three airline associations, and an airport hotel operator. The H7 Final Decision records that the airlines "*repeated many of the concerns they had raised at earlier stages of the process, suggesting that the proposed charge was too high and should be no more than around £18.50 on average across the H7 period*" and that they "*considered that the Final Proposals included a number of fundamental errors in relation to areas such as the passenger forecast, the cost of capital and the RAB adjustment*".⁸³ HAL was also critical of the H7 Final Proposals, and raised a wide range of challenges on all key areas of the building and the price control as a whole. HAL considered that the proposed charge was too low.⁸⁴
- 3.30 The H7 Final Proposals stated the CAA would consider adopting a new passenger forecast and revising its proposals for the H7 price control if "*strong evidence*" were to emerge during the period of consultation that indicated the CAA's "mid" case was not an appropriate average forecast for 2022 and beyond, and that retaining it would create significant bias.⁸⁵ As explained in Section 4 below, as the Covid-19 pandemic restrictions were gradually lifted in the spring and early summer 2022,⁸⁶ passenger numbers at Heathrow did increase significantly in 2022 beyond the 45.4 million which had been forecast by HAL,⁸⁷ and 54.9 million as forecast by the CAA,⁸⁸ to 61.6 million.⁸⁹ This upward trajectory exceeded the projections by HAL and the CAA by c. 36% and c. 12%, respectively.
- 3.31 Developments in the economy after the H7 Final Proposals, namely the high degree of volatility in forecasts of inflation and interests rates in autumn 2022,⁹⁰ led the CAA to extend the period to consider (i) the responses to its H7 Final Proposals and (ii) whether a further consultation would be likely to help the CAA to discharge its duties in making the final determination on the H7 price control.⁹¹ The CAA considered that it was "*no longer possible to reach and implement a Final Decision on all aspects of the H7 settlement in a timely way to come into effect when the current holding price cap expires on 31 December 2022*".⁹² As it had done in December 2021, the CAA decided to introduce a further holding price for 2023, on a similar basis to the interim arrangements which the CAA had introduced a year earlier through the Holding Price Cap 2022.

⁷⁹ H7 Initial Proposals Summary) [Vol A / Tab 8 / p.647 / para 77 / Table 4].

⁸⁰ H7 Final Proposals [Vol A / Tabs 1 – 7].

⁸¹ H7 Final Proposals Summary [Vol A / Tab 1 / p.39 / para 117].

⁸² CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8615 / para 10].

⁸³ H7 Final Decision Summary [Decision / Tab 1 / p.10 / para 20].

⁸⁴ H7 Final Decision Summary [Decision / Tab 1 / p.10 / para 20].

⁸⁵ H7 Final Proposals Summary [Vol A / Tab 1 / p.38 / para 108].

⁸⁶ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8615 / para 10].

⁸⁷ H7 Final Decision Summary [Decision / Tab 1 / p.14 - 16 / para 48 and Table 1].

⁸⁸ H7 Final Proposals Summary [Vol A / Tab 1 / p.20 / para 48 / Table 1].

⁸⁹ H7 Final Decision Summary [Decision / Tab 1 / p.14 / para 40 / Table 1].

⁹⁰ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8615 / para 13].

⁹¹ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8616 / para 11].

⁹² CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8617 / para 1.5].

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- 3.32 On 8 December 2022, the CAA published ‘Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023’ (the **Holding Price Cap 2023 Consultation Document**).⁹³ The CAA stated that the proposed interim cap (£31.57 in nominal prices) would replace the Holding Price Cap 2022 which was due to expire on 31 December 2022, and its value was in line with the price cap in the H7 Final Proposals. As with the Holding Price Cap 2022, the CAA committed to ‘true up’ or ‘true down’ the interim price cap for 2023 to account for any difference between it and the final price cap for the H7 period. The consultation period closed on 22 December 2022 (two weeks following the publication of the Holding Price Cap 2023 Consultation Document), with the new holding price cap expected to come into effect during February 2023.⁹⁴
- 3.33 The Holding Price Cap 2023 Consultation Document did not specify a month for the CAA’s final decision in respect of the H7 price control, but did indicate that the “*wider H7 price review programme will continue at an appropriate pace with the aim of allowing both the CAA’s Final Decision and any appeal to the CMA to be concluded during 2023*”.⁹⁵ In response of the Holding Price Cap 2023 Consultation Document, HAL stated that it was “*unacceptable to have no clear complete timeline for the regulatory process and to rely on last minute publications to ensure the right provisions are in place*”,⁹⁶ and criticised the CAA’s H7 Final Proposals, published in June 2022, as “*materially out of date*”.⁹⁷ It pointed out that the delays to the price control “*also mean that 2022 performance*” – which respondents to the CAA’s consultation had provided forecasts for – “*is now available and does not need to be forecast*”.⁹⁸ Delta and VAA similarly requested that the CAA publish “*a timetable for its Final Decision and indicates what, if any, further work it is doing at this stage*”⁹⁹ and stated that “[*e*]ach round of delay comes at the expense of certainty for the industry at large, and the longer the CAA takes, the more review of prior evidence it will have to carry out (as the evidence base becomes increasingly outdated)”.¹⁰⁰ Delta and VAA expressed concern that the CAA might have insufficient time to “*do material work to amend the interim cap in light of the consultation responses*”, ahead of the CAA’s proposal to implement the interim cap in February 2023,¹⁰¹ given the requirement that a licence modification may not take effect less than six weeks after the date on which notice of the licence modification is published.¹⁰²
- 3.34 On 1 February 2023, the CAA published ‘Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023’ (the **Holding Price Cap 2023 Decision**).¹⁰³ The Holding Price Cap 2023 Decision gave notice under section 22(6) of the Act of the CAA’s decision to modify HAL’s licence in order to set an interim price cap for 2023 of £31.57 (the **Holding Price Cap 2023**), with effect from mid-March 2023. The CAA stated that it was aiming to publish its final decision on the H7 price control in March 2023. As discussed in paragraph 3.35 below, the CAA did so on 8 March 2023. Consequently, the CAA’s Holding Price Cap 2023 came into effect only after the CAA had already published the H7 Final Decision.
- 3.35 Although initially timetabled by the CAA for May/June 2022,¹⁰⁴ the CAA’s H7 Final Decision was published on 8 March 2023. The H7 Final Decision set a price cap of £23.06 (2020 real prices) for the H7 price control period,¹⁰⁵ and again confirmed the CAA’s April 2021 RAB Adjustment

⁹³ *Ibid.*

⁹⁴ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8623 - 8624 / para 2.19 – 2.20].

⁹⁵ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488) [Vol A / Tab 82 / p.8623 / para 2.18].

⁹⁶ HAL, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488), Heathrow’s Response [Vol A / Tab 83 / p.8630 / para 1.1.2].

⁹⁷ HAL, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488), Heathrow’s Response [Vol A / Tab 83 / p.8631 / para 2.1.2].

⁹⁸ HAL, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488), Heathrow’s Response [Vol A / Tab 83 / p.8631 / para 2.1.3].

⁹⁹ Delta and VAA, Response to CAP2488 – HAL 2023 Holding Price Cap [Vol A / Tab 84 / p.8644 / para 3.12(a)].

¹⁰⁰ Delta and VAA, Response to CAP2488 – HAL 2023 Holding Price Cap [Vol A / Tab 84 / p.8639 / para 2.2].

¹⁰¹ Delta and VAA, Response to CAP2488 – HAL 2023 Holding Price Cap [Vol A / Tab 84 / p.8635].

¹⁰² Section 22(9) CAA12 [Vol A / Tab 13 / p.933].

¹⁰³ CAA, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP 2515) (CAA **Holding Price Cap 2023**) [Vol A / Tab 52].

¹⁰⁴ H7 Initial Proposals Summary [Vol A / Tab 8 / p.647 / para 77 / Table 4].

¹⁰⁵ H7 Final Decision Summary [Decision / Tab 1 / p.19 / para 64 and Table 7].

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Decision to make an upward adjustment of £300 million to HAL's RAB.¹⁰⁶ A notice under section 22(6) of the Act specifying the necessary modifications to HAL's Licence accompanied the H7 Final Decision and those modifications are due to come into effect on 1 May 2023.¹⁰⁷ The CAA concluded in the H7 Final Decision that the Holding Price Cap 2023 would not be changed for 2023.¹⁰⁸

¹⁰⁶ H7 Final Decision Summary [**Decision / Tab 1 / p.17 / para 54**].

¹⁰⁷ CAA, H7 Final Decision: Appendix C (CAP2524E2) (**H7 Final Decision Appendix C**) [**Decision / Tab 6 / p.260 / para C9**].

¹⁰⁸ H7 Final Decision Summary [**Decision / Tab 1 / p.19 – 20 / para 65**].

SECTION 4: GROUND 1 – PASSENGER FORECAST

A. Overview

- 4.1 This ground concerns the CAA's errors in forecasting the number of passengers travelling to and from Heathrow Airport during each year of the H7 price control period.
- 4.2 In the H7 Final Decision, the CAA explained that the number of passengers using Heathrow Airport is of "*central importance to the overall economics of the airport*", and the passenger forecast the CAA sets is a "*key driver of our calculation of the maximum allowed level of allowed airport charges.*" ¹⁰⁹
- 4.3 Specifically the passenger forecast is used as the 'denominator' for translating the revenue requirement that the CAA determines is appropriate for HAL to be able to generate in order to deliver AOS during H7 into a maximum 'yield per passenger' which can be used by HAL to set airport charges.¹¹⁰ The per-passenger charge is therefore highly sensitive to changes in passenger forecasts.
- 4.4 In the H7 Final Decision, the CAA explained that "*an appropriate passenger forecast helps to ensure that the airport charges HAL sets are no higher than necessary to recover its efficient costs and to provide an appropriate return, and is a fundamental step in allowing us properly to further the interests of consumers, having regard to the matters required by CAA12.*"¹¹¹ Under- or over-estimating passenger forecasts by even a relatively small amount can have significant consequences for airport charges.
- 4.5 The Appellant submits that the CAA has erred in the H7 Final Decision by setting the passenger forecast too low. The CAA has failed to adequately explain its methodology, in particular the underlying use of the passenger forecasting model, and has committed several additional methodological errors leading it to significantly underestimate passenger numbers for H7. The CAA has also failed to make consequential amendments to HAL's asymmetric risk allowance (which relies on passenger numbers as an input). The consequence of these errors, both individually and collectively, is that the maximum allowed yield per passenger (i.e. the per passenger charge) has been set too high, contrary to the interests of consumers. These errors are described in sub-section C.
- 4.6 The Appellant contends that the CAA's H7 Final Decision with regard to the passenger forecast was based on errors of fact, law and discretion and was therefore wrong within the meaning of section 26 of the Act. These legal consequences are summarised in sub-section D below and explained in more detail at Annex 1.
- 4.7 These errors are material. Once corrected, the passenger forecast increases by 17 million passengers over the five year price control period, and the per passenger charge is reduced by £1.32 on average over the H7 period as shown in sub-section E.
- 4.8 The Appellant therefore requests that the CMA quash the H7 Final Decision under section 27(2) of the Act insofar as it sets the passenger forecasts on the basis of the numbers in the final row of Table 1.7, Chapter 1 of the H7 Final Decision with a total of 375.5 million passengers over the H7 period (as replicated in Table 1 which follows). The Appellant requests that the CMA should substitute these numbers with corrected passenger forecasts (also in Table 1), which totals 392.5 million passengers over the H7 period. The relief sought is further detailed in sub-section E.

¹⁰⁹ CAA, H7 Final Decision: Section 1 on the regulatory framework (CAP2524B) (**H7 Final Decision Section 1**) [**Decision / Tab 2 / p.30 / para 1.1**].

¹¹⁰ The passenger forecast is also important for other elements of the price control including the calibration of the TRS mechanism, operating and capital expenditure and commercial revenues [**Decision / Tab 2 / p.30 / para 1.1 – 1.2**].

¹¹¹ H7 Final Decision Section 1 [**Decision / Tab 2 / p.30 / para 1.3**].

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Table 1: Corrected passenger forecasts for H7, as produced by the Appellant

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA's decision	61.6	73.0	78.9	80.7	81.3	375.5
Corrected passenger forecasts¹¹²	64.3	77.6	82.0	83.6	85.0	392.5

- 4.9 The key evidence that the Appellant requests the CMA reads when considering this ground is:
- (a) Chapter 1 of the H7 Final Decision in which the CAA explains the process it undertook in setting the passenger forecast for H7 and the results of this process;
 - (b) Chapter 1 of the H7 Final Proposals;
 - (c) A report by Skylark entitled 'H7 Forecast Update Review' dated February 2023 which was commissioned by the CAA (the **2023 Skylark Report**); and
 - (d) CW1, in which Chris Walker, on behalf of the Appellant, provides evidence to support the position that the passenger forecast set by CAA is too low.

B. The CAA's decision

- 4.10 In this section and CW1, the Appellant more fully describes the substantive and procedural background to the CAA's decision on passenger forecasts.
- 4.11 The CAA has adapted its methodology for setting the passenger forecasts for H7 during the price control process, including in the H7 Final Decision where it was able to take into account actual data for 2022 passenger numbers.
- 4.12 **In the H7 Initial Proposals**, the CAA explained that the onset of the Covid-19 pandemic in early 2020 delivered an unprecedented shock to the aviation industry with passenger numbers in April 2020 having "*collapsed at Heathrow airport to approximately 3% of the levels expected when the interim price control and airport/airline commercial deal was put in place in 2020 and 2021*".¹¹³
- 4.13 This meant that HAL's established approach to forecasting was not fit for purpose so HAL adapted its approach to model the impact of travel restrictions related to the Covid-19 pandemic. HAL's RBP showed "*steady recovery from the impact of the covid-19 pandemic*"¹¹⁴ albeit none of the output scenarios exhibited a return to 2019 passenger volumes (80.9 million passengers).
- 4.14 The CAA decided to use HAL's adapted model as the basis for its passenger forecast for its H7 Initial Proposals on the basis that it considered this represented a "*reasonable approach*"¹¹⁵ to modelling passenger volumes in light of the difficult and uncertain circumstances of the Covid-19 pandemic. However, the CAA also acknowledged that HAL's use of the models to create scenarios involved a number of "*difficult judgements*"¹¹⁶ meaning that it was important that the CAA should carefully review HAL's approach so the resulting forecasts represented a reasonable review of the likely level of passenger numbers in the future. The CAA explained

¹¹² As explained in more detail in section H of CW1.

¹¹³ CAA, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 1: Overall approach and building blocks (CAP2265B) (**H7 Initial Proposals Section 1**) [Vol A / Tab 93 / p.9837 / para 2.7].

¹¹⁴ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9837 / para 2.8].

¹¹⁵ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9842 / para 2.23].

¹¹⁶ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9842 / para 2.23].

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“we have decided to use HAL’s models as the basis for our passenger forecast for Initial Proposals, but where our views have differed from HAL’s, we have made adjustments in the models, or corrected the output to reflect the likely effect of such differences”.¹¹⁷ The adjustments made by the CAA included:

- (a) corrections to mitigate the effect of asymmetric distributions in HAL’s model to remove downside bias;¹¹⁸
 - (b) adjustments to remove the effect of fare increases due to reduced business travel;¹¹⁹
 - (c) the removal of supply capping for all but the ‘low’ scenario;¹²⁰
 - (d) adjustments to increase fleet capacity where assumptions were judged to be overly pessimistic;¹²¹ and
 - (e) adjustments to correct for HAL’s erroneous assumptions about market share constraints.¹²²
- 4.15 These adjustments led to the passenger forecast used in the H7 Initial Proposals to be set at 339.2 million, which was 6.8% higher than HAL’s forecast in RBP Update 1 of 317.7 million.¹²³ The CAA published a report from Skylark Consulting Group (**Skylark**), which supported these forecasts.¹²⁴
- 4.16 As part of the H7 Initial Proposals, the CAA consulted on the **Holding Price Cap 2022**. The CAA explained that (at that time) the final decision was not expected “until early in 2022” and that “without further action by the CAA, there will be no price cap applicable to HAL from 1 January 2022”.¹²⁵ The proposals for the Holding Price Cap 2022 were based on the H7 Initial Proposals,¹²⁶ including the passenger forecast number for 2022.¹²⁷ As noted above, the Holding Price Cap 2022 was to be ‘trued up or down’ in the light of the H7 Final Decision.¹²⁸
- 4.17 **In response to the H7 Initial Proposals**, HAL provided RBP Update 2 which included updated passenger forecasts. HAL’s mid-case forecast was slightly lower than its earlier forecasts at 317.1 million passengers, but its low case forecast was revised upwards to 244.1 million passengers.
- 4.18 The Airline Operators Committee (**AOC**) and London (Heathrow) Airline Consultative Committee (**LACC**), on behalf of airlines, provided new passenger forecasts informed by latest trends including the removal of traffic restrictions, airline activity, and Heathrow Airport performance against UK-wide trends, which projected 398 million passengers for H7 and recovery in 2022 at 89% of 2019 levels.¹²⁹
- 4.19 Airlines, including the Appellant, submitted that the CAA’s forecasts were unduly pessimistic and referred to recent Eurocontrol forecasts for total flights and schedule data for 2022 as evidence that the recovery would be faster than the CAA had suggested.¹³⁰

¹¹⁷ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,842 / para 2.24].

¹¹⁸ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,842 / para 2.24 – 2.25].

¹¹⁹ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,843 / para 2.27 – 2.29].

¹²⁰ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,842 / para 2.30 – 2.32].

¹²¹ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,843 / para 2.30 – 2.32].

¹²² H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,844 - 9845 / para 2.36 – 2.39].

¹²³ H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,845 - 9846 / para 2.45 and Table 2.1].

¹²⁴ Skylark Consulting Group, CAA H7 Forecast Review: Final Report (2021 Skylark Report) [Vol A / Tab 94].

¹²⁵ CAA, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 3: Incentives and other issues (CAP2265D) (H7 Initial Proposals Section 3) [Vol A / Tab 10 / p.823 / para 15.4].

¹²⁶ H7 Initial Proposals Section 3 [Vol A / Tab 93 / p.828 / para 15.34 – 15.36].

¹²⁷ This equated to 45.6 million passengers (the CAA’s mid case for the H7 Initial Proposals). H7 Initial Proposals Section 1 [Vol A / Tab 93 / p.9,846 / Table 2.1].

¹²⁸ CAA, Economic regulation of Heathrow Airport Limited: Notice of licence modifications (CAP 2305) (CAA Holding Price Cap 2022) [Vol A / Tab 81 / p.8,598 / para 2.19].

¹²⁹ LACC, AOC and IATA, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 108].

¹³⁰ Delta, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 109 / p.10,136].

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- 4.20 Airlines also raised concerns about a lack of access and transparency in the forecasting process and the actual models used in the CAA's analysis. A key concern was the overreliance by the CAA on using HAL's forecasting model. The Appellant explained "*by the CAA's own admission the passenger numbers used are outdated and outside of independent forecasts. This has the impact of heavily skewing the range and placing disproportionate cost onto consumers*".¹³¹
- 4.21 The CAA responded to these concerns by communicating its intent to comply with the airlines' request and grant them access to HAL's RBP model. However, as explained in Section H of CW1, the CAA later explained that HAL had strongly opposed the CAA's proposals and suggested that the CAA should share a limited portion of the model within a narrow confidentiality ring.
- 4.22 **In the H7 Final Proposals**, the CAA acknowledged that forecasting passenger volumes during the Covid-19 pandemic was "*particularly challenging*".¹³² The CAA accepted that there had been a "*strong recovery*" in passenger numbers but considered that there "*remained uncertainties about the path of recovery in the light of macroeconomic headwinds and other uncertainties*".¹³³
- 4.23 Importantly, the CAA recognised that, despite repeated requests, "*HAL has refused to make its passenger forecasting models openly and transparently available to stakeholders*".¹³⁴ The CAA confirmed that HAL's conduct "*has undermined our confidence in the credibility and robustness of HAL's passenger forecasts and caused us to place less weight on this evidence*".¹³⁵
- 4.24 The CAA modified the approach it had used in the H7 Initial Proposals and stated that it had sourced and considered a range of traffic forecasts, alongside other relevant information and evidence. This included: (i) sourcing independent traffic forecasts from different sectors of the industry; (ii) developing a method to consistently derive Heathrow-specific forecasts of passengers; (iii) assessing recent developments (in relation to the Covid-19 pandemic, the evolving macroeconomic outlook and the impact of the Russian invasion of Ukraine); and (iv) exploring the latest developments in the industry with stakeholders.¹³⁶
- 4.25 The CAA explained that it had used a "*much wider range of information*" to set passenger forecasts in the H7 Final Proposals and that "*HAL's forecast and forecasting method has been given less weight in the development of [its] forecast, as it has become one of a number of forecasts that [it had] considered*".¹³⁷ The CAA used this information to develop 'low' and 'mid' scenarios with the 'mid' scenario driving the CAA's calculation of the airport charges. It also applied a 'shock' factor on the basis that it considered there remained a possibility for unforeseen external demand shocks.
- 4.26 The CAA confirmed that the starting point for developing the passenger forecast was "*a forecast using our own assumptions and HAL's model*".¹³⁸ The CAA identified concerns with elements of HAL's model and applied adjustments (partly building on those applied in the H7 Initial Proposals) to address these issues.
- 4.27 The CAA also considered revised forecasts from HAL and from AOC and LACC, on behalf of the airlines noting that there was a "*significant divergence*" of views and a "*great deal of continuing uncertainty over how developments in the industry, the economy, the aviation market and the course of the covid-19 pandemic will affect traffic at Heathrow*".¹³⁹
- 4.28 In setting the H7 Final Proposals forecasts, the CAA considered the 2022 forecast separately from the rest of the H7 period. The CAA concluded that passenger numbers in 2022 should be set at 68% of 2019 levels. This contrasted with the forecasts from AOC and LACC which

¹³¹ Delta, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab / p.10137].

¹³² H7 Final Proposals Section 1 [Vol A / Tab 2 / p.50 / para 1.14].

¹³³ *Ibid.*

¹³⁴ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.50 / para 1.15].

¹³⁵ *Ibid.*

¹³⁶ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.50 / para 1.17].

¹³⁷ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.51 / para 1.18].

¹³⁸ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.51 / para 1.20].

¹³⁹ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.55 / para 1.32].

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predicted that passenger numbers would be at 89% of 2019 levels and HAL’s modelling which suggested that passenger numbers would only be at 56% of 2019 levels.

- 4.29 For 2023 to 2026, the CAA concluded there was less emerging evidence and so it placed more reliance on its CAA-amended HAL forecast, identifiable long-term trends and how the CAA expected Heathrow traffic to be affected by them. As a general principle, the CAA suggested that “forecasts are more affected by the standard economic and supply drivers of passenger demand and less by covid-19” during this period.¹⁴⁰
- 4.30 The CAA noted that “almost all of the forecasts we considered which covered the whole H7 period predicted a return to 2019 levels of traffic (HAL’s being an outlier in the overall sample of forecasts that did not predict a return to 2019 levels)”.¹⁴¹
- 4.31 Moreover, while acknowledging the potential impact of macroeconomic factors such as rising oil prices, the CAA confirmed that “the effect of these factors is tempered by a consideration of how demand at Heathrow has historically been more robust in the face of economic headwinds than at the rest of the UK airports, helped by the pressure of airlines to protect valuable Heathrow slots”.¹⁴²
- 4.32 The CAA concluded by finding that on balance it was appropriate to allow for a “modest reduction” in passenger numbers in 2023 and 2024 (largely reflecting economic pressures) and a “modest increase” in 2025 to 2026 (reflecting the longer-term resilience of passenger traffic at Heathrow Airport). The CAA stated that these changes “smooth the path of the forecast over the remainder of H7 without significantly altering the overall passenger volumes for H7”.¹⁴³
- 4.33 The CAA also considered it appropriate to apply a ‘shock factor’ to cover temporary and difficult to predict ‘non-economic shocks’ (such as major volcanic eruptions, terrorism events and wars) to air travel. The CAA explained that this was “in line with regulatory precedent, in the form of previous adjustments made by the CAA in the Q6 HAL price control”.¹⁴⁴
- 4.34 The synthesis of the CAA’s H7 Final Proposals passenger forecasts from its CAA-amended HAL forecast were presented in Table 1.5 (which is replicated in the table which follows)¹⁴⁵.

H7 Final Proposals, Table 1.5 Summary of CAA forecast synthesis process, H7

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA-Amended HAL Mid (shocked)	52.0	67.7	76.5	80.1	81.1	357.4
CAA-Amended HAL Mid (unshocked)	52.4	68.3	77.1	80.8	81.8	360.5
Adjustment	+3.0	-0.4	-1.1	+0.9	+0.5	360.5
CAA FP Mid (unshocked)	55.4	67.9	76.0	81.7	82.3	363.4
CAA FP Mid	54.9	67.3	75.4	81.0	81.6	360.2

¹⁴⁰ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.65 / para 1.70].

¹⁴¹ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.66 / para 1.71].

¹⁴² H7 Final Proposals Section 1 [Vol A / Tab 2 / p.66 / para 1.74].

¹⁴³ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.66 / para 1.76].

¹⁴⁴ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.67 / para 1.77].

¹⁴⁵ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.67 / para 1.78].

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- 4.35 The CAA shared a further report produced by Skylark, which had undertaken an independent quality assurance of the CAA’s modified approach to forecasting passenger volumes for H7 (**2022 Skylark Report**). The CAA reported that the 2022 Skylark Report had approved of viewing the available evidence “*in the round*” and considered this would more likely result in a realistic traffic outlook for H7 but considered that the forecast may prove pessimistic for 2022 and potentially optimistic in 2026.¹⁴⁶
- 4.36 The CAA’s numbers were significantly lower than those proposed by the AOC and LACC, which predicted passenger numbers steadily rising throughout the H7 period.¹⁴⁷

H7 Final Proposals: Extract from Table 1.6: CAA H7 Final Proposals passenger forecasts compared with HAL and AOC/LACC forecasts H7

Passengers (millions)	2022	2023	2024	2025	2026	H7
AOC/LACC	72.0	77.7	80.9	82.5	84.9	398.0
HAL RBP Mid u2	45.5	58.0	67.7	71.8	80.9	356.6
CAA FP Mid	54.9	67.3	75.4	81.0	81.6	360.2

- 4.37 The CAA committed to adopting a new passenger forecast if conclusive evidence were to emerge that the CAA’s mid-case was no longer a “*credible average forecast for 2022 and beyond*”.¹⁴⁸
- 4.38 **In December 2022**, given that the CAA’s H7 Final Decision was still pending, the CAA outlined its proposals to implement the **Holding Price Cap 2023**. The CAA explained the Holding Price Cap 2023 would “*allow time for proper consideration of*” new evidence and specific developments “*and to ensure that the interests of consumers are properly protected*”.¹⁴⁹ The CAA’s proposals for the Holding Price Cap 2023 relied on the CAA’s H7 Final Proposals.¹⁵⁰ Various stakeholders (including Delta and VAA by way of joint response) responded to the Holding Price Cap 2023 Consultation Document and were critical of the CAA’s proposals, including as the CAA proposed to rely on outdated data and evidence.¹⁵¹ The CAA issued the Holding Price Cap 2023 Decision on 1 February 2023,¹⁵² adopting the position as set out in its consultation. The CAA stated that it intended the Holding Price Cap 2023 would be ‘trued up or down’ in the light of the H7 Final Decision.¹⁵³
- 4.39 At the beginning of 2023, the CAA and the airlines had the benefit of having actual passenger numbers for 2022. In 2022, 61.6 million passengers travelled through the airport (albeit the numbers were affected by the impact of HAL’s Local Rule A restrictions). This was c. 12%

¹⁴⁶ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.67 - 68 / para 1.81 - 83].
¹⁴⁷ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.67 - 68 / para 1.83 – 1.85].
¹⁴⁸ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.70 / para 1.86].
¹⁴⁹ CAA, Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2488). [Vol A / Tab 82 / p.8615 / para 13].
¹⁵⁰ This resulted in the interim price cap being based on a passenger forecast of 65.2 million for 2023. [Vol A / Tab 82 / p.8622 / para 2.12].
¹⁵¹ Delta and VAA, Response to CAP2488 – HAL 2023 Holding Price Cap [Vol A / Tab 84 / p.8637 / para 1.8] and BA, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 116 / p.10509].
¹⁵² CAA, Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP 2515) (CAA Holding Price Cap 2023) [Vol A / Tab 52].
¹⁵³ CAA Holding Price Cap 2023 [Vol A / Tab 52 / p.5746 / para 2.37].

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higher than the CAA's H7 Final Proposals mid-case forecast, and c.35% higher than HAL's RBP Update 2 mid-case forecast.

- 4.40 **In the H7 Final Decision**, the CAA summarised responses to the H7 Final Proposals noting that HAL had repeated its objections to the assumptions and amendments made by the CAA to its forecasting models and had provided new information and arguments to support its claims.¹⁵⁴ Meanwhile airlines had *"for the most part ... presented a unified view"*¹⁵⁵ on the passenger forecasts and raised concerns that the CAA's model had underestimated the pace at which the number of passengers using Heathrow Airport had returned towards the levels observed before the Covid-19 pandemic and that the data the CAA had relied upon was outdated. Airlines also criticised the CAA's continued reliance on HAL's forecasting model which was not available for scrutiny and encouraged more reliance on the available external forecasts.¹⁵⁶
- 4.41 The CAA confirmed that it had reviewed the new information which HAL had provided but *"do not consider these arguments are sufficiently persuasive for us to adopt a different approach"*.¹⁵⁷ Moreover, the CAA noted that *"our CAA-amended HAL Mid case forecast is more in line with external forecasts than HAL's Mid case forecast and we consider this supports the suitability of the set of amendments we have made to HAL's model"*.¹⁵⁸
- 4.42 The CAA acknowledged that both HAL and the airlines had proposed that the CAA should look again at passenger forecasts before reaching a decision. HAL stated that *"comparing its risk-weighted forecasts to external forecasts which are not risk-weighted was inappropriate"*.¹⁵⁹ Airlines stated that the CAA's forecasts *"should not reflect the effect of HAL's 'Local Rule A' capacity cap in 2022"*, on the basis that it was more appropriate to use the underlying demand that would have been served by the airport had the cap not been imposed. Airlines provided confidential material demonstrating their bookings and/or fleet plans for winter 2022/23 and summer 2023.¹⁶⁰
- 4.43 The CAA explained that during 2022:
- "Easter saw delays and cancellations at Heathrow and elsewhere as staffing and capacity shortages caused airports and airlines to struggle to meet returning demand. Between May [sic] and October 2022, HAL applied capacity restrictions under Local Rule A to increase operational resilience and reduce queues, delays and cancellations. In both November and December 2022, passenger numbers reached 89 per cent of 2019 levels, the highest percentage of 2019 passenger numbers at Heathrow airport since the start of the covid-19 pandemic. Since then, bookings have remained robust, despite the economic pressures being faced by consumers"*.¹⁶¹
- 4.44 The CAA recognised that since publication of the H7 Final Proposals *"we have observed a stronger than anticipated recovery in passenger volumes"*.¹⁶² The CAA further acknowledged that the mid-case used in the H7 Final Proposals is *"no longer an appropriate forecast"* and that retaining the forecast would create *"significant bias"*.¹⁶³
- 4.45 In light of the above, the CAA decided to adapt its method to forecasting on the basis that it was no longer necessary to forecast passenger numbers for 2022 since the actual number of passengers that used Heathrow Airport during that period was available.¹⁶⁴ The CAA explained that it had based its decision on the forecast used for the H7 Final Proposals, but having

¹⁵⁴ CAA, H7 Final Decision: Section 1 on the regulatory framework (CAP2524B) (H7 Final Decision Section 1) [Decision / Tab 2 / p.34 / para 1.2].

¹⁵⁵ H7 Final Decision Section 1 [Vol A / Tab 2 / p.35 / para 1.22].

¹⁵⁶ H7 Final Decision Section 1 [Decision / Tab 2 / p.35 / para 1.22 – 1.23].

¹⁵⁷ H7 Final Decision Section 1 [Decision / Tab 2 / p.35 / para 1.25].

¹⁵⁸ H7 Final Decision Section 1 [Decision / Tab 2 / p.35 / para 1.25].

¹⁵⁹ H7 Final Decision Section 1 [Decision / Tab 2 / p.36 / para 1.30 – 1.32].

¹⁶⁰ H7 Final Decision Section 1 [Decision / Tab 2 / p.36 / para 1.33 – 1.34].

¹⁶¹ *Ibid.* Local Rule A restrictions in fact applied from July.

¹⁶² H7 Final Decision Section 1 [Decision / Tab 2 / p.37 / para 1.37].

¹⁶³ *Ibid.*

¹⁶⁴ H7 Final Decision Section 1 [Decision / Tab 2 / p.40 / para 1.50].

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modified it to reflect the actual demand and forward bookings observed up to December 2022 and the change in economic outlook since the H7 Final Proposals had been published.¹⁶⁵

- 4.46 The CAA applied a four step methodology to achieve its revised numbers:¹⁶⁶
- (a) Step 1: Updating for actual passenger numbers and forward bookings: this involved taking account of actual passenger data for 2022 and forward bookings to amend the forecast from the H7 Final Proposals across the H7 period;
 - (b) Step 2: Updating for economic forecasts: this involved considering the impact of the latest forecasts for the economic outlook on the passenger forecasts;
 - (c) Step 3: Validating with external forecasts: this involved comparing the CAA's passenger forecasts with independent external forecasts; and
 - (d) Step 4: Updating for traffic shocks: this involved applying a shock factor to the years 2023 to 2026 to take account of asymmetric non-economic downside risks (due to events such as adverse weather, volcanic eruptions, terrorism or strike action).
- 4.47 Having applied various adjustments, the CAA determined that it should adopt a passenger forecast of 375.5 million for the H7 period. This was 4.2% higher than the CAA's H7 Final Proposals forecast; 8.5% higher than HAL's Mid forecast of 346.1 million submitted in December 2022; and 5.2% lower than the forecast submitted by AOC and LACC in August 2022 of 396.0 million passengers.
- 4.48 The CAA procured the 2023 Skylark Report to provide an independent quality assurance, reporting that Skylark found the forecast to be "*both reasonable and appropriate*".¹⁶⁷
- 4.49 The final passenger forecast numbers were presented in Table 1.6 of the H7 Final Decision (which is replicated below).

H7 Final Decision: Table 1.6 Final Decision passenger forecast, H7 – final stage

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA Final Proposals: Mid (shocked)	54.9	67.3	75.4	81.0	81.6	360.2
CAA FP Mid (unshocked)	55.4	67.9	76.0	81.7	82.3	363.4
Step 1: Updated for actuals and bookings	61.6	74.4	80.6	82.2	82.9	381.7
Step 2: Updated for economic forecasts	61.6	73.6	79.6	81.4	82.0	378.2
Step 3: Validated	61.6	73.6	79.6	81.4	82.0	378.2

¹⁶⁵ H7 Final Decision Section 1 [Decision / Tab 2 / p.40 - 41 / para 1.49 – 1.52].

¹⁶⁶ H7 Final Decision Section 1 [Decision / Tab 2 / p.41 – 45 / para 1.53 – 1.67].

¹⁶⁷ H7 Final Decision Section 1 [Decision / Tab 2 / p.47 - 48 / para 1.70 – 1.71].

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against external forecasts						
Step 4: CAA FD Mid (shocked)	61.6	73.0	78.9	80.7	81.3	375.5

Note: The Appellant has amended the descriptor in the left hand column to show more clearly how the CAA’s four step methodology was applied.

C. The CAA’s errors

4.50 In this section, the Appellant describes the errors made by the CAA in setting the H7 passenger forecast. The Appellant contends that the CAA has failed to adequately explain its methodology, in particular the use of the passenger forecasting model. The CAA has committed several additional methodological errors leading it to significantly underestimate passenger numbers for H7. It has also erred by failing to make consequential amendments to the asymmetric risk allowance which relies on passenger forecast inputs.

Error 1(a): Errors in the CAA’s methodology for setting the H7 passenger forecast

4.51 In the first place, the CAA has failed to adequately explain its methodology for setting the H7 passenger forecast. It is not clear from the H7 Final Decision (or its wider consultation process) precisely how the CAA’s forecast was reached. This lack of transparency is particularly acute in relation to the role of the HAL’s forecasting model for the reasons explained below.

4.52 The precise role of HAL’s model in the CAA’s forecast is difficult to determine. As described above, and detailed further below, the figures for 2022 were based on the actual passenger numbers, and the figures for 2023 were produced without explicit reference to HAL’s model. Figures for 2024 onwards were “*extrapolated*” from the 2022 and 2023 figures.¹⁶⁸ This extrapolation is not further explained by the CAA. However, it is plain that the CAA has relied on the HAL model to some extent:

- (a) in the H7 Final Decision, the CAA confirmed “*we have decided to base our final decision on the forecast we used for the Final Proposals, after modifying it to reflect the actual demand and forward bookings observed up to December 2022, and the change in economic outlook since we published the Final Proposals*”;¹⁶⁹
- (b) it is clear, therefore, that the starting point for the CAA in reaching its decision was to use “*a forecast using our own assumptions and HAL’s model*”;¹⁷⁰
- (c) the CAA identifies some limited benefits from relying on HAL’s model (namely, that it takes account of Heathrow specific circumstances and is well understood by the CAA);¹⁷¹ and
- (d) as set out in Table 1.7 (which is replicated below), the CAA’s H7 FD Mid forecasts are very close to HAL’s Dec-22 High case forecast. This may be coincidental, but suggests that the extrapolation performed by CAA has been influenced to some degree by HAL’s model (even if the CAA considers HAL’s central case to be unduly pessimistic).

¹⁶⁸ H7 Final Decision Section 1 [Decision / Tab 2 / p.41 - 42 / para 1.57].
¹⁶⁹ H7 Final Decision Section 1 [Decision / Tab 2 / p.41 / para 1.52].
¹⁷⁰ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.51 / para 1.20].
¹⁷¹ H7 Final Decision Section 1 [Decision / Tab 2 / p.38 / para 1.41].

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H7 Final Decision: Table 1.7 Final Decision on the passenger forecast for H7 compared with forecasts submitted by HAL and AOC/LACC

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

Note: Highlighting added by the Appellant to show the contrast between HAL Dec-22 High and CAA FD Mid.

- 4.53 Although the HAL model was an input to the CAA’s H7 Final Decision, the HAL model was not shared with airlines as a result of “HAL not being prepared to share its model in a full and transparent way with stakeholders”, as the CAA acknowledged, both in its H7 Final Proposals¹⁷² and in the H7 Final Decision.¹⁷³
- 4.54 This is significant because, while the CAA endeavoured to determine how, and to what extent to utilise the HAL model, and what adjustments should be made to correct its multiple flaws, all this was done without the benefit of any input from those best placed to scrutinise the model and its outputs – that is, the airlines. It also meant that the forecasting exercise was not conducted transparently or fairly as explained in Section H of CW1. Without transparency as to the model and its use, the Appellant is unable precisely to identify (for example) double counting or inconsistency in the CAA’s blending of the use of the HAL model and the four step methodology described in sub-section B. However, it is clear from the available evidence that the CAA has significantly underestimated the passenger forecasts for H7.
- 4.55 The CAA’s failure to adequately explain its methodology is a breach of its statutory duties. As explained in sub-section D of Section 2, the CAA is obliged to ensure that its activities are carried out in a way that is both transparent¹⁷⁴ and accountable¹⁷⁵. The Appellant contends that the H7 Final Decision on passenger forecasts is neither, with the consequence that the decision cannot be relied upon.
- 4.56 This error has far-reaching consequences in that it has impaired the Appellant’s ability to scrutinise the CAA’s decision on the appropriate passenger forecast for each year of the H7 price control – i.e. from 2022 to 2026 inclusive. Nonetheless, the Appellant has identified several additional methodological errors in the CAA’s four step methodology – detailed in errors 1(a)(i) – 1(a)(vi) below. In summary, the errors are:
- (a) to the extent that the CAA has relied on the HAL model (which, as above, is unclear) the CAA is wrong to have done so as it is unduly pessimistic and proven to be inaccurate;

¹⁷² H7 Final Proposals Section 1 [Vol A / Tab 2 / p.49 - 51 / para 1.13 – 1.19].

¹⁷³ H7 Final Decision Section 1 [Decision / Tab 2 / p.39 / para 1.43].

¹⁷⁴ Section 2, sub-section D, paragraph 2.12(g)(i).

¹⁷⁵ Section 2, sub-section D, paragraph 2.12(g)(ii).

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- (b) in Step 1, the CAA is wrong to have ignored the impact of Local Rule A and threatened capacity restrictions in coming to a conclusion for passenger numbers in 2022 and in constructing the appropriate baseline of demand for 2023 onward;
- (c) in Step 1, the CAA is wrong to have found 2023 traffic levels would be 92% of 2019 levels, by ignoring relevant evidence and/or not taking proper account of the evidence before it;
- (d) in Step 2, the CAA is wrong to have downgraded its forecast for 2023 in response to macroeconomic forecasts;
- (e) in Step 3, the CAA is wrong not to have uplifted its forecasts further to its cross checks against external forecasts; and
- (f) in Step 4, the CAA is wrong to apply a shock factor of 0.87% and wrong to apply a shock factor in full to 2023 when some months of 2023 have already elapsed.

Error (1)(a)(i) To the extent that the CAA has relied on the HAL model, the CAA is wrong to have done so

- 4.57 Despite the CAA having made various adjustments to its methodology for setting passenger forecasts in the H7 Final Decision, the CAA's decision remains tainted by HAL's erroneous forecasts because of the CAA's reliance on HAL's model in informing its forecast at the H7 Final Proposals stage.
- 4.58 The Appellant contends that the CAA's continued reliance on HAL's model as an input to setting the passenger forecast for H7 is wrong for several reasons.
- 4.59 First, as the CAA is aware, HAL has a clear incentive to underestimate the passenger forecasts so as to increase passenger charges. Specifically, if actual passenger numbers exceed forecasts, HAL benefits from additional revenues (to the detriment of customers). This is because:
- (a) using lower passenger forecasts as the basis for calculating the price cap results in a higher overall per passenger charge; and
 - (b) when actual passenger traffic exceeds the forecast, HAL receives additional revenues (equal to the passenger charge multiplied by the difference between forecast and actual passenger numbers).¹⁷⁶
- 4.60 The lower the forecast feeding into the price cap calculation, the higher the per passenger charge and the more revenues HAL obtains if the forecasts are exceeded.
- 4.61 Second, it is clear that HAL's model is not fit for purpose given that, as expected given these incentives, it significantly underestimates the passenger numbers for H7.
- 4.62 This is evidenced most starkly by the material variations between HAL's forecasts (despite repeated updates), as compared with the actual passenger numbers, for 2022, which the CAA found to be 61.6 million. Notably:
- (a) in December 2021 HAL was forecasting as its mid case 45.5 million passengers for 2022 (shocked), which underestimated passenger numbers by more than 25%.¹⁷⁷

¹⁷⁶ H7 Final Decision Section 1 [Decision / Tab 2 / p.54 / para 2.20]. The Appellant recognises that the proposed introduction of the TRS mechanism will mean that HAL is required to 'share' any revenues in an upside scenario with consumers, but despite this, HAL still has an incentive to push for lower passenger forecasts seeing it will still obtain some benefit if the price cap is comparatively higher and actual passenger numbers outperform forecasts. Indeed, as noted by AlixPartners in their report analysing the CAA's H7 Final Proposals (as submitted by the airlines in response to the H7 Final Proposals) (the **AP Initial Report**) the impact of the TRS mechanism is asymmetric and does not remove the incentives from HAL. [Vol A / Tab 1.119 / p.10,900 / para 4.4.6].

¹⁷⁷ HAL, A20. RBP Update 2 [Vol A / Tab 80 / p.8511 and Table 7].

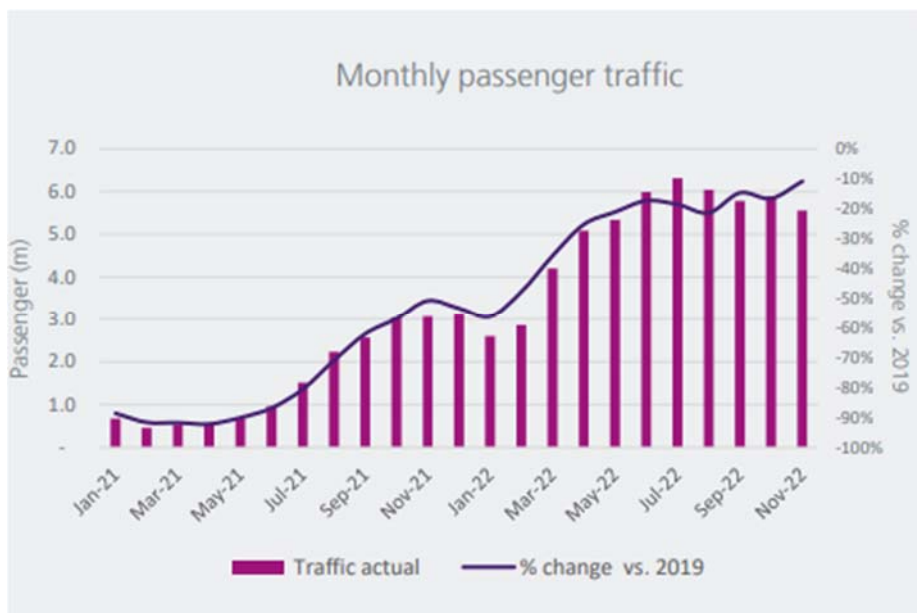
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- (b) in June of 2022, HAL was forecasting 54.4 million passengers for 2022 (shocked),¹⁷⁸ and took until September 2022 to forecast more than 60 million passengers for 2022.¹⁷⁹
- (c) even at December 2022, HAL’s mid-case forecasted 60.7 million passengers for 2022 (shocked), which underestimated the total number by approximately 1 million passengers (presumably therefore underestimating the number of passengers flying in the month of December 2022 by approximately 1 million).¹⁸⁰

4.63 HAL’s revised December 2022 estimates continue to produce forecasts which significantly underestimate the number of passengers for H7.

- (a) HAL’s mid case forecast for 2023 is 66.6 million, according to the H7 Final Decision,¹⁸¹ or 67.2 million (unshocked).¹⁸²
- (b) HAL notes that 67.2 million would represent 83% of the 2019 passenger levels, far below the 89% of 2019 passenger levels achieved in the final months of 2022, and completely at odds with the steady rise of passenger numbers against 2019 levels as HAL had recorded in its investor presentations (shown at Figure 1 below).¹⁸³

Figure 1: Chart showing trend in passenger levels as against 2019 levels, Heathrow (SP) Limited Investor Report December 2022¹⁸⁴



4.64 It is evident from Table 1.7 of the H7 Final Decision (replicated at paragraph 4.52(d) above) that the CAA considers that HAL’s December 2022 model continues to underestimate passenger numbers.¹⁸⁵

4.65 Third, as described above and further in Section H of CW1, HAL has been reluctant to expose its model to scrutiny from stakeholders, which further undermines its credibility and utility in informing the H7 passenger forecasts. As the CAA records in the H7 Final Decision with respect to HAL’s December 2022 model, “HAL has not provided us with a copy of its latest model spreadsheets”.¹⁸⁶ HAL’s lack of transparency justifies the CAA in not relying on HAL’s forecasts.

¹⁷⁸ Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report June 2022 [Vol A / Tab 95 / p.9919].
¹⁷⁹ Heathrow (SP) Limited, Results for the 9 Months Ended 30th September 2022 [Vol A / Tab 96 / p.9942].
¹⁸⁰ Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report December 2022 [Vol A / Tab 97 / p. 9979].
¹⁸¹ H7 Final Decision Section 1 [Decision / Tab 2 / p.47 / Table 1.7].
¹⁸² Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report December 2022 [Vol A / Tab 97 / p.9972].
¹⁸³ Ibid.
¹⁸⁴ Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report December 2022 [Vol A / Tab 97 / p.9973].
¹⁸⁵ H7 Final Decision Section 1 [Decision / Tab 2 / p.46 / para 1.69].
¹⁸⁶ H7 Final Decision Section 1 [Decision / Tab 2 / p.41 / para 1.51].

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Given that the CAA clearly signalled it would reach a final decision on H7 in Q1 2023 it is unclear why HAL chose not to share with the CAA the model spreadsheets to support its latest forecast. As noted above, the CAA confirmed that HAL's conduct "*has undermined our confidence in the credibility and robustness of HAL's passenger forecasts and caused us to place less weight on this evidence*".¹⁸⁷ However, it is wrong that the CAA continues to place any reliance on the HAL model.

4.66 Overall, there is no good reason for the CAA to have any confidence in HAL's model or the forecasts which it generates.

4.67 While the Appellant accepts that the CAA has taken steps from the H7 Initial Proposals stage onwards when using HAL's model to make "*amendments to its inputs and assumptions*"¹⁸⁸, it was not reasonable or appropriate for the CAA to use HAL's model to inform the H7 passenger forecasts when:

- (a) HAL has no incentive to ensure its model generates credible forecasts;
- (b) HAL's model has persistently under-estimated passenger numbers (despite regularly updating its forecasts); and
- (c) the CAA has better information in the form of future booking data from airlines and independent external forecasts, which do not suffer from the same downward bias (or the incentives to under-estimate) as HAL's model does.

4.68 The Appellant submits that even where the CAA made adjustments to account for clear bias and negatively skewed assumptions in HAL's model, these adjustments were insufficient. The Appellant has limited visibility on the specific adjustments made by the CAA to HAL's model because of the continuing lack of transparency in the process. As explained in paragraph 3.6.26 of the AP Initial Report: "*most of the CAA's deviations from the amended HAL RBPu2 model come from an arbitrary qualitative discussion. Therefore, the CAA final estimates are either driven by HAL's model, which are subject to HAL's incentives to under-estimate passenger volumes as described in the previous section, or by an arbitrary process*".¹⁸⁹ However, it is clear that the adjustments made by the CAA were insufficient to address the weaknesses and biases in the HAL model, as evidenced by the fact that the CAA's forecast at both the H7 Initial Proposals and the H7 Final Proposals materially underestimated the passenger numbers for 2022. Indeed, as explained in paragraph 108(d) of CW1, "*Given the wide range of adjustments that the CAA needed to make to HAL's model to try to ensure it was fit for purpose, it should have been evident to the CAA that it was not reasonable to rely on HAL's model to any extent*".

Error (1)(a)(ii): In Step 1, the CAA is wrong to have ignored the impact of Local Rule A and threatened capacity restrictions in coming to a conclusion for passenger numbers in 2022 and in constructing the appropriate baseline of demand for 2023 onward

4.69 First, in the H7 Final Decision, the CAA decided to adapt its forecasting methodology on the basis that it was no longer necessary to forecast passenger numbers for 2022 since the actual number of passengers that used the airport during the full year was available.¹⁹⁰

4.70 In adopting actual passenger numbers for 2022, the CAA failed to make any adjustment for the impact of Local Rule A which had been implemented at Heathrow Airport. The introduction of Local Rule A led to a capacity cap which suppressed actual passenger numbers in 2022. Between July 2022 and October 2022, Local Rule A limited the number of passengers who could depart from Heathrow Airport to 100,000 per day (as opposed to c.120,000 total daily passengers absent the rule.)

4.71 The CAA explained: "*We are not convinced that we should make adjustments for HAL's introduction of Local Rule A. This was introduced in the exceptional circumstances of the*

¹⁸⁷ *Ibid.*

¹⁸⁸ H7 Final Decision Section 1 [Decision / Tab 2 / p.40 / para 1.49].

¹⁸⁹ AP Initial Report [Vol A / Tab 119 / p.10,892 / para 3.6.26].

¹⁹⁰ H7 Final Decision Section 1 [Decision / Tab 2 / p.40 / para 1.50].

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recovery from the covid-19 pandemic and in response to legitimate concerns about the ability of the airport and a range of service providers (including airlines) to cope with a relatively sharp increase in passenger numbers and the difficulties for passengers that might be created if such concerns were to crystallise. To make an adjustment as suggested by airlines would penalise HAL and could create perverse incentives for the future and would not be in the interests of consumers.”¹⁹¹

- 4.72 As explained in paragraphs 114 to 129 of CW1, the reason that the introduction of Local Rule A was required sat squarely with HAL’s lack of operational readiness. The CAA’s suggestion that HAL would be ‘penalised’ if the CAA took account of Local Rule A is incorrect: as explained in Ground 3, Section 6, in April 2021 the CAA had adjusted HAL’s RAB precisely so that it could make the necessary investments to ensure that the circumstances which led to Local Rule A being required did not occur.¹⁹² In other words, the issue which arose was anticipated and express provision to address this had been made by regulatory action. The CAA had incentivised HAL to take the action which was required to protect consumer interest, but HAL had failed to do so.
- 4.73 The current position is that not only have consumers suffered the practical detriment caused by the imposition of Local Rule A, but HAL is also being doubly rewarded for its failure to make the necessary investment:
- (a) as explained in Ground 3, Section 6,¹⁹³ the CAA proposes that HAL is allowed to retain the April 2021 RAB adjustment, notwithstanding the demonstrable absence of investment and failures in operational capacity; and
 - (b) HAL benefits from the CAA’s use of the lower passenger numbers in 2022 caused by those very failures.
- 4.74 In any event, HAL should not be incentivised to impose capacity caps. Should it do so in any other year of the H7 period, with the result of depressing passenger numbers below the forecast, HAL will bear the consequences of doing so.¹⁹⁴ There is no reason a different approach should apply for 2022.
- 4.75 As Chris Walker explains in CW1, *“Put simply, HAL failed to sufficiently prepare for the predicted surge in travel demand after the Covid-19 restrictions were lifted in 2022. The capacity limits imposed by HAL were entirely unreasonable and unacceptable. Airline customers expect their bookings to be honoured. This is yet further evidence of HAL putting its needs – and that of its shareholders – before passengers. The CAA is wrong to let HAL profit from this behaviour by ignoring the impact of Local Rule A on 2022 passenger numbers”*.¹⁹⁵
- 4.76 The effect of Local Rule A was that some passengers who would have flown from Heathrow Airport did not fly from it in 2022. As detailed further in section H of CW1, the Appellant estimates that the imposition of the capacity caps in 2022 reduced passenger numbers at Heathrow Airport by 2.7 million and so the correct passenger number for 2022 for the purposes of the price cap calculation is 64.3 million. The effect on passenger numbers was therefore clearly material.
- 4.77 Second, the Appellant contends that the CAA should also have taken account of the depressive effect of Local Rule A on the passenger numbers when setting its baseline for 2023. Instead, when setting its baseline for 2023, the CAA took a mid-point estimate between:

¹⁹¹ H7 Final Decision Section 1 [**Decision / Tab 2 / p.39 - 40 / para 1.45**].

¹⁹² See, in particular, Section 6.B setting out the context for the CAA’s decision, and *“the CAA was wrong to conclude that an adjustment to HAL’s RAB was necessary to secure that all reasonable demands for AOS at Heathrow Airport are met”* at paragraph 6.38 onwards.

¹⁹³ See, in particular, Section 6.B setting out the context for the CAA’s decision, and Section 6.D, the Failure to Review Error.

¹⁹⁴ Albeit the consequences for HAL would be ameliorated by the application of the TRS mechanism.

¹⁹⁵ CW1, paragraph 138.

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- (a) a lower bound of total passengers at a level equal to 90% of 2019 levels, being one percentage point higher than that seen at the end of 2022; and
- (b) an upper bound of total passengers of 94% at a level equal to 2019 levels, derived from forward bookings data for 2023 (as reported in December 2022) being at 94% of the equivalent period in 2019.

4.78 The incorrectness of this approach in general is discussed in error 1(a)(iii) below. However, even assuming that it was open to the CAA to choose a lower bound of one percentage point higher than traffic levels seen at the end of 2022 (which the Appellant disputes), the CAA should have taken account of the depressive effect of HAL's imposition of Local Rule A and threatened capacity restrictions on passenger numbers in November and December 2022. Instead, the CAA wrongly dismissed (or failed to give appropriate weight to) these factors:

- (a) the effect of Local Rule A between July and October affected both airlines' plans and consumer confidence in flying from Heathrow, and, for the reasons explained in paragraphs 132 to 133 of CW1, will have had a negative impact on the total number of passengers who flew to/from Heathrow in November and December 2022; and
- (b) the actual numbers for November and December 2022 were also depressed by threatened capacity restrictions. HAL consulted on possible further capacity caps with airlines from October 2022 as a result of HAL's concern that passenger demand over the Christmas period "*could be undeliverable*".¹⁹⁶ In October 2022, HAL made comments in the media as to Heathrow's readiness for Christmas demand, inter alia warning passengers that Heathrow was not "*back to full capacity*".¹⁹⁷ As Chris Walker explains in Section H of CW1, this messaging undoubtedly affected consumer confidence, *even absent* the imposition of capacity caps over the Christmas period. The Appellant had warned of this effect in its response to the H7 Final Proposals.¹⁹⁸

4.79 Overall, the CAA's failure to have regard to the effect of Local Rule A and threatened capacity caps is an error. As a result, the CAA (i) used the incorrect (and too low) figure for 2022 and (ii) used an incorrect (and too low) baseline for 2023. Further, as forecasts for 2024 onwards were extrapolated from the actual passengers flown in 2022 and forecasts for 2023, this error would also result in depressing passenger forecasts for 2024 onwards (although, because of the lack of transparency in the CAA's methodology, the precise effect is not clear).

Error 1(a)(iii): In Step 1, the CAA is wrong to have found 2023 traffic levels would be 92% of 2019 levels

4.80 The CAA's methodology for setting the passenger forecast for 2023 was flawed in any event, as (i) regardless of the correct figure for November/December 2022, the CAA was wrong to choose a lower bound which assumed only a one percentage point growth in passenger numbers as compared to the 2019 position and (ii) it was wrong to treat forward booking data for 2023 as an upper bound. In both cases the CAA's forecast was unduly pessimistic given the available evidence of increasing passenger demand and therefore unreasonable. It follows that picking a mid-point between these two points resulted in a forecast for 2023 which materially underestimates the number of passengers likely to fly to and from Heathrow Airport.

4.81 As noted above, the CAA used a lower bound for 2023 of 90% of the passenger levels seen in 2019, being one percentage point higher than the equivalent figure in the last two months of 2022. The CAA's reasoning on this point was exceptionally brief, and, in full, was: "*Although downside risks still exist, we would expect an average forecast for Heathrow airport to continue to increase in 2023 (as was the case for the forecast we used for the Final Proposals and all of*

¹⁹⁶ HAL, Letter to Airlines regarding Winter 2022 Christmas Capacity Consultation, 5 October 2022 [Vol A / Tab 136].

¹⁹⁷ Heathrow Media Centre, 'Heathrow busiest European hub over summer, but outlook for demand remains uncertain' [Vol A / Tab 98]. See further CW1 at 134.

¹⁹⁸ Delta, Response to H7 Final Proposals (CAP2365) - Supplement to response (Non-Confidential Version) [Vol A / Tab 113 / p.10454 / para 1.13].

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HAL's RBP forecasts). Therefore, our minimum forecast for 2023 is 90 per cent of the 2019 actual passenger numbers."¹⁹⁹

- 4.82 The CAA acknowledges that passenger numbers are likely to continue to grow in 2023, but then applies a lower bound that represents just a one percentage point increase to the 2019 relative passenger levels. As explained at paragraph 145 of CW1: "... the CAA's methodology for setting the 2023 forecast is arbitrary and not well-justified. It is difficult to see why the CAA would adopt an assumption of 1% growth from 2022 given the way passenger numbers swiftly rebounded once the Covid-19 restrictions were lifted. Delta and VAA have provided firm evidence that passenger demand in 2023 is likely to significantly exceed the 2022 numbers."
- 4.83 Indeed, as shown in Figure 1 above, the passenger numbers at Heathrow Airport, expressed as a proportion of 2019 passenger levels, grew:
- (a) Four percentage points from September to December 2022;
 - (b) Eight percentage points from July to December 2022; and
 - (c) 25 percentage points from March to December 2022.
- 4.84 The trend is very clear, and very positive. There is simply no evidence that a credible lower bound for 2023 would mean that growth in passenger numbers (relative to 2019 levels) would stagnate at just one percentage point over the year. Such an approach is also inconsistent with the CAA's own belief that it would "expect growth to slow as the runway capacity begins to limit the ability to increase passengers up": i.e. that growth would be quicker while overall passenger numbers remain far below the airport's capacity.²⁰⁰
- 4.85 The approach is also inconsistent with the CAA's recognition that "covid-19 related requirements have been lifted",²⁰¹ and so the sluggish growth in passenger numbers observed in the winter of 2021/22 cannot reasonably be expected to be repeated.
- 4.86 In any event, actual figures for the first two months of 2023, ahead of the H7 Final Decision in March 2023 support the proposition that 90% is too low a bound for 2023. Passenger levels in January 2023 (which would have been available to the CAA in early February) were 92% of that of 2019, and passenger levels in February 2023 were 95% of 2019 levels.
- 4.87 Conversely, the CAA used an upper bound of 94% of the passenger levels seen in 2019. This reflects the level of forward bookings, expressed as a proportion of 2019 levels, as of December 2022. In the H7 Final Proposals, the CAA used forward bookings as a lower bound.²⁰² In the H7 Final Decision the CAA noted that it was not appropriate to use forward bookings as a lower bound due to (i) the fact the "majority of bookings for the year are yet to be made"; (ii) downside risks; and (iii) non-economic risks including staffing challenges.²⁰³ Bearing those factors in mind, the CAA decided forward bookings should be the upper bound for 2023. This is wrong for the following reasons:
- (a) the fact that the majority of bookings for the year were yet to be made is of limited relevance: both upside and downside outcomes would be available. Given the general *upwards* trend in passenger numbers, it is *more likely*, and therefore more reasonable to expect, that passenger numbers would continue to grow throughout 2023 and *exceed* the position as reflected in forward bookings, as explained further in paragraph 143(a)(ii) of CW1;
 - (b) the position in relation to non-economic risks (including staffing challenges) is no worse than that at the time the CAA published its H7 Final Proposals, and indeed the outlook in

¹⁹⁹ H7 Final Decision Section 1 [Decision / Tab 2 / p.41 / para 1.55].

²⁰⁰ H7 Final Decision Section 1 [Decision / Tab 2 / p.44 / para 1.64].

²⁰¹ H7 Final Decision Section 1 [Decision / Tab 2 / p.61 / para 3.17].

²⁰² H7 Final Proposals Section 1 [Vol A / Tab 2 / p.64 / para 1.66].

²⁰³ H7 Final Decision [Decision / Tab 2 / p.41 / para 1.55].

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relation to staffing challenges is more positive as business returns to usual following the Covid-19 pandemic;

- (c) the other “downside risks” are otherwise not detailed at all:
 - (i) to the extent that the CAA’s consideration was driven by updated macroeconomic forecasts, that would be duplicative of the exercise it carried out in Step 2;²⁰⁴
 - (ii) to the extent the downside risks also informed the lower bound, as one would expect them to do, those downside risks would have been double counted;
 - (iii) to the extent the downside risks also informed the choice of the midpoint, as indicated by the 2023 Skylark Report,²⁰⁵ those downside risks would have been double counted;
- (d) in any event, non-economic risks are accounted for in the shock factor applied at Step Four. In particular, the 2023 Skylark Report notes that the CAA chose the midpoint of 92% in part because of “*industrial action and similar disruption*”.²⁰⁶ The shock factor at Step 4 expressly covers the impact of “*strike action*”;²⁰⁷ and
- (e) other metrics available to the CAA would suggest passenger levels in 2023 exceeding 94% of 2019 levels. For example, current on-sale capacity for 2023 is c.98% of 2019; and February 2023 actual passenger levels were 95% of 2019 levels.

4.88 It follows from the above that the CAA has failed to properly have regard to and/or to give appropriate weight to relevant evidence that should have been used to inform the 2023 passenger forecast (for example, on-sale capacity, and the latest booking data). Moreover, the CAA erred by making methodological errors that resulted in illogical double counting. Where the CAA exercised its discretion, it fell into error by (i) choosing to adopt an unduly pessimistic and therefore unreasonable approach and (ii) ignoring relevant evidence which supported a higher forecast.

4.89 In summary, the CAA used a lower bound that was too low, and an upper bound that was too low. This means that the range is wrong with clear consequences for the CAA’s selection of the mid-point as its point estimate for 2023 within that range.

4.90 As a result of these errors, the passenger forecast for 2023 is set too low. As forecasts for 2024 onwards were extrapolated from the actual passengers flown in 2022 and forecasts for 2023, these errors would also result in depressing passenger forecasts in 2024 onwards (although the precise effect is not clear owing to the lack of transparency in the CAA’s decision).

Error (1)(a)(iv): In Step 2, the CAA is wrong to have downgraded its forecast for 2023 in response to macroeconomic forecasts

4.91 At Step 2, the CAA used the UK GDP forecast produced by Oxford Economics in December 2022, coupled with the experience of the 2008 recession to indicate how changes to UK GDP may affect passenger demand at Heathrow Airport. The CAA decided to apply a downward adjustment to the passenger forecasts for 2023 to 2026.

4.92 The brevity of the CAA’s explanation means that it is unclear what the CAA has actually done and how the latest GDP forecasts have been translated to adjustments in the forecast. The

²⁰⁴ The CAA says that its considerations in Step 1 took place “before considering the effect of the change in economic outlook in step 2” H7 Final Decision Section 1 [Vol A / Tab 2 / p.41 / para 1.53] but it is otherwise unclear why the CAA would use such sluggish growth as its lower bound for 2023.

²⁰⁵ Skylark Consulting Group’s H7 Forecast Update Review (2023 Skylark Report) [Decision / Tab 13 / p.448].

²⁰⁶ 2023 Skylark Report [Decision / Tab 13 / p.448].

²⁰⁷ H7 Final Decision Section 1 [Decision / Tab 2 / p.49 / para 1.66].

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2023 Skylark Report explains that the CAA “have assumed that the reduction in the size of the economy will impact demand by 1% from 2023 onwards over the H7 period”.²⁰⁸

- 4.93 It is not at all clear why a 1% reduction has been forecasted for Heathrow specifically; nor do the figures presented in Table 1.3 in the H7 Final Decision actually apply a 1% reduction to traffic in all years.²⁰⁹ It therefore appears that the Oxford Economics forecast has ‘fed in’ to the CAA modelling in some (unclear) way. The CAA has therefore failed in its duty to carry out its activities both transparently²¹⁰ and accountably.²¹¹ As explained in paragraph 164 of CW1:

“It is frustrating to have reached the final decision in the H7 process and find that the CAA has introduced a new methodology, which has not been consulted on and which is very difficult to scrutinise and understand. Given the importance of passenger forecasts in calculating the per passenger charge and the CAA’s statement that it intended to ensure charges were ‘no higher than necessary’ it cannot be justified for the CAA to make so many arbitrary downwards adjustments to passenger forecasts – particularly when this is contradicted by a strong trend towards passenger growth.”

- 4.94 Moreover, the Appellant contends that, the CAA’s decision to apply such a downwards adjustment is arbitrary, unjustified and therefore wrong because:

- (a) the CAA failed to have proper regard to and/or to give appropriate weight to the evidence that HAL’s business is reasonably well insulated to UK macroeconomic factors. The 2023 Skylark Report, for example, noted that “*traffic at Heathrow remained relatively stable ... during the Global Financial Crisis*”;²¹²
- (b) the CAA failed to have proper regard in Step 2 to the interaction between its macroeconomic adjustment and the continued reliance that it places on the HAL model, which has consistently produced forecasts which are unduly pessimistic and proven to be erroneously low. It is not reasonable or justifiable for the CAA to apply additional downside adjustments when the underlying forecasting model has proven to produce estimates which are too low;
- (c) this is compounded by the CAA’s failure to have proper regard in Step 2, and to take account of, other mechanisms that the CAA applies, and methodological steps that it has taken, which reflect a “pessimistic” approach at each stage; namely:
 - (i) the selection of the “baseline” for 2023 in Step 1, as identified in errors 1(a)(ii) and 1(a)(iii) above;
 - (ii) the application of a further shock factor in Step 4 (discussed at error 1(a)(vi) below); and
 - (iii) the adoption of the TRS mechanism which protects HAL from downside passenger risk.

Error 1(a)(v): In Step 3, the CAA is wrong not to have uplifted its forecasts further to its cross checks against external forecasts

- 4.95 The CAA stated in the H7 Final Proposals that it had “*explored a broad range of external forecasts for potential use in our synthesised forecast*”.²¹³ The CAA noted that in the context of H7 and the post-pandemic recovery it was particularly important to rely on a range of data; and that “*significant uncertainty about future passenger numbers*” was one of the reasons why it

²⁰⁸ 2023 Skylark Report [Decision / Tab 13 / p.453].

²⁰⁹ The reduction is close to 1% in all years, and it may be that there is a rounding issue, but that is not clear from the H7 Final Decision.

²¹⁰ Section 2, sub-section D, paragraph 2.12(g)(i).

²¹¹ Section 2, sub-section D, paragraph 2.12(g)(ii).

²¹² 2023 Skylark Report [Decision / Tab 13 / p.453].

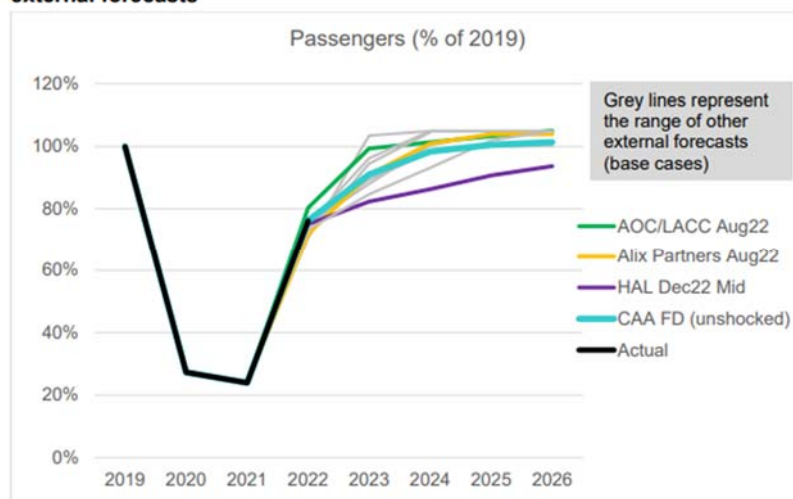
²¹³ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.56 / para 1.35].

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decided to modify the forecasting approach in the H7 Final Proposals and consider external forecasts to a greater extent.²¹⁴

- 4.96 In the H7 Final Decision, the CAA in Step 3 compares its (unshocked) passenger forecast as against a range of external forecasts. The CAA considers that that exercise “validates” its forecast for the H7 period, as its forecast “is within the range” of the external forecasts, and notes that its own “risk weighted” forecast is in any event expected to “tend towards the lower end of the range”. As a result, the CAA makes no amendments to its forecasts in Step 3.²¹⁵
- 4.97 The Appellant contends that the CAA was wrong not to make any adjustments as a result of its comparison to external forecasts, because:
- (a) Figure 1.4 of the H7 Final Decision (replicated below) confirms that the CAA's forecast is at the very low end of the ‘amended’ external forecasts which it has used. This can be seen because the only line that remains below the CAA's line across the H7 period is HAL's forecast (and not any of the independent external forecasts). The CAA's forecast assumes a longer time for passenger numbers to reach 2019 levels, and the forecasts only become clustered towards the end of the H7 period where the overall capacity at Heathrow Airport starts to limit further growth. In other words, the external forecasts provide good reason to consider that the CAA has materially underestimated passenger numbers for 2023 in particular. This is not surprising, given the CAA's errors in forecasting 2023 figures as detailed in errors 1(a)(ii) and 1(a)(iii) above.

Figure 1.4: Comparison of the Final Decision (unshocked) forecast and external forecasts



Source: CAA

- (b) Further, Figure 1.4 above compares the CAA's forecast prior to the application of a (significant) shock factor (applied in Step 4). Figure 1.4 therefore includes a CAA forecast that is *more optimistic* than the one the CAA in fact adopts. Should the CAA have compared its *shocked* forecast with external forecasts, it would more clearly show that the CAA's forecast is significantly more pessimistic than the balance of external (independent) forecasts.
- (c) The CAA refers to the benefit of its own forecast being “risk-weighted”,²¹⁶ but it is unclear both (i) what that refers to and its relevance and (ii) how that differs from external forecasts (which would, in coming to a view, undoubtedly consider plausible downside as well as upside scenarios).

²¹⁴ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.50 / para 1.16 – 1.17].

²¹⁵ H7 Final Decision Section 1 [Decision / Tab 2 / p.44-45 / para 1.64 – 1.65].

²¹⁶ H7 Final Decision Section 1 [Decision / Tab 2 / p.44 / para 1.64].

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- (d) Independent, external forecasts have shown themselves to be useful and credible. This is clearly evident for 2022. The final number of passengers travelling through HAL in 2022 was 61.6 million (albeit this total was suppressed by the impact of Local Rule A). The mid-point between two external forecasts recommended to be used by AlixPartners in the AP Initial Report (the ACI World Airport Traffic Forecast and the Tourism Economics/International Air Transport Association (**IATA**) forecast) predicted 57.8 million passengers in 2022. These external forecasts were therefore considerably more accurate, as compared with 54.9 million passengers in the CAA's forecast and 45.5 million passengers in the HAL forecast.²¹⁷
- 4.98 The result of the above is that the CAA did not properly have regard to and/or give appropriate weight to the independent forecasts in coming to its passenger forecast for H7. The CAA failed to engage properly with the clear implication from those forecasts that its own forecast was too low.
- 4.99 For completeness, in addition to the external forecasts, the CAA also engaged Skylark to "provide independent quality assurance" of the CAA's approach.²¹⁸ While in places the 2023 Skylark Report provides useful further detail as to the approach the CAA has taken, the scope of the 2023 Skylark Report is very limited (as set out in more detail in CW1) and so cannot provide robust support for the CAA approach as opposed to external forecasts.²¹⁹

Error 1(a)(vi): In Step 4, the CAA is wrong to apply a shock factor of 0.87% and wrong to apply a shock factor in full to 2023 when some months of 2023 have already elapsed

- 4.100 The CAA's decision to apply a 'shock factor' adjustment of 0.87% is not well justified or explained. There is a clear potential overlap with the downwards adjustment made by the CAA at Step 2 for 'macroeconomic effects' given that the 'non-economic effects' identified by the CAA in Step 4 include strike action and the impact of war. As explained in paragraph 158 of CW1, "*The CAA presents its methodology as involving four separate steps – each giving rise to a potential adjustment to the passenger forecast numbers. However, the methodology is far from clear and the adjustments made at each step risk being duplicative. There are obvious potential overlaps between Step 2 and Step 4. Moreover, neither of these adjustments are required given that 'downside risk' will already have been factored into the underlying HAL model, CAA's own amended model (given the adjustments it made to the HAL model) and in external forecasts. The application of this 'additional' shock factor at Step 4 is therefore wholly unjustified.*"
- 4.101 Moreover, the selection of 0.87% as the appropriate figure appears wholly arbitrary and is not supported by any robust evidence. That the decision is poorly justified is evident in the fact that the CAA has applied a blanket application of a 'shock factor' adjustment of 0.87% to the whole of 2023 despite the fact that the CAA's H7 Final Decision was taken partway through the year and at a time when the CAA had the benefit of forward booking data which already shows their forecast for 2023 to be pessimistic, as discussed above at error 1(a)(iii) above.
- 4.102 Overall, the Appellant contends that there is no merit in applying any shock factor and this should be removed.

Summary and the correct forecast

- 4.103 In conclusion, and based on the above, the Appellant submits that there are clear errors in the CAA's decision which render the passenger forecast for H7 wrong. The H7 Final Decision is based on errors of fact, wrong in law and reflects erroneous exercises of discretion. It will cause direct and enduring harm to consumers as a result of per passenger charges that are higher than necessary.
- 4.104 The CAA erred by taking an approach to its passenger forecast that was not transparent, in breach of its duties to be transparent and accountable. It continued to place reliance on a model prepared by HAL which has not been shared with stakeholders and which has been shown to

²¹⁷ Initial AP Report [Vol A / Tab 119 / p.10895 / para 3.6.44].

²¹⁸ H7 Final Decision Section 1 [Decision / Tab 2 / p.47 / para 1.70].

²¹⁹ CW1, paragraphs 161 to 163.

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be self-serving and incorrect. The CAA's four step process has not alleviated those errors, as it: (i) ignores the impact of HAL's unilaterally imposed and threatened capacity restrictions on 2022 and 2023 demand; (ii) applies a flawed and pessimistic methodology to forecast 2023 passenger demand; (iii) fails to have regard to external forecasts which demonstrate that the CAA has under-estimated demand over the H7 period; and (iv) applies unjustified downside adjustments in a context where its estimates are already too low. There are clear overlaps at each step of the CAA's methodology meaning that it was wrong for the CAA to have applied the steps cumulatively.

- 4.105 CW1 sets out an approach that corrects for these errors. The corrected numbers are set out below (this replicates Table 1 which follows paragraph 4.8 above). If it would assist the CMA, the Appellant would readily provide further data showing actual numbers of passengers flown in 2023 or other forward looking data during the course of the appeal.

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA's decision	61.6	73.0	78.9	80.7	81.3	375.5
Corrected passenger forecasts ²²⁰	64.3	77.6	82.0	83.6	85.0	392.5

Error 1(b) Having updated its passenger forecast for 2022, the CAA erred by failing to make a consequential adjustment to the asymmetric risk allowance

- 4.106 As noted above, the task of estimating passenger numbers also impacts other building blocks within the H7 price control. This includes the asymmetric risk allowance. The CAA has made an error by failing to update the allowance for asymmetric risk to reflect the higher outturn traffic in 2022.
- 4.107 As set out in section 8 of the WACC Report, this error has occurred because the CAA failed to update its calculations to reflect actual passenger numbers in 2022.
- 4.108 As a result of this error, the CAA wrongly over-estimated the revenue requirement for HAL by around £7 million in the H7 Final Decision.

D. Legal consequences

- 4.109 The Appellant submits that the H7 Final Decision, insofar as it concerns the passenger forecast for H7, was wrong on the following statutory grounds:
- (a) It was based on errors of fact, pursuant to section 26(a) of the Act. This is for reasons including that the CAA: (i) relied on flawed evidence and assumptions (e.g. unjustifiably relied on the HAL model; assumed a lower bound which implied passenger growth of just one percentage point across 2023); (ii) made false comparisons (e.g. between its own forecast and independent external forecasts); (iii) had the wrong facts or interpreted them incorrectly (e.g. concluding that forward bookings data represented the upper bound of passenger traffic in 2023); and (iv) reached conclusions without reasonable basis (e.g. concluding that adjustments were required for macroeconomic factors without engaging with the downside skew inherent in the forecast).
- (b) It was wrong in law, pursuant to section 26(b) of the Act. This is for reasons including that the CAA: (i) acted contrary to its primary duty under section 1(1) of the Act to further the interests of consumers regarding the range, availability, continuity, cost and quality of AOS; (ii) acted contrary to its duty to promote economy and efficiency on the part of HAL

²²⁰ As explained in more detail in section H of CW1.

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in its provision of AOS at Heathrow Airport under sections 1(3)(c) of the Act; (iii) acted inconsistently with its duty to have regard to the principles of best regulatory practice under section 1(3)(g) and 1(4) of the Act, namely that regulatory activities should be carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed (in particular by adopting an approach that lacked transparency and relied on a model which has not been subjected to scrutiny by stakeholders); (iv) relied on flawed evidence and assumptions (e.g. wrongly relied on the HAL model despite evidence that it is not fit for purpose); (v) failed properly to inquire (e.g. not properly considering the evidence available from external forecasts, and not inquiring either transparently or in detail as to the effect of macroeconomic factors on HAL's likely performance and/or passenger demand); (vi) failed to take proper account of relevant considerations (e.g. data suggesting that passenger growth in 2023 will outperform the CAA's forecasts); (vi) was procedurally unfair (e.g. because key stakeholders were not able to scrutinise or comment on the HAL model); and (viii) acted in defiance of logic (e.g. by applying multiple downward adjustments despite evidence that its forecast were already too low and where HAL is protected from downside risk by the TRS, by assuming only one percentage point growth across 2023 given evidence to the contrary).

- (c) There were errors made in the exercise of a discretion, pursuant to section 26(c) of the Act. This is for reasons including that the CAA: (i) failed to meet any of its own key consumer interest objectives (in particular by failing to keep the maximum passenger charge at a level no higher than necessary); (ii) failed to provide proper reasons (e.g. to explain clearly its four step methodology); and (iii) made erroneous methodological choices (e.g. chose not to uplift its forecast despite strong evidence this was required).

4.110 These statutory grounds are set out and explained in more detail in Annex 1.

E. Relief sought

4.111 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the Act insofar as it implements the CAA's passenger forecast and substitute the correct passenger forecast as set out in Table 1 which follows paragraph 4.8 (and is replicated in paragraph 4.105).

4.112 This would have the following effect on the maximum yield per passenger over the H7 period.

Max yield per passenger (£)	2022	2023	2024	2025	2026	Average
H7 Final Decision	26.96	26.06	21.03	21.03	21.03	23.22
Corrected	26.96	26.06	19.49	18.83	18.19	21.90

4.113 The Appellant also requests that the CMA quash the H7 Final Decision insofar as it over-estimates HAL's revenue requirements as a result of error 1(b) (failure to make a consequential adjustment to the asymmetric risk allowance) and substitute a corrected decision which removes £7 million.

4.114 In accordance with the overriding objective, the Appellant will provide all such assistance to the CMA as is necessary to secure the implementation of the required relief within the CMA's statutory timetable.

SECTION 5: GROUND 2 – WACC

A. Overview

- 5.1 Ground 2 concerns the CAA's decision to set the WACC at 3.18%, within a range of 2.64 - 3.73%.
- 5.2 The CAA describes the WACC as “a key building block”²²¹ of the revenue HAL is permitted to earn under the price control and considers that it forms a “very significant component”²²² of the price cap calculation. The CAA explains that “[s]etting an appropriate WACC furthers the interests of consumers”²²³ by helping to secure not only that HAL is able to finance necessary investment, but also that efficient financing costs, are reflected in the price control, which are no higher than necessary.
- 5.3 The CAA made three material errors when setting the WACC with the result that the WACC for H7 is too high. These errors are described in sub-section C.
- (a) the **Asset Beta error** – which concerns the CAA's errors in estimating HAL's asset beta, in particular in estimating HAL's pre-pandemic asset beta and in calculating the impact of the TRS mechanism;
- (b) the **Index-linked Premium error** – which concerns the CAA's erroneous decision to add a premium on index-linked debt; and
- (c) the **Point Estimate error** – which concerns the CAA's failure to ‘aim down’ when setting a point estimate for the WACC.
- 5.4 The Appellant contends that the CAA's H7 Final Decision to set the WACC was based on errors of fact, law and discretion and was therefore wrong within the meaning of section 26 of the Act. The legal consequences are summarised in sub-section D and explained in more detail at Annex 2.
- 5.5 The CAA's errors are material. They increase HAL's allowed revenue by £713 million throughout H7 by increasing the average per passenger charge by £1.93 meaning consumers are significantly over-paying. This is contrary to the CAA's stated intention that passenger charges should be “no higher than necessary” so as to deliver value for money.²²⁴ As the CAA has acknowledged, a WACC which is set too high leads to a higher per passenger charge resulting in “consumers paying too much”²²⁵ and investors being over-compensated. The risk of harm to consumers is a material issue for H7 given the focus on recovery from the impact of the Covid-19 pandemic, the cost of living crisis and the fact that HAL's airport charges are already among the highest in the world.²²⁶
- 5.6 In terms of relief, the Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the Act insofar as it sets the WACC at 3.18% and substitute the decision with a corrected WACC. The result of correcting the errors is to give a WACC point estimate of 2.46%, within a range of 2.34 - 2.71%, as explained in sub-section E.
- 5.7 The key evidence that the Appellant requests the CMA reads when considering this ground is:

²²¹ CAA, H7 Final Decision: Section 3 on the financial framework (CAP2524D) (H7 Final Decision Section 3) [Decision / Tab 4 / p.146 / para 9.1].

²²² H7 Final Decision Summary [Decision / Tab 1 / p.9 / para 17].

²²³ H7 Final Decision Section 3 [Decision / Tab 4 / p.146 / para 9.1].

²²⁴ H7 Final Decision: Summary [Decision / Tab 1 / p.6 – 7 / para 5].

²²⁵ H7 Final Decision Section 3 [Decision / Tab 4 / p.178 / para 9.192]; H7 Final Proposals Section 3 [Vol A / Tab 4 / p.319 - 320 / para 9.392]; CAA, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 2: Financial issues (CAP2265C) (H7 Initial Proposals Section 2) [Vol A / Tab 9 / p.693 / para 9.8].

²²⁶ Jacobs, 2022 Review of Airport Charges [Vol A / Tab 118 / p.10676].

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- (a) the H7 Final Decision (paragraphs 51-53 of the Summary Document and Chapter 9 of Section 3 (Financial Issues and Implementation) entitled 'Weighted Average Cost of Capital' (pages 7-44));
- (b) the H7 Final Proposals (paragraphs 58-64 of the Summary Document and Chapter 9 of Section 3 (Financial Issues and Implementation) entitled 'Weighted Average Cost of Capital' (pages 8-86));
- (c) the WACC Report prepared by AlixPartners LLP, which explains that the CAA has "*significantly overestimated the WACC*";²²⁷ and
- (d) CW1, in which Chris Walker on behalf of the Appellant describes the engagement with the CAA throughout the H7 process on setting the WACC and explains why the WACC is too high.

B. The CAA's decision

- 5.8 In this section and in section I of CW1, the Appellant more fully describes the substantive and procedural background to the CAA's decision to set the WACC at 3.18%, focusing on the three aspects of the WACC where the Appellant contends the CAA has made errors in the H7 Final Decision. An explanation of how the WACC is calculated is provided in the WACC Report.
- 5.9 The CAA commenced its work on setting the WACC for H7 in around 2017. For the reasons explained in Section 3 (Background), the Q6 price control was ultimately extended. During this extended period the CAA consulted on a range of topics including the WACC. This included the **June 2020 Consultation** where the CAA set out its emerging policy on financeability and the cost of capital.²²⁸
- 5.10 **April 2021 Way Forward Document:** On 27 April 2021, the CAA set out its views on work that was required ahead of the H7 Initial Proposals including evaluating the impact of the pandemic on the parameters forming the WACC. On the three areas of contention, its views were as follows:
- (a) Asset beta: The CAA set out three possible parameters for estimating HAL's asset beta (noting it would see benefit in further analysis), including (i) the 'pre-Covid' equity beta, (ii) the equity beta including the 'unmitigated' impact of the pandemic, and (iii) the equity beta including the impact of the pandemic as well as the effect of the incentive framework and the iH7 RAB adjustment.²²⁹
 - (b) Index-linked premium: The CAA denied HAL's request to include an index-linked premium in relation to the cost of new debt on the basis that HAL had failed to present evidence in support of this.²³⁰ The CAA considered that no such premium was warranted but agreed to consider the issue further in the H7 Initial Proposals.²³¹
 - (c) Point estimate: The CAA outlined various considerations that it considered were relevant for determining a point estimate for setting the WACC. These considerations were informed by the CMA's Final Determination for PR19 and included promoting investment, asymmetry in the choice of WACC parameters, the balance of risk in H7 and cross-checks on the level of WACC (including regarding financeability).²³²
- 5.11 **H7 Initial Proposals:** On 19 October 2021, the CAA's H7 Initial Proposals proposed a range of 3.6% - 5.6% for the WACC. On the three areas of contention:

²²⁷ WACC Report [Vol A / Tab 123 / p. 11,065 / para 3].

²²⁸ CAA, Economic regulation of Heathrow: policy update and consultation (CAP 1940) [Vol A / Tab 74].

²²⁹ CAA, Appendices to Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (CAP2139A) (**April 2021 Way Forward Document Appendices**) [Vol A / Tab 85 / p.8715 / para 43].

²³⁰ April 2021 Way Forward Document Appendices [Vol A / Tab 85 / p.8736 / para 159].

²³¹ April 2021 Way Forward Document Appendices [Vol A / Tab 85 / p.8735 - 8736 / para 156- 159].

²³² April 2021 Way Forward Document Appendices [Vol A / Tab 85 / p.8738 - 8740 / para 171 - 182].

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- (a) Asset beta: The CAA proposed an asset beta of 0.52 - 0.67. This range was informed by a report from Flint (the **2021 Flint Report**),²³³ upon which the CAA stated it relied “*heavily*”.²³⁴ The CAA noted that this range was higher than the Q6 position, and higher than the CMA’s Provisional Findings for NERL RP3, which the CAA considered reflected the impact of the Covid-19 pandemic. The CAA also confirmed that the proposed range was significantly higher than recent CMA determinations for asset betas in the water and energy sectors, which it stated reflected market evidence of higher risks associated with investment in airports.²³⁵ The CAA’s methodology followed the three-step approach introduced in the April 2021 Way Forward Document (as described in paragraph 5.10 above), albeit with methodological changes including amendments to the comparator set.²³⁶
- (b) Index-linked premium: The CAA examined issuance spreads on HAL Class A index-linked bonds and found that they generally exhibited higher issuance spreads than the relevant contemporaneous iBoxx indices.²³⁷ The CAA also noted that there are benefits to consumers of HAL being able to access index-linked markets, and therefore HAL should not be penalised by being prevented from recovering costs associated with issuing index-linked debt.²³⁸ The CAA decided to add a premium of 5bps to the cost of debt, in line with HAL’s RBP Update 1.
- (c) Point estimate: The CAA acknowledged HAL’s position was that the CAA should aim up when setting the WACC point estimate but noted that the introduction of the TRS mechanism “*substantially reduces HAL’s risk exposure (and will mean extra costs for airlines and consumers in downside scenarios)*” and, as a consequence, the CAA considered this should reduce the extent of aiming up required “*and/or suggests that the WACC could be set at or below our current mid-point estimate*”.²³⁹ The CAA underlined that it would be guided by its statutory duties in reaching a decision that “*delivers appropriate charges for consumers*”²⁴⁰ while encouraging necessary investment.
- 5.12 **Response to H7 Initial Proposals**: The CAA received a significant number of responses to its H7 Initial Proposals, including from the Appellant, underlining the importance of protecting the interests of consumers and strongly opposing the inflated WACC proposed in the H7 Initial Proposals.²⁴¹
- 5.13 The Appellant also endorsed VAA’s response which agreed that the WACC proposed by the CAA was too high.²⁴² VAA relied upon an expert report from CEPA (the **2021 CEPA Report**), which estimated that the WACC for H7 should be within a range of 1.3% - 2.8%.²⁴³ VAA was critical of the CAA’s approach, in particular highlighting the CAA’s errors in setting the asset beta (causing a difference of 100-160bps on the vanilla WACC²⁴⁴) and cost of debt. VAA further emphasised the importance of selecting an appropriate point estimate and called for more transparency in the CAA’s approach, including as regards sharing information provided by HAL.²⁴⁵
- 5.14 Submissions from LACC, AOC and IATA, on behalf of airlines, relied on the 2021 CEPA Report as evidence that the CAA had significantly overestimated the risks which HAL is exposed to resulting in the proposed WACC being too high.²⁴⁶

²³³ Flint, Support to the Civil Aviation Authority: Estimating Heathrow’s beta post-COVID-19 (CAP 2266E) (**2021 Flint Report**) [Vol A / Tab 86 / p.8789]

²³⁴ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.700 / para 9.54].

²³⁵ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.705 - 706 / para 9.75 – 9.76].

²³⁶ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.700 - 701 / para 9.55 – 9.58].

²³⁷ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.730 / para 9.217].

²³⁸ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.737 / para 9.260].

²³⁹ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.736 / para 9.259].

²⁴⁰ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.737 / para 9.260].

²⁴¹ Delta, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 109 / p.10138].

²⁴² VAA (and Delta), Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 111 / p.10,353 / para 3.3].

²⁴³ CEPA, Response to CAA H7 Initial Proposals: Cost of Capital, IATA [Vol A / Tab 87 / p.8882 / Table 3.1].

²⁴⁴ VAA (and Delta), Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 111 / p.10,357 / para 3.16].

²⁴⁵ VAA (and Delta), Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 111 / p.10,353 / para 3.4].

²⁴⁶ LACC, AOC and IATA, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 108 / 10,123 / para B.3].

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- 5.15 Responses from the airlines contrasted with that of HAL. HAL argued that the CAA had materially underestimated the WACC and suggested that a more appropriate post-tax (vanilla) WACC was 6.77% (as per RBP Update 2).²⁴⁷
- 5.16 **H7 Final Proposals:** On 28 June 2022, the CAA published its H7 Final Proposals. The CAA proposed a wider WACC range of 2.44% - 4.08%. It adopted the mid-point in the range as the point estimate, resulting in an RPI-real vanilla WACC of 3.26%.²⁴⁸
- 5.17 **Asset beta:** The CAA acknowledged that asset beta “*is an important input into our cost of capital estimate*” and estimated that “*a 0.01 increase in the asset beta results in an 8bps increase in the WACC*”.²⁴⁹ The CAA relied on an updated report from Flint produced in May 2022²⁵⁰ (the **2022 Flint Report**) and adopted the proposed asset beta range of 0.44 - 0.62. The CAA explained that it had preserved the framework adopted at the H7 Initial Proposals but updated the analysis “*in light of new data to March 2022*” and made targeted adjustments based on stakeholder feedback and other evidence.²⁵¹
- 5.18 The CAA proposed to set the asset beta using the following three-step methodology:
- (a) **Pre-pandemic asset beta.** The CAA adopted a figure of 0.50 for HAL’s asset beta, which was the same as for Q6. The CAA noted that this was at the bottom of the baseline asset beta range (based on observed Q6 betas for AENA (Madrid), ADP (Paris) and Fraport (Frankfurt)) estimated by Flint (0.50-0.60). It explained that the difference was due to Flint not carrying out a relative risk analysis.²⁵² The CAA considered that a lower asset beta for HAL relative to comparator airports was warranted on the basis that, absent the pandemic, HAL would have exhibited lower risk exposure because it would benefit from excess demand during H7 (due to capacity constraints at Heathrow Airport), similar to Q6.²⁵³
 - (b) **Impact of the pandemic on HAL’s asset beta.** The CAA considered the impact of the pandemic on the risk differential between HAL and comparator airports, and the impact of the pandemic on comparator airports.
 - (i) The CAA considered that the pandemic had effectively eliminated the risk differential that previously existed between HAL and comparator airports.²⁵⁴ The CAA stated that it did not expect that HAL would benefit from substantially greater excess demand than other airports during H7 – it considered that neither HAL or its comparators would be likely to reach their capacity in the near future.²⁵⁵ For this reason, at the upper end, the CAA proposed to add 0.10 to HAL’s asset beta to create a range which corresponded to Flint’s pre-pandemic asset beta range for the comparator set (0.50-0.60).²⁵⁶
 - (ii) In addition to the impact on relative risk, the CAA also considered that the pandemic had increased the asset beta of airports generally. Flint estimated a pandemic impact of 0.02-0.11 based on data for a set of six comparator airports (AENA, ADP, Fraport, Zurich, Vienna and Sydney).²⁵⁷
 - (c) **Impact of the TRS mechanism.** The CAA estimated that the TRS mechanism reduced HAL’s asset beta by 0.08-0.09. The CAA had considered the most appropriate method

²⁴⁷ HAL, Heathrow’s Response to Initial Proposals (redacted) [Vol A / Tab 90 / p.9519 / para 7.1.17].

²⁴⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.327 / Table 9.20].

²⁴⁹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.254 / para 9.24].

²⁵⁰ Flint, Support to the Civil Aviation Authority: H7 Updated Beta Assessment (CAP2366B) (**2022 Flint Report**) [Vol A / Tab 88 / p.8894].

²⁵¹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.260 / para 9.50].

²⁵² H7 Final Proposals Section 3 [Vol A / Tab 4 / p.262 / para 9.62] and 2022 Flint Report [Vol A / Tab 88 / p.8897].

²⁵³ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.262 / para 9.62].

²⁵⁴ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.267 / para 9.81].

²⁵⁵ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.260 – 261 / para 9.52 / p.266 – 267 / para 9.80 and p.277 – 278 / para 9.148 – 9.149].

²⁵⁶ Flint, Support to the Civil Aviation Authority: Estimating Heathrow’s beta post-COVID-19 (CAP 2266E) (**2021 Flint Report**) [Vol A / Tab 86 / p.8791].

²⁵⁷ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.278 / para 9.150 – 9.151].

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for estimating the impact of the TRS mechanism on the H7 asset beta, and determined that the best available approach involved applying a reduction assuming a degree of convergence with regulated network utilities. The CAA adopted the following methodology:²⁵⁸

- (i) Comparing the pre-TRS asset beta for HAL with network utility benchmarks – where the CAA considered it was reasonable to use the average of the PR19 and RIIO-GD2/T2 benchmarks (0.342).²⁵⁹
- (ii) Calculating the difference in asset beta due to traffic risk between HAL and benchmark companies – which the CAA estimated to be between 50% and 90% on the basis that other factors in addition to traffic risk could account for the risk difference (although it did not specify which other risks those would be).
- (iii) Assuming the TRS would reduce HAL’s exposure to traffic risk by 50%.
- (iv) Concluding that this implied that the TRS mechanism reduced HAL’s asset beta by between 25% and 45% of the difference between the pre-TRS asset beta and the network utilities’ asset beta benchmark (resulting in a reduction of 0.08-0.09). The CAA recognised that the adjustment relied to a significant extent on judgment in areas where there is limited evidence. However, it considered that applying such an adjustment was preferable to not making an adjustment or adopting a lower point estimate within the WACC range.²⁶⁰

5.19 The CAA set out its calculations for the asset beta in Table 9.2 of the Final Proposals (replicated for ease of reference).

H7 Final Proposals: Table 9.2, Summary of the CAA Final Proposals estimate for the asset beta in H7

Component	Low	High
Pre-pandemic asset beta	0.50	0.50
Impact of the pandemic on risk differential between HAL and comparator airports	n/a	0.10
Flint baseline asset beta	0.50	0.60
Impact of the pandemic on comparator airports asset betas	0.02	0.11
Impact of the TRS	(0.08)	(0.09)
H7 asset beta	0.44	0.62

5.20 Index-linked debt premium: In line with the H7 Initial Proposals, the CAA applied a premium to all index-linked debt (both new and embedded) to reflect higher observed spreads at issuance on HAL’s index-linked debt compared with its fixed-rate debt.²⁶¹

5.21 The CAA estimated the value of the premium at 15bps, in line with HAL’s business plan (RBP Update 1), which led it to allow for an additional 5bps on the cost of debt.

²⁵⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.279 - 280 / para 158].

²⁵⁹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.279 - 280 / para 158].

²⁶⁰ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.280 / para 9.160].

²⁶¹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.310 / para 9.338].

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- 5.22 Point estimate: The CAA proposed to adopt a point estimate of 3.26%, which was the midpoint of the WACC range.
- 5.23 The CAA outlined a range of issues that it considered to be relevant to the choice of the point estimate. This included issues discussed by the CMA in the PR19 Final Determination together with other considerations which the CAA considered to be specific to the H7 price control, namely:
- (a) Consumer welfare. The CAA considered that a degree of ‘aiming up’ may be warranted due to welfare effects and investment considerations in the circumstances of the H7 control.²⁶²
 - (b) Asymmetry in the WACC parameter ranges. The CAA noted that the assumption of a stable total market return (TMR) gives rise to an upward skew within the parameter range, which warranted a degree of aiming down within the WACC range. It considered that “*the degree of aiming down is potentially material*”.²⁶³
 - (c) Asymmetry in the broader price control. The CAA did not consider that there were any material uncompensated asymmetries within the H7 price control. It noted that HAL is subject to significant asymmetric risk associated with passenger volumes but took account of this through the shock factor and asymmetric risk allowance.²⁶⁴
 - (d) Market cross-checks. The CAA considered that it lacked robust market benchmarks that could be used to cross-check the CAPM-based WACC estimates.
 - (e) Financeability. The CAA considered that the financeability considerations did not warrant deviating from the mid-point.
- 5.24 The CAA decided to apply two factors in determining its choice of point estimate: welfare effects and the asymmetry of parameters. The CAA considered that these two factors counterbalanced each other and found there was no strong evidence for either aiming up or down. Accordingly, the CAA proposed to adopt the mid-point of the range.²⁶⁵
- 5.25 **Response to H7 Final Proposals**: In response to the H7 Final Proposals, the Appellant and VAA provided a joint response (**H7 Final Proposals - Joint Response**) which noted that there remained flaws in the CAA’s proposed methodology for setting the WACC, which required further downward adjustment.²⁶⁶ In the Appellant’s own supplemental response to the H7 Final Proposals, it underlined the CAA’s failure to appropriately adjust the asset beta for the impact of the TRS mechanism.²⁶⁷ The Appellant also highlighted that the CAA had failed to assess the overall impact of the H7 Final Proposals on both HAL and consumers, which resulted in H7 Final Proposals over-compensating HAL and disincentivising it to promote growth and/or to achieve further cost efficiency.²⁶⁸
- 5.26 The H7 Final Proposals - Joint Response was supported by an expert report from AlixPartners LLP (the **AP Initial Report**) which highlighted specific errors in the CAA’s methodology, and concluded that once these errors were corrected the WACC should be set at a lower level of 2.65%. In particular, the H7 Final Proposals - Joint Response underlined the CAA’s error in calculating the impact of the TRS mechanism on asset beta, and found that the CAA was wrong to assume that only 50% - 90% of the risk differential between HAL and the utility benchmarks was due to traffic risks.²⁶⁹ On this topic, the Appellant also highlighted that “*given the multiple layers of protection afforded to HAL, in particular through the TRS, the asset beta should be*

²⁶² H7 Final Proposals Section 3 [Vol A / Tab 4 / p.322 / para 9.406].

²⁶³ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.323 / para 9.411].

²⁶⁴ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.323 / para 9.412].

²⁶⁵ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.325 / para 9.420].

²⁶⁶ VAA and Delta, Response to H7 Final Proposals (CAP2365) (**H7 Final Proposals - Joint Response**) Vol A / Tab 115 / p.10,469 / para 1.19.3].

²⁶⁷ Delta, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 114 / p. 10,462].

²⁶⁸ Delta, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 114 / p. 10,462].

²⁶⁹ H7 Final Proposals - Joint Response [Vol A / Tab 115 / p.10,486 / para 5.9].

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reduced.²⁷⁰ The H7 Final Proposals - Joint Response also endorsed the findings in the AP Initial Report that there was a strong basis for aiming down, given the information and incentive asymmetries.²⁷¹

- 5.27 In its response to the H7 Final Proposals, HAL continued to argue that the WACC should be significantly increased – in this case to 6.9%, significantly in excess of the CAA’s proposed upper bound for the WACC range – and asserted that the CAA’s approach contained a number of material errors.²⁷² HAL suggested that the financial package proposed by the CAA, especially the WACC, was in its opinion too low, and would lead to undercompensating investors for risks and create risks to investment. To support its position on asset beta, HAL provided a report from Oxera, in which Oxera proposed an alternative method of estimating asset betas.
- 5.28 **H7 Final Decision:** On 8 March 2023, the CAA published its H7 Final Decision. The CAA determined that a WACC point estimate of 3.18%, which was the mid-point in the WACC range of 2.64% - 3.73%.²⁷³ The CAA confirmed that its methodology was largely unchanged since the H7 Final Proposals, and attributed the change in WACC to macroeconomic conditions, noting “*the macroeconomic situation has shifted considerably since we published the Final Proposals and we have decided to update our estimate of the WACC for these recent changes.*”²⁷⁴
- 5.29 **Asset beta:** The CAA “*decided to retain asset beta range of 0.44-0.62 from the Final Proposals*”²⁷⁵ and made no further methodological changes.
- 5.30 **Index-linked debt premium:** The CAA applied a premium of 15bps, both for new and embedded debt, consistent with its position in the H7 Final Proposals.
- 5.31 **Point estimate:** The CAA maintained the decision to adopt a midpoint in the range, at 3.18%. The CAA recalled that at the H7 Final Proposals stage it had reached this decision by balancing two key considerations: (i) welfare effects and (ii) parameter asymmetry (as noted above).²⁷⁶ The CAA considered a range of other factors, which stakeholders had raised in response to the H7 Final Proposals. These included:²⁷⁷
- (a) **Affordability:** The CAA disagreed that affordable prices should be the ‘principal’ concern, albeit emphasising in the H7 Final Decision Summary that prices should be “*no higher than necessary*”.²⁷⁸
 - (b) **Information asymmetry:** The CAA disagreed that the presence of information asymmetries warranted aiming down within the range, given regulatory precedent and the CMA’s decision in the RIIO-T2/GD2 price control appeals.
 - (c) **CMA PR19 determination:** The CAA noted that the CMA found that Ofgem’s decision to adopt a point estimate in the middle of the range was not wrong in the RIIO-GD2/T2 price control appeals.
 - (d) **Consideration of Oxera’s analysis:** The CAA disagreed with HAL’s allegation that it did not give sufficient consideration to Oxera’s analysis submitted by HAL.
 - (e) **Traffic uncertainty:** The CAA considered that risk and uncertainty associated with traffic in H7 did not warrant aiming up, unless it could be demonstrated that the traffic forecasts are skewed or asymmetric.

²⁷⁰ Delta, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 114 / p. 10,462].

²⁷¹ H7 Final Proposals - Joint Response [Vol A / Tab 115 / p.10,488 / para 5.18].

²⁷² HAL, Economic Regulation of Heathrow Airport Limited: H7 Final Proposals (CAP 2365) (H7 Final Proposals - HAL Response) [Vol A / Tab 89 / p.9158 / para 10.1.1].

²⁷³ H7 Final Decision Section 3 [Decision / Tab 4 / p.182 / Table 9.6].

²⁷⁴ H7 Final Decision Section 3 [Decision / Tab 4 / p.153 / para 9.38].

²⁷⁵ H7 Final Decision Section 3 [Decision / Tab 4 / p.161 / para 9.90].

²⁷⁶ H7 Final Decision Section 3 [Decision / Tab 4 / p.179 / para 9.193].

²⁷⁷ H7 Final Decision Section 3 [Decision / Tab 4 / p.180 - 181 / para 9.197 – 9.204].

²⁷⁸ H7 Final Decision Summary [Decision / Tab 1 / p.6 – 7 / para 5].

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- (f) Impact of capacity constraint: The CAA noted that it already addressed the impact of traffic forecasts being inherently skewed by the application of the shock factor and the asymmetric risk allowance.
- (g) Congestion premium: The CAA disagreed that the existence of a congestion premium, if one exists, is relevant to the question of setting the point estimate for the WACC.
- 5.32 The CAA considered that the impact of the recent market developments on the appropriate choice of point estimate was mixed.²⁷⁹ It noted that the RFR increased significantly, reducing the upward skew relative to the H7 Final Proposals, whereas the inflation forecast might imply a greater skew than was the case in the H7 Final Proposals. Overall, the CAA considered that choosing the midpoint for the H7 WACC remained appropriate and that *“the evidence is broadly balanced”*.²⁸⁰
- 5.33 The CAA’s summarised the WACC estimates in the H7 Final Decision and the H7 Final Proposals in Table 9.6 of Final Decision (replicated below).

H7 Final Decision: Table 9.6 Impact of market developments on the Final Proposals WACC

WACC	Final Decision		H7 Final Proposals	
	High	Low	High	Low
Gearing	60%	60%	60%	60%
RFR	0.59%	0.59%	-2.03%	-2.03%
TMR	5.85%	5.85%	5.85%	5.85%
Asset beta	0.62	0.44	0.62	0.44
Debt beta	0.05	0.1	0.05	0.1
Equity beta	1.47	0.95	1.47	0.95
Post-tax cost of equity	8.32%	5.59%	9.56%	5.45%
Cost of new debt	4.22%	4.22%	0.89%	0.89%
Cost of embedded debt	-0.08%	-0.08%	0.17%	0.17%
Issuance and liquidity costs	0.25%	0.25%	0.18%	0.18%
Cost of debt	0.67%	0.67%	0.43%	0.43%
Vanilla WACC	3.73%	2.64%	4.08%	2.44%
Point estimate	3.18%		3.26%	

²⁷⁹ H7 Final Decision Section 3 [Decision / Tab 4 / p.181 / para 9.205].

²⁸⁰ H7 Final Decision Section 3 [Decision / Tab 4 / p.181 / para 9.207].

C. The CAA's errors

- 5.34 In this section the Appellant describes the three errors made by the CAA in setting the WACC for H7. These errors are material and mean that the CAA has “*significantly overestimated the WACC (by 0.72 percentage points), and consequently overstated HAL’s H7 aeronautical revenue requirement by £713 million (in 2020 prices)*”.²⁸¹
- 5.35 The CAA erred by: (1) setting HAL’s asset beta too high, (2) including a premium when calculating the cost of HAL’s index-linked debt, and (3) choosing the mid-point of the WACC range when selecting a point estimate.

Error (1) The CAA set HAL’s asset beta too high

- 5.36 In the H7 Final Decision, the CAA adopted a range of 0.44-0.62 for HAL’s asset beta. The Appellant contends that the CAA made material methodological errors in setting the asset beta, in all three steps of the methodology, with the result that the asset beta is too high. These errors are set out in more detail below.

(a) Errors in setting the pre-pandemic asset beta

- 5.37 As explained in sub-section B, the CAA assumed that HAL’s pre-pandemic asset beta was 0.50, based on the figure in Q6. Since HAL’s beta is not directly observable, because HAL does not have listed equity, its beta must be calculated with reference to listed comparators. To arrive at this figure in Q6, the CAA used Fraport (asset beta of 0.52-0.55) and ADP (asset beta of 0.59-0.60) as comparators.²⁸² The CAA then adjusted the value down to 0.5 to account for HAL’s lower systematic risk as a result of excess demand at Heathrow Airport.²⁸³
- 5.38 The Appellant contends that the CAA was wrong to rely on the Q6 asset beta of 0.5 to establish HAL’s pre-pandemic asset beta, when more recent pre-pandemic asset beta data for the comparator set was available. The 2022 Flint Report, which the CAA relied on in arriving at its decision, provided more up-to-date asset beta information for the comparator set up to January 2020.²⁸⁴ These results are replicated in Table 3 of the WACC Report, together with a revised calculation covering the pre-pandemic period up to 20 February 2020.²⁸⁵ As set out in paragraph 46 of the WACC Report, more up-to-date estimates for the comparators’ asset betas for pre-pandemic period “*clearly cluster around 0.50*”. In addition, Flint provided estimates for broader comparators sets, based on sets with four and six comparators. As further explained in the WACC Report, “*the extended comparator group reinforces 0.50 as a central asset beta for the pre-pandemic asset beta comparator*”.²⁸⁶ As calculated by AlixPartners, up-to-date estimates are 0.055-0.065 lower than the corresponding values at the time of the Q6 determination. Accordingly, the correct value of the pre-pandemic beta should be lower by 0.055- 0.065 than the Q6 value of 0.5. Therefore the correct value should be 0.44 (i.e. 0.5 minus 0.055-0.065).
- 5.39 It is important to underline that the Q6 figures relied upon by the CAA are heavily outdated, as they were estimated in 2013 for the purpose of the CAA’s Q6 decision in 2014. As explained by Chris Walker in paragraph 186 of CW1, “*From Delta’s perspective, it is clearly wrong for the CAA to rely on a decade-old report when the CAA had readily available, and elsewhere in the H7 Final Decision relied upon, a report which contained much more recent information*”.

²⁸¹ WACC Report [Vol A / Tab 123 / p. 11,065 / para 3].

²⁸² CAA, Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences (CAP 1115) [Vol A / Tab 92 / p.9799 / Figure 7.3].

²⁸³ CAA, Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences (CAP 1115) [Vol A / Tab 92 / p.9799 / para 7.70].

²⁸⁴ 2022 Flint Report [Vol A / Tab 88 / p.8915 / Table 3].

²⁸⁵ WACC Report [Vol A / Tab 123 / p. 11,081 / Table 4].

²⁸⁶ WACC Report [Vol A / Tab 123 / p. 11,079 / para 46].

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- 5.40 As a result of not relying on the most recent data, the CAA set the HAL's pre-pandemic beta too high. This had important implications for the overall level of HAL's asset beta and, by extension, the CAA's estimation of the WACC.

(b) Errors in calculating the impact of the pandemic on HAL's asset beta

- 5.41 The CAA made two erroneous adjustments to reflect the impact of the pandemic on HAL's asset beta: (i) an adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports, and (ii) an adjustment of 0.02-0.11 to reflect the impact of the pandemic on asset betas of comparator airports.
- 5.42 First, when making an adjustment for relative risk, the CAA wrongly increased HAL's asset beta to account for the change in HAL's risk compared with the comparator airports.
- 5.43 The CAA added an adjustment of 0.1 at the upper end of HAL's asset beta range, effectively matching it to the upper end of comparators' Q6 asset betas (i.e. 0.60). The CAA explained that the purpose of this adjustment was to capture the effect of the relaxation of HAL's capacity constraints "*relative to*" those of comparator airports.²⁸⁷ Therefore, the CAA should have undertaken analysis on whether there has in fact been a relaxation in HAL's capacity constraints since Q6 relative to comparator airports. The CAA failed to conduct such analysis, simply assuming that the pandemic neutralised the effect of the capacity constraint on HAL's beta relative to comparators' betas. Notably, in the H7 Final Proposals, the CAA simply stated that "*we do not expect that HAL will benefit from substantially greater excess demand than other airports in H7*"²⁸⁸ and noted that "*neither HAL nor the airports in our comparator set are likely to fully reach their capacity constraints in the near future*".²⁸⁹ Accordingly, the CAA's decision to make an adjustment, and to consider that the pandemic "*neutralised*" the risk differential between HAL and other airports, is not well-justified.
- 5.44 As explained in paragraph 51 of the WACC Report, the CAA failed to consider its own analysis of the projected passenger numbers throughout H7 in the H7 Final Decision when considering the impact of the pandemic on HAL's capacity constraints. The CAA's forecast of HAL's traffic volumes for 2023 are at virtually the same level as the CAA had forecast in Q6 for 2018/9,²⁹⁰ at which time it held that HAL was capacity constrained.²⁹¹ Moreover, for 2024 onwards the CAA's passenger forecasts are at least 97.5% of HAL's 2019 peak passenger numbers.²⁹² On this basis, it is clear that HAL would likely continue to benefit from excess demand, which would likely insulate it from risks.
- 5.45 In any event, the adjustment was wrong because the CAA had wrongly relied on outdated pre-pandemic figures for the comparator set when making the adjustment, as discussed in 1(a) above. As explained in paragraph 46 of the WACC Report, when the updated asset beta data for comparators is considered (see Table 3 of the WACC Report), their asset betas clustered around 0.5. Therefore, the CAA's decision to set HAL's asset beta at 0.60 places HAL's asset beta above ADP and Fraport, which is unsupported by any evidence.²⁹³ This is a clear error.
- 5.46 Accordingly, the CAA's decision to make an adjustment to account for the change in relative risk between HAL and comparator airports, is unjustified and wrong.
- 5.47 Second, the CAA erred in calculating the impact of the pandemic on comparator airports. Relying on Flint's analysis, the CAA considered that the pandemic increased HAL's asset beta

²⁸⁷ H7 Final Decision Section 3 [Decision / Tab 4 / p.154 / para 9.45].

²⁸⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.277 - 278 / para 9.148].

²⁸⁹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.266 – 267 / para 9.80]

²⁹⁰ CAA, Economic regulation at Heathrow from April 2014: Final Proposals (CAP 1103) [Vol A / Tab 63 / p.6629 / Figure 3.4] which indicates that the CAA forecast that HAL would carry 73.2m passengers in 2018/19, which is only marginally higher than the CAA now forecasts HAL would carry in 2023 H7 Final Decision Section 1 [Decision / Tab 2 / p.47 / Table 1.7].

²⁹¹ CAA, Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences (CAP 1115) [Vol A / Tab 92 / p.9799 / para 7.70]

²⁹² In any event, as explained in Section 4, sub-section C, the CAA has erred in setting the passenger forecasts for H7.

²⁹³ WACC Report [Vol A / Tab 123 / p. 11,080 / para 49].

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by 0.02-0.11, based on return data for a broader set of six comparator airports.²⁹⁴ However, the methodology adopted by Flint to calculate the impact of the pandemic is seriously flawed and has resulted in a further, material error in the CAA's calculation of the asset beta.

- 5.48 Flint was wrong to rely on a weighted least squares (**WLS**) estimator. As explained in paragraph 53 of the WACC Report, Flint used the WLS estimator to address the structural break in the share price time series caused by Covid-19, rather than using the standard econometric practise of using a 'slope dummy' for the beta in the pandemic period or (if the model residual variances differ over the non-pandemic and pandemic periods – which in this case they do), through separate regression models for each period. WLS is a less precise method for estimating regression coefficients compared to slope dummy variables, and therefore it was wrong for the CAA to rely on it.²⁹⁵ There was no good reason for Flint to depart from the standard econometric practices of using slope dummy or separate regression models.
- 5.49 Moreover, Flint combined pandemic and non-pandemic periods, which resulted in distortions to the calculation of HAL's asset beta and overestimated the adjustment needed to account for the impact of the pandemic on the asset beta.
- 5.50 As explained in paragraph 55 of the WACC Report, the difference between equity and asset beta, is driven by a company's debt gearing.
- 5.51 As set out in Table 5 of the WACC Report, data indicates that debt gearing of most airports increased during the pandemic period, as a result of falling shareholder equity value and increased debt. This had an impact on increasing equity betas. However, Flint's methodology of combining data from both pandemic and non-pandemic periods did not pick up on the different levels of gearing. As a result, part of the increase in the beta was erroneously attributed to the pandemic, whereas it would have been a result of higher gearing. As explained in paragraph 56 of the WACC Report, the difference between equity and asset beta during the pandemic period was between 0.07 to 0.23 (average 0.15) higher than it was when averaged for the whole period (pandemic and non-pandemic).
- 5.52 Flint estimated that the difference in the asset beta between the pandemic and the pre-pandemic period for comparator airports was 0.28. Therefore, roughly half (0.15) of the increase in Flint's estimate of the asset beta during the pandemic period is erroneously caused by the increase in comparator company equity beta from increased gearing and not from the pandemic.²⁹⁶
- 5.53 This is a clear error, which resulted in overestimating the impact of the pandemic on asset betas. The CAA was wrong to adopt this methodology. Instead, the correct approach is to estimate equity betas separately for the pandemic and the non-pandemic period. Once the correct calculations are undertaken, the range for the pandemic adjustment is 0.004-0.061 (as opposed to the Flint estimate of 0.02-0.11), as explained in paragraph 60 of the WACC Report.
- 5.54 Following this step, the correct value of HAL's asset beta after the pandemic-related adjustments is 0.444 - 0.501 as explained in paragraph 61 of the WACC Report.

(c) Errors in calculating the TRS adjustment

- 5.55 As explained above, the CAA considered that between 50% and 90% of the difference in the asset beta between HAL and benchmark companies was due to traffic risk. This decision was wrong.
- 5.56 The TRS mechanism is relevant to all types of traffic risk. The TRS is designed so that it reduces the traffic volume risk that HAL is exposed to by re-allocating traffic risk between HAL and consumers. The CAA has described the TRS mechanism as "*reduc[ing] the risk of significant gains or losses for HAL that could arise from changes in passenger numbers*" and "*reducing HAL's exposure to the current uncertain environment*".²⁹⁷ The CAA explained in the H7 Final

²⁹⁴ 2022 Flint Report [Vol A / Tab 88 / p.8937].

²⁹⁵ WACC Report [Vol A / Tab 123 / p. 11,081 / para 53].

²⁹⁶ WACC Report [Vol A / Tab 123 / p. 11,081 / para 53].

²⁹⁷ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.78 – 79 / para 2.35].

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Proposals that the application of the TRS mechanism would reduce HAL's asset beta by mitigating the impact of future pandemic-like events as well as the impact of "*business as usual*" traffic volatility on HAL's equity returns.²⁹⁸

- 5.57 In the H7 Final Proposals, the CAA listed multiple compelling reasons in support of using network utilities as a benchmark, including that: (i) they are asset-heavy businesses with significant operating margins under normal business conditions; (ii) their assets are generally long-lived with long-term payback periods and durations; (iii) they are natural monopolies subject to price caps that are set at similar intervals to HAL; and (iv) they are subject to incentives that promote the reduction of cost and improvements to service quality with opportunities to earn rewards where they outperform regulatory assumptions.²⁹⁹ The CAA concluded that the principal distinction between HAL's and a network utilities' asset betas is HAL's exposure to volume (i.e. traffic) risk.³⁰⁰
- 5.58 Notwithstanding this analysis, the CAA assumed that only 50% - 90% of the asset beta differential between HAL and network utilities was due to traffic risk. The CAA's reasoning on this point in the H7 Final Proposals is limited to a reference to an instance where economic consultants CEPA "*noted*" that there might be "*other factors*" (which are not identified by the CAA) which *could* account for this difference.³⁰¹ In the H7 Final Decision, the CAA did not provide any further rationale to support its assumptions and failed to explain what other risks HAL would plausibly be exposed to. The CAA merely stated that it considered that it had "*used a reasonable range for the likely proportion of the difference between HAL and utility asset betas that can be attributed to volume risk*".³⁰²
- 5.59 This approach is incorrect for the reasons explained in paragraphs 64 to 68 of the WACC Report, which emphasises that:
- (a) the regulated entities are all regulated with reference to five-year price controls and receive returns on an indexed RAB;
 - (b) HAL and the utilities operate under output and service quality incentives regimes, with bonus and penalty payments; and
 - (c) there are structural similarities in the cost structures between HAL and the other UK regulated companies.
- 5.60 In addition, as explained in section 4.2.3 of the WACC Report, regardless of the CAA's failure to appropriately analyse them, the "*other factors*" referred to by CEPA, are not relevant and do not provide a basis to justify the CAA's conclusion.³⁰³ There is, therefore, no other risk that HAL is plausibly exposed to compared to other regulated utilities.
- 5.61 Accordingly, it is logical to conclude that traffic risk accounts for a far higher percentage of the differential between HAL's and the utilities' asset betas than 50% - 90%. As explained in paragraph 71 of the WACC Report, it is appropriate to attribute 90% to 100% of the asset beta differential to traffic risk. Applying this corrected assumption reduces HAL's asset beta by 0.05-0.07.
- 5.62 In conclusion, the CAA made multiple material errors when setting HAL's asset beta. These errors, both individually and collectively, mean that the CAA has set the WACC too high and at a level which is wrong because it is not supported by evidence.
- 5.63 As explained in paragraph 75 and Table 8 of the WACC Report, to correct the CAA's errors, HAL's asset beta should be reduced from 0.44-0.62 to 0.39-0.43.

²⁹⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.261 / para 9.53 and 9.54].

²⁹⁹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.279 / para 9.154].

³⁰⁰ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.279 / para 9.155].

³⁰¹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.280 / para 9.158].

³⁰² H7 Final Decision Section 3 [Decision / Tab 4 / p.160 / para 9.84].

³⁰³ WACC Report [Vol A / Tab 123 / p. 11,087 / footnote 54].

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- 5.64 Applying this correction reduces the overall WACC by 0.62%, with a consequential reduction in H7 aeronautical revenue requirements of £614 million, and a reduction in charges of £1.67 per passenger (in 2020 prices).³⁰⁴

Error (2): The CAA wrongly included a premium when calculating the cost of index-linked debt

- 5.65 HAL's notional debt structure includes both nominal and index-linked debt. As explained above, the CAA applied a premium of 15bps to HAL's index-linked debt, for both new and embedded debt. This decision was wrong, for the reasons set out below.
- 5.66 First, as explained in paragraph 81 of the WACC Report, the CAA has failed to justify this adjustment. As observed in the WACC Report, no such premium was used in recent regulatory decisions, including in Ofgem's determination of RIIO-1 or RIIO2 or the CMA's PR19 redetermination. The CAA appears to justify the existence of such a premium by comparing the spreads of five HAL index-linked bonds with contemporaneous iBoxx spreads. The CAA's interpretation of the data is wrong because for three of the five bonds, the issuance spread is *lower* for HAL's index-linked bonds and the simple average difference is that HAL's index-linked bonds have a *negative premium* of over 10bps. The CAA's reported average is based on a weighted average which gives 60.5% weight to a single observation. As set out in the WACC Report at paragraph 81, the CAA should not have relied on the weighted average, and should have instead considered the simple average.
- 5.67 Moreover, investors generally require a lower return on index-linked debt because it does not carry inflation risk, meaning the CAA's estimation is also wrong conceptually.³⁰⁵ As a result, a premium should not be *added* on to nominal gilt yields to calculate the cost of index-linked debt, but rather *subtracted* (to reflect the lower risk carried by such debt).³⁰⁶
- 5.68 Second, the CAA has misstated the magnitude of the adjustment required to calculate the cost of HAL's index-linked debt.
- 5.69 Rather than considering a sample of only five HAL index-linked bonds, to assess the magnitude of an adjustment, the CAA should have considered the position as regards all index-linked bonds.³⁰⁷ As set out at paragraphs 84-89 of the WACC Report, the correct methodology for estimating the appropriate adjustment involves comparing the yields on index-linked and nominal bonds issued, not just by HAL, but in the market more widely.
- 5.70 This analysis indicates that the nominal yield (minus expected inflation) has always been higher than index-linked yield, as explained in paragraph 87 of the WACC Report. This suggests that the cost of index-linked debt should be reduced, rather than increased, compared to the cost of nominal bonds.
- 5.71 In addition, it is also inappropriate to add a premium of 15bps in circumstances where HAL will also receive a benefit of lower costs from issuing its own index-linked bonds. As observed in the WACC Report, in the context of RIIO-2, it was estimated that energy network companies issued nominal debt at 11bps below equivalent nominal debt.³⁰⁸ Therefore, as explained at paragraph 90 of the WACC Report, it would be appropriate to *reduce* the cost of index-linked debt by up to 10bps, rather than to apply a 15bps premium.
- 5.72 In conclusion, the CAA's decision to add a premium of 15bps to calculate the cost of index-linked debt was based on clear errors. The correct approach is to apply a negative adjustment in a range of 0bps to 10bps when calculating the cost of index-linked debt.³⁰⁹

³⁰⁴ WACC Report [Vol A / Tab 123 / p. 11,089 / para 75].

³⁰⁵ WACC Report [Vol A / Tab 123 / p. 11,092 / para 83].

³⁰⁶ Ibid.

³⁰⁷ WACC Report [Vol A / Tab 123 / p. 11,092 / para 84].

³⁰⁸ WACC Report [Vol A / Tab 123 / p. 11,093 / para 89].

³⁰⁹ WACC Report [Vol A / Tab 123 / p. 11,094 / para 90].

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- 5.73 Reducing the cost of index-linked debt by a range of 0-10bps would reduce the cost of debt by 0.05-0.8% and the overall WACC by 0.03-0.05%, with a consequential reduction of HAL's allowed revenue of £40 million (in 2020 prices).³¹⁰

Error (3) The CAA wrongly chose the mid-point of the WACC range when selecting a point estimate

- 5.74 To determine the WACC for H7 the CAA estimated each of the WACC components to produce an overall range and then selected a point estimate within that range. The choice of the point estimate therefore has a material impact on the overall per passenger charge for H7.

- 5.75 The CAA's decision to choose the mid-point or to 'aim-straight' for H7 is wrong. As explained in paragraph 95 of the WACC Report "*In general, taking the mid-point of the WACC range is reasonable (as argued by the UKRN), but not in the circumstances that apply here. The CAA has erred by ignoring these circumstances*".

(a) The CAA's decision not to aim down is unjustified, because it has ignored or misjudged relevant factors

- 5.76 The CAA's decision to choose the mid-point of the WACC range, results from a failure to have proper regard to and to take account of all relevant considerations given the timing of H7 (including a cost of living crisis and no major capacity expansion). Specifically, as explained in paragraph 96 of the WACC Report, the CAA has failed adequately to consider:

- (a) asymmetry of costs and benefits;
- (b) asymmetry of pandemic events;
- (c) information asymmetries between HAL and the CAA;
- (d) the effect of distortions created by the outer band of the TRS; and
- (e) other relevant factors which support the case for aiming down.

- 5.77 First, when considering costs and benefits, the CAA was wrong to conclude that the trade-off between welfare effects and investment considerations warrants *aiming up* in the WACC range.³¹¹ In fact, for H7, the opposite is true.

- 5.78 As a general principle, the Appellant recognises and accepts the UKRN's reasoning that setting the WACC too low (with the risk that this gives rise to under-investment) may result in a worse outcome for consumers than setting a WACC too high (and risk over-compensating investors).³¹²

- 5.79 However, in the specific circumstances of the H7 price control, there is a clear imperative to secure affordable prices for consumers – as is evident from the CAA's repeated emphasis that its objective in setting the H7 control is to ensure that prices should be "*no higher than necessary*" to protect consumers. As explained in section F of CW1, ensuring charges are affordable is vital to support the aviation sector's recovery from the impact of Covid-19.

- 5.80 Conversely, there is little pressing need for large scale capital expenditure (**capex**) investment given the continuing restrictions on capacity and the H7 specific provisions to mitigate the risk of under-investment, including a generous capex allowance, service delivery incentives and other incentives to promote efficient investment.³¹³ This is particularly evident when comparisons are made with the capex requirements for energy networks where new investment

³¹⁰ WACC Report [Vol A / Tab 123 / p. 11,094 / para 91].

³¹¹ H7 Final Decision Section 3 [Decision / Tab 4 / p.179 / para 9.913].

³¹² 2022 UKRN Report [Vol A / Tab 120 / p.10,972].

³¹³ WACC Report [Vol A / Tab 123 / p. 11,096 / para 98].

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is a critical consideration in the regulatory price controls given the need to meet the government's net zero targets, as explained in paragraph 99 and Figure 6 of the WACC Report.

- 5.81 In this context, it is only reasonable to conclude that welfare effects outweigh investment considerations for H7 such that *"the CAA should have prioritised lower prices and aimed-down within the WACC range"*.³¹⁴
- 5.82 Second, when considering the impact of pandemic risks, the CAA failed to have proper regard to or account for the asymmetry in probabilities of a pandemic event when estimating HAL's asset beta.
- 5.83 The CAA, relying on work by Flint, adjusted the asset beta by a range of 0.02 to 0.11, which in turn formed the assumptions for the upper and lower WACC range from which the point estimate was selected (and the mid-point taken in error).
- 5.84 The CAA arrived at this figure having made assumptions about the likelihood of a future occurrence of a pandemic (with a frequency of once every 20 or 50 years), and the duration of any future pandemic occurrence (either 17 or 39 months).
- 5.85 As explained in paragraph 104 and Figure 7 of the WACC Report, the probability of these events occurring is asymmetric. However, the CAA erroneously assumed that they carry equal weight. By taking the mid-point of the range, the CAA assigned 50% weight to the two extreme cases and zero weight to the two middle cases. The CAA failed to recognise that when dealing with such an asymmetric distribution of pandemic events, the correct measure of central tendency is the mean (8.2%) or the median (6.8%) and not the mid-point between two extremes (9.5%) that the CAA adopted.³¹⁵
- 5.86 This is a clear methodological error. Adopting the correct measure – even on the most conservative approach (i.e. applying the mean rather than the median) – gives a central point of 40% within the range. As explained in paragraph 105 of the WACC Report, this is equivalent to aiming down by four percentage points within the WACC range (down to 46% in the range).³¹⁶
- 5.87 Third, the CAA failed to have regard to or give appropriate weight to information asymmetry. In the H7 Final Decision, the CAA wrongly dismissed evidence from the AP Initial Report submitted by the Appellant in response to the H7 Final Proposals that *"the presence of potential information asymmetries warrants aiming down within the range"*.³¹⁷
- 5.88 Information asymmetries clearly exist in the context of the H7 price control. The CAA has made repeated reference to this throughout the H7 process. For example, in the H7 Final Decision, the CAA emphasised *"the relatively low quality of certain aspects of the business plan information provided by HAL [footnote: In particular the lack of detailed information on a number of its capital expenditure programmes as discussed in our Initial and Final Proposals.] and its opposition to the release of key information on issues such as its approach to passenger forecasting"*.³¹⁸ As explained in section I of CW1, the extent of such information asymmetry between HAL and the CAA, has had a detrimental impact on the CAA's ability to reach a robust decision for H7 which is well-supported by evidence.
- 5.89 Despite acknowledging the poor quality of information provided by HAL, the CAA nonetheless concluded that there is no *"uncompensated asymmetry remaining within the H7 price control"*.³¹⁹ The Appellant contends that this statement is unconvincing and ignores important asymmetries which have not adequately been addressed – most notably in respect of the passenger forecasting model (as explained in Ground 1, Section 4), but also in relation to operational expenditures (**opex**), commercial revenues and HAL's cost of debt (given the complexity of HAL's debt structure). As explained in paragraph 108 of the WACC Report, *"aiming down within*

³¹⁴ WACC Report [Vol A / Tab 123 / p. 11,097 / para 100].

³¹⁵ WACC Report [Vol A / Tab 123 / p. 11,098 / para 105].

³¹⁶ *Ibid.*

³¹⁷ H7 Final Decision Section 3 [Decision / Tab 4 / p.180 / para 9.199].

³¹⁸ H7 Final Decision Summary [Decision / Tab 1 / p.7 / para 7].

³¹⁹ H7 Final Proposals Section 3 [Vol A / Tb 4 / p.323 / para 9.412].

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the range is necessary to compensate for information asymmetries that exist between HAL and CAA”.

- 5.90 The CAA's attempts to justify its approach with reference to the CMA's determination in the RIIO-T2/GD2 price control appeals (where aiming down for asymmetries was rejected) are not persuasive. The H7 case is clearly distinguishable from the position in RIIO-2, as explained in paragraph 109 of the WACC Report, for the following reasons: (i) the constant criticisms the CAA has levied on HAL for repeatedly providing poor information, (ii) the fact that HAL is a single licensee meaning CAA cannot benefit from benchmarking across similar companies in the way Ofgem does, and (iii) given the lack of risk sharing under HAL's opex and commercial revenues regulatory regime, which means that HAL is highly incentivised to present forecasts that favour its own interests.
- 5.91 Overall, the CAA had no good case to reject the relevance of information asymmetries when choosing the point estimate for the H7 WACC. The correct approach to properly account for and/or give appropriate weight to the stark information asymmetries between HAL and the CAA is to aim down when setting the WACC point estimate.
- 5.92 Fourth, the CAA should have accounted for the distortions created by the outer band of the TRS mechanism when selecting the WACC point estimate and has erred in not doing so.
- 5.93 A brief description of the TRS mechanism is given in section I of CW1. As explained in paragraph 111 of the WACC Report, the calibration of the outer band of the TRS mechanism has two distortive effects. First, it transfers additional (and asymmetric) price risk onto consumers, and second, it potentially undermines incentives for HAL to increase passenger traffic in times of severe recession. As a result, *“these distortions constitute errors by harming consumer interests through higher passenger charges, including possibly at times when the market is recovering from challenging economic conditions”*.³²⁰
- 5.94 The CAA has acknowledged that there are asymmetries in shocks to Heathrow Airport's traffic, i.e. downward shocks are more common than upward shocks. As a result, while it is possible that the lower 10% outer band will be breached, a breach of the upper 10% outer band is far less likely, largely due to HAL's capacity constraint.³²¹
- 5.95 As explained in paragraph 114 of the WACC Report, once the lower band is breached, a further 1% fall in traffic results in a 1.05% increase in airport charges. Consumers are, therefore, exposed to an asymmetric upward risk on the airport charges they pay. In contrast, there is no corresponding downward risk to HAL's charges as breaching the upper 10% outer bound is highly unlikely. Breaching the upper band would, for instance, require traffic to reach 89.43 million by the last year of H7 – which is 10.6% higher than Heathrow's 2019 passenger volume peak of 80.89 million.³²² Consequently, the TRS, as implemented in the H7 Final Decision, results in the asymmetry of risk. The CAA has failed to take proper account of or have regard to the Appellant's submissions on this point as explained in section I of CW1.
- 5.96 In addition, the CAA failed to consider the incentives once the lower outer band of the TRS is breached during the H7 period. In particular, the CAA's choice of a 105% sharing factor for the outer band, according to the CAA's assumptions and calculations, will protect HAL from 91 - 94% of the EBITDA impact from the traffic deviation.³²³ As explained in paragraph 116 of the WACC Report, given the difficulties in estimating the opex and commercial revenue elasticities on which this calculation depends, the CAA has failed to accord a reasonable margin for error.³²⁴ The consequence is that the CAA has created a situation whereby HAL is left with either limited incentive to promote traffic growth, or (perversely) an incentive to constrain traffic (particularly given the costs that may be incurred to increase traffic further – notwithstanding the benefits to consumers).

³²⁰ WACC Report [Vol A / Tab 123 / p. 11,100 / para 112].

³²¹ Report [Vol A / Tab 123 / p. 11,100 / para 114].

³²² *Ibid.*

³²³ H7 Final Proposals Section 1 [Vol A / Tab 2 / p.82 / para 2.44]

³²⁴ Not least because of the information asymmetries discussed at paragraphs 5.87 - 5.91 above.

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- 5.97 The Appellant contends that when proper account is taken of the distortive effects of the TRS mechanism, this supports the case for aiming-down when selecting the point estimate of the WACC.
- 5.98 Fifth, the CAA failed to have proper regard to or take account of other relevant factors, which strongly support the case for aiming down when selecting the point estimate of the WACC for H7.
- 5.99 As explained in Section I of CW1, the CAA erred in failing to consider its proposals for H7 in aggregate. The CAA's approach to setting the H7 control has involved consideration of a series of individual 'building blocks' including passenger forecasts, opex, commercial revenues and WACC. What is absent, is a clear and compelling analysis of the combined impact of these building blocks which would have revealed the numerous layers of protection that the CAA has afforded HAL, and which immunise it against risk.
- 5.100 As explained in paragraph 291 of CW1 "*It is clear that the CAA has failed to fully consider the cumulative impact of the individual decisions it has made at the building block level when setting HAL's price control. When assessed in aggregate, it is clear that HAL is protected through a range of mechanisms such as the TRS and asymmetric risk measures as well as an over-inflated WACC. Given the CAA's desire to ensure that passenger charges are 'no higher than necessary' it is wrong for the CAA to have effectively immunised HAL against risk at the expense of consumers*" (emphasis added).
- 5.101 In particular, the CAA ought to have had more regard to HAL's financial position when reaching a final decision on the WACC. In the H7 Initial Proposals the CAA recognised that "*it may be appropriate for [it] to take into account a wider set of issues in reaching judgments*".³²⁵ Yet, owing to its failing to consider issues in aggregate, the CAA has failed to take into account factors such as HAL's extremely high gearing and propensity to prioritise payments to shareholders over passenger need.
- 5.102 Indeed, as explained in section I of CW1, the CAA should have sent a strong signal to HAL's investors, that consumers should not continue to bear a disproportionate degree of risk for H7. As explained in paragraph 223 of CW1: "*There has been a staggering lack of investment by HAL's shareholders at a time when it is most needed and a long history of shareholders reaping the benefits of HAL's monopoly profits with little regard for the needs of passengers using Heathrow Airport. The CAA's primary duty is to protect consumers. To satisfy this duty, the CAA should have aimed down when selecting the point estimate of the WACC*".
- (b) The CAA's decision not to aim-down when selecting the point estimate for the WACC is harmful*
- 5.103 The CAA's erroneous decision not to aim-down when selecting the point estimate for the WACC will give rise to material harm to consumers and means the per passenger charge is set far higher than necessary, contrary to the CAA's stated intention.
- 5.104 The 2022 UKRN Paper recommends that "*[r]egulators should only deviate from the mid-point of the CAPM cost of equity range if there are strong reasons to do so*".³²⁶ This condition is clearly satisfied in the specific circumstances of H7.
- 5.105 Aiming down is not only warranted because of the factors discussed in (a) above, but also, given the specific circumstances of H7, as a means to avoid material harm to consumers through the imposition of unjustifiably high airport charges throughout the H7 price control.
- 5.106 As explained in paragraph 224 of CW1, "*The reason aiming down is firmly justified in the particular circumstances of the H7 price control, is because the WACC is a really important component of the H7 per passenger charge and setting the charge too high will be particularly harmful for H7 as the aviation sector recovers from the global pandemic. HAL already benefits*

³²⁵ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.737 / para 9.260].

³²⁶ UKRN, Guidance for regulators on the methodology for setting the cost of capital [Vol A / Tab 120 / p.10,976].

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from having the highest airport charges in the world. There is no good justification for setting a WACC that simply protects HAL at the expense of consumers.”

- 5.107 **In conclusion**, when proper account is taken of the available evidence and the material risk of harm to consumers from setting the point estimate of the WACC too high, the correct approach is to aim down when selecting the point-estimate.
- 5.108 Taking into account all of the evidence, as explained in paragraph 120 of the WACC Report, it would be appropriate to aim down at the 33% point in the range. This would have the impact of reducing the WACC by 0.06% with a consequential reduction in HAL’s overall allowed revenue for H7 of £59 million.
- 5.109 However, once the overall WACC range is corrected (i.e. taking into account all of the errors identified in sub-section C), the Appellant notes that this reduces the overall WACC range to a much narrower range (2.34 – 2.71%) which in turn has the effect of reducing the impact of aiming down.³²⁷

D. Legal consequences

- 5.110 In summary, the Appellant submits that the H7 Final Decision, insofar as it sets the WACC at 3.18%, within a broad range of 2.64 - 3.73%, was wrong on the following statutory grounds:
- (a) It was based on errors of fact, pursuant to section 26(a) of the Act. This is for reasons including that the CAA: (i) relied on flawed evidence and assumptions (e.g. relied on the Q6 asset beta to establish HAL’s pre-pandemic asset beta, relied on out-dated pre-pandemic figures for the comparator set when making the adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports, assumed that 50% - 90% of the asset beta differential between HAL and network utilities was due to traffic risk); (ii) made false comparisons (e.g. by considering that the CMA final determination in RIIO-2 was a relevant regulatory precedent justifying not aiming down for information asymmetry); (iii) had the wrong facts or interpreted them incorrectly (e.g. considered that all of the increase in comparator airports’ asset betas over the pandemic period was due to the pandemic, incorrectly interpreted the bonds data when calculating the cost of index-linked debt, overestimated the importance of investment incentives in H7); and (iv) reached conclusions without a reasonable basis (e.g. assumed that the pandemic neutralised the effect of the capacity constraint on HAL’s beta relative to comparators’ betas, added a premium contrary to investors’ expectation that index-linked debt carries lower risk, failed to consider the specific circumstances of the H7 price control).
- (b) It was wrong in law, pursuant to section 26(b) of the Act. This is for reasons including that the CAA: (i) acted contrary to its primary duty under section 1(1) of the Act to further the interests of consumers regarding the range, availability, continuity, cost and quality of AOS (in particular by failing to take account of the consumer harm as a result of aiming straight); (ii) acted contrary to its duty to promote economy and efficiency on the part of HAL in its provision of AOS at Heathrow Airport under section 1(3)(c) of the Act (in particular by failing to consider the protections afforded to HAL across each building block in a holistic way when selecting the point estimate and by over-compensating investors at the expense of consumers); (iii) relied on flawed evidence and assumptions (e.g. relied on the Q6 asset beta to establish HAL’s pre-pandemic asset beta, relied on out-dated pre-pandemic figures for the comparator set when making the adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports, assumed that there were factors other than traffic risk accounting for the difference in risk between HAL and other regulated utilities); (iv) failed properly to inquire (e.g. failed to properly analyse whether there has been a relaxation in HAL’s capacity constraints since Q6 relative to the comparator airports, failed to analyse factors mentioned by CEPA that it stated could account for the difference in the risk differential between HAL and network utilities, failed to consider the holistic impact of the numerous layers of protection that the

³²⁷ WACC Report [Vol A / Tab 123 / p. 11,102 / para 121].

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CAA has afforded HAL); (v) failed to take proper account of relevant considerations (e.g. failed to consider its own analysis of the projected passenger numbers throughout H7 when considering the impact of the pandemic on HAL's capacity constraints, failed to take proper account of its own analysis that the principal distinction between HAL's and network utilities' asset betas is HAL's exposure to volume risk, failed to take into account the simple average difference between HAL's index-linked bonds and iBoxx spreads, failed to properly consider the impact of various factors relevant to the choice of the WACC point estimate); (vi) reached conclusions without adequate supporting evidence (e.g. considered that there were factors other than traffic risk accounting for the difference in risk between HAL and regulated utilities, considered that there were no uncompensated asymmetries in the price control); (vii) made methodological errors (e.g. selected the wrong data when setting the pre-pandemic asset beta, relied on a WLS estimator and combined pandemic and non-pandemic periods when calculating the impact of the pandemic on comparator airports, relied on a weighted average when comparing HAL's index-linked bonds and iBoxx indices, did not follow the correct methodology to calculate the adjustment to the cost of the index-linked debt, used the mid-point to measure central tendency when calculating the risk of pandemic events); and (viii) acted in defiance of logic (e.g. failed to conclude that traffic risk accounts for a higher percentage of the differential between HAL's and the utilities' asset betas than 50%-90%).

- (c) There were errors made in the exercise of a discretion, pursuant to section 26(c) of the Act. This is for reasons including that the CAA: (i) failed to take relevant factors into account (e.g. the holistic impact of the proposals on HAL and the consumers, HAL's financial position); (ii) failed to meet any of its own key consumer interest objectives (because the decision to aim straight in the WACC range harms the interests of consumers); (iii) failed to achieve its stated intent of ensuring that passenger charges were "*no higher than necessary*"; (iv) failed appropriately to balance competing considerations (e.g. when considering the trade-off between welfare effects and investment); and (v) made erroneous methodological choices (e.g. there was no good reason for the departure from the standard econometric practises of using 'slope dummy' or separate regression models when calculating the impact of the pandemic on comparator airports).

5.111 These statutory grounds are set out and explained in more detail in Annex 2.

E. Relief sought

5.112 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the Act to set the vanilla WACC at 3.18%, and substitute its own decision which sets the vanilla WACC at 2.46% as per Table 12 of the WACC Report.

5.113 In accordance with the overriding objective, the Appellant will provide all such assistance to the CMA as is necessary to secure the implementation of the required relief within the CMA's statutory timetable.

SECTION 6: GROUND 3 – RAB ADJUSTMENT

A. Overview

- 6.1 Ground 3 concerns the CAA's decision to make an ex post £300 million (in 2018 prices) upward adjustment to HAL's RAB (the **RAB adjustment**) in response to the impact of the Covid-19 pandemic. The RAB adjustment is retained in the H7 Final Decision and implemented by way of modification to HAL's Licence.³²⁸
- 6.2 The RAB adjustment results in a RAB which, contrary to the CAA's statements, does not reflect "*the value of the investments that HAL has made in its regulated business*".³²⁹ It creates a significant and lasting distortion to airport charges and unreasonably benefits HAL's investors at consumers' expense. It was not justified or necessary and was (unsurprisingly) ineffective in incentivising HAL to invest in preparation for the return of passenger demand. The CAA's refusal to make use of the "*additional [consumer] protections*" it put in place and review the RAB adjustment – despite clear evidence of HAL's failure to deliver and repeated stakeholder requests – is in breach of its earlier commitment.³³⁰ It has resulted in an erroneous H7 Final Decision which "*preserve[s]*"³³¹ and "*retain[s]*" the RAB adjustment and its associated consumer harm.³³² Further details about the CAA's decision to make and retain the RAB adjustment are provided in sub-section B.
- 6.3 The Appellant submits that the CAA made two significant errors in the H7 Final Decision with regard to the RAB adjustment. These errors are summarised below and described in more detail in sub-sections C and D:
- (a) the **RAB Adjustment error** – which concerns the CAA's error in making the RAB adjustment, as it is unjustified, unnecessary and harmful to consumers; and
 - (b) the **Failure to Review error** – which concerns the CAA's failure to review the RAB adjustment before reaching the H7 Final Decision and to reverse or reduce that adjustment in light of clear evidence of HAL's failure to deliver on its specified investment commitments and on capacity and quality of service.
- 6.4 The Appellant contends that the CAA's H7 Final Decision with regard to the RAB adjustment was based on errors of fact, law and discretion and was therefore wrong within the meaning of section 26 of the Act. These legal consequences are summarised in sub-section E and explained in more detail at Annex 3.
- 6.5 The CAA's errors are material. The RAB adjustment will cost the Appellant on average an additional £0.17 per passenger in airport charges over the H7 price control period.³³³ Further details of the effect on Delta are set out in Section J of CW1. The impact will continue beyond 2026 at levels dependent on the depreciation rate and the WACC in force in future price controls. More generally, it will cost consumers £338.48 million (in 2021 prices) in net present value (**NPV**) terms³³⁴ – and even more in cash terms – with payments being made over multiple price control periods. The RAB adjustment is also damaging to regulatory integrity, and there are important points of economic and regulatory principle at stake which have the potential to affect future price controls.

³²⁸ H7 Final Decision Appendix C [Decision / Tab 6 / p.265 / Condition C1.4].

³²⁹ H7 Final Decision Section 3 [Decision / Tab 4 / p.184 / para 10.1].

³³⁰ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3418 / para 3.63].

³³¹ H7 Final Decision Summary [Decision / Tab 1 / p.15 / para 54].

³³² H7 Final Decision Section 3 [Decision / Tab 4 / p.197 / para 10.73].

³³³ Calculated by AlixPartners on the basis of the CAA's PCM.

³³⁴ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.349 / Table 10.2].

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- 6.6 In terms of relief, the Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the Act insofar as it implements the RAB adjustment and that the RAB adjustment be removed from HAL's Licence, as explained in sub-section F.
- 6.7 The key evidence that the Appellant requests the CMA reads when considering this ground is:
- (a) the H7 Final Decision (paragraph 54 of the Summary Document and Chapter 10 of Section 3: (Financial Issues and Implementation) entitled 'The H7 Regulatory Asset Base' (pages 45-59));
 - (b) the H7 Final Proposals (paragraphs 74-79 of the Summary Document and Chapter 10 of Section 3: (Financial Issues and Implementation) entitled 'The H7 Regulatory Asset Base and HAL's request for a RAB adjustment' (pages 87-109));
 - (c) the April 2021 RAB Adjustment Decision;
 - (d) CW1, in which Chris Walker on behalf of the Appellant describes key aspects of the Q6 price control, the objectives of and background to the H7 price control including the RAB adjustment, the material impact of the RAB adjustment, HAL's failure to deliver on its specified investment commitments and on capacity and quality of service, and the CAA's failure to review and to reverse or reduce the RAB adjustment; and
 - (e) the RAB Report prepared by AlixPartners LLP.

B. The CAA's decision

- 6.8 In this section and in CW1, the Appellant more fully describes the substantive and procedural background to the RAB adjustment.
- 6.9 **HAL's Application:** On 27 July 2020, HAL requested that the CAA make an upward adjustment to its RAB in order to reflect the shortfall in revenues it expected to recover in 2020 and 2021 due to the impact of the Covid-19 pandemic on its business.³³⁵ HAL stated that a RAB adjustment was "*a principled long-term regulatory solution*"³³⁶ which would: "*allow greater investment in 2021*"³³⁷; "*lead to lower charges in H7*"; avoid long-term increases in HAL's cost of capital; increase the viability of HAL's expansion; and support airlines to restore traffic volumes. HAL stated that without such adjustment, the RAB model would result in a "*calamitous*" permanent loss of value and long-term equity and financeability for HAL.
- 6.10 On 4 August 2020, AOC and LACC requested that HAL's Application be withdrawn. AOC and LACC stated that a RAB adjustment would be "*unprecedented*" and that "*HAL's actions and approach ... are neither considered appropriate nor supported*".³³⁸ It said "*that it is not for, nor in the interests of, consumers to fund an adjustment of the RAB to solve HAL's issues ... some of which follow business decisions it has made*".³³⁹ It further noted that "*HAL must consider and exhaust all other sources of funding up to and including an appropriate equity injection from owners*".³⁴⁰
- 6.11 **October 2020 Consultation:** On 9 October 2020, the CAA published a consultation seeking views on HAL's request for a RAB adjustment, the CAA's approach to assessing that request, the CAA's initial assessment, and the CAA's proposed next steps and timetable:

³³⁵ HAL, Application for Covid-related RAB Adjustments – Final Submission (**HAL's Application**) [Vol A / Tab 32].

³³⁶ HAL's Application [Vol A / Tab 32 / p.2495].

³³⁷ HAL's Application [Vol A / Tab 32 / p.2501 / second paragraph].

³³⁸ Letter from AOC and LACC to HAL regarding Airline Community feedback re HAL's Application for RAB Adjustment dated 4 August 2020 [Vol A / Tab 126 / p.11,201].

³³⁹ Letter from AOC and LACC to HAL regarding Airline Community feedback re HAL's Application for RAB Adjustment dated 4 August 2020 [Vol A / Tab 126 / p.11,202].

³⁴⁰ Letter from AOC and LACC to HAL regarding Airline Community feedback re HAL's Application for RAB Adjustment dated 4 August 2020 [Vol A / Tab 126]. See also the two responses to HAL's Application from AOC/LACC/IATA (on behalf of the airline community at Heathrow), dated 18 August 2020 [Vol A / Tab 127] and 10 September 2020 [Vol A / Tab 128] respectively.

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- (a) The CAA acknowledged that the sector was facing “a severe and prolonged downturn, and the path of any further recovery is highly uncertain”.³⁴¹ It stated: “In simple terms, increasing HAL’s RAB at the start of 2022 would allow it to increase charges to airlines in future years.”³⁴²
- (b) The CAA noted that airlines had objected to HAL’s Application and had suggested that HAL had been too slow to introduce efficiency savings; HAL should seek additional support from its shareholders given that its problems, in part, arose from the high level of gearing it had adopted (far exceeding that allowed for the ‘notional’ company); the returns made by HAL’s shareholders during the Q6 price control period were excessive and no further assistance was warranted; HAL’s comparisons with the adjustments made at other regulated airports for the impact of the Covid-19 pandemic were misleading; regulatory intervention would be inconsistent with the Q6 regulatory framework, which was based on the assumption that HAL would be responsible for managing traffic volume risks; and no other major airport (or airline) in the UK was seeking to compensate its shareholders for loss of revenue by increasing its prices to consumers and it would not be appropriate for the only airport subject to full price control regulation to be allowed to do so.³⁴³
- (c) The CAA concluded that the evidence HAL had provided “so far falls short of that required robustly to justify its claims that “urgent support/action is necessary”” and that any such support should be in the form and of the scale in HAL’s request.³⁴⁴
- 6.12 **Response to October 2020 Consultation:** In response to the October 2020 Consultation, HAL stated that, as a result of lower traffic forecasts since its Application, its requested RAB adjustment had increased to £2.8 billion.³⁴⁵ Responses from airlines continued to object, and suggested that a RAB adjustment would be neither appropriate nor in the interests of consumers. The Appellant supported the CAA view that there was no evidence for an urgent intervention or adjustment,³⁴⁶ and VAA, stated that it was “wholly unreasonable for HAL to seek a RAB adjustment when it has significantly outperformed for most of the period”.³⁴⁷
- 6.13 **February 2021 Consultation:** On 5 February 2021, the CAA published a consultation document setting out its latest views. The CAA stated that the impact of the Covid-19 pandemic was clearly exceptional, outside HAL’s control and beyond the levels of previous traffic shocks experienced by HAL.³⁴⁸ It concluded that, in these exceptional circumstances, there was a “reasonable expectation” that the CAA should consider what interventions would further the interests of consumers in accordance with its primary statutory duty.³⁴⁹ The CAA emphasised that, as part of the Q6 settlement it had “set out no clear expectation... as to what, if any, specific actions [it] would take if [it] were to re-open the price control” and that it had “made no explicit commitment to protect HAL from the impact of extreme traffic shocks”.³⁵⁰
- 6.14 **Response to February 2021 Consultation:** Airlines continued to oppose any regulatory intervention by the CAA, stating that “HAL have repeatedly demonstrated that they do not have any issues relating to liquidity or financeability”.³⁵¹ HAL’s recent debt investor updates had signalled there was no immediate danger of HAL breaching its financing covenants and that HAL had sufficient liquidity to continue in operation even under severe downside traffic scenarios.³⁵² Airlines considered that HAL had a sufficient capital plan in place without any

³⁴¹ October 2020 Consultation [Vol A / Tab 33 / p.2,538 / para 2].

³⁴² October 2020 Consultation [Vol A / Tab 33 / p.2,539 / para 4].

³⁴³ October 2020 Consultation [Vol A / Tab 33 / p.2,540 / para 12].

³⁴⁴ October 2020 Consultation [Vol A / Tab 33 / p.2,543 / para 16].

³⁴⁵ Heathrow, Economic regulation of Heathrow: response to its request for a covid-19 related RAB adjustment (CAP1966), Heathrow’s response [Vol A / Tab 124] and CAA, Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098) [Vol A / Tab 53 / p.5,762].

³⁴⁶ Delta, Response to Heathrow RAB adjustment (CAP1966) [Vol A / Tab 101].

³⁴⁷ VAA, Response to HAL’s RAB adjustment application (CAP1966) [Vol A / Tab 102].

³⁴⁸ February 2021 Consultation [Vol A / Tab 53 / p.5,772 / para 1.7].

³⁴⁹ February 2021 Consultation [Vol A / Tab 53 / p.5,772 / para 1.7].

³⁵⁰ February 2021 Consultation [Vol A / Tab 53 / p.5,772 / para 1.8].

³⁵¹ LACC and AOC, Response to Heathrow RAB adjustment (CAP2098) [Vol A / Tab 104 / p. 10,038].

³⁵² BA, Response to Heathrow RAB adjustment (CAP2098) [Vol A / Tab 105 / p.10,079 / para 8.1.1].

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intervention by the CAA to allow it to maintain service quality to consumers, carry out essential maintenance activity and re-open Terminal 4 when demand so required.³⁵³

6.15 **April 2021 RAB Adjustment Decision:** On 27 April 2021, the CAA published the April 2021 RAB Adjustment Decision.

- (a) The CAA stated that it had decided *“that the best way ... to further the interests of consumers ... in response to the issues raised by HAL’s request is by making a targeted and focused regulatory intervention ahead of the H7 price review.”*³⁵⁴ This early regulatory intervention would be in the form of a RAB adjustment of £300 million.³⁵⁵ The CAA considered that either not intervening or making an adjustment of the scale proposed by HAL would not meet its duties.³⁵⁶
- (b) With regard to quantum, the CAA stated:
- (i) *“...our projections show that a RAB adjustment of £300 million will reduce HAL’s notional gearing below an important threshold used to assess consistency with strong investment grade finance and should provide an important signal that the regulatory framework is consistent with enabling the notional company to continue to access cost effective debt finance”*,³⁵⁷ and
- (ii) *“HAL has set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 and beyond. This includes investment to provide appropriate capacity at the airport if there is a particularly strong recovery in demand. We consider that an intervention that provides gearing headroom above its level of planned investment, for example, in the range £230 million to £300 million, would provide a clear and strong incentive for HAL to: undertake any necessary investment; maintain service quality; and provide necessary capacity during 2021.”*³⁵⁸
- (c) The CAA considered that additional protections – in the form of a review mechanism – should be put in place to mitigate the risks that consumers did not benefit from the RAB adjustment. It stated: *“ ... if evidence were to emerge of HAL failing to deliver on an appropriate quality of service in 2021, we will conduct a review of these matters. ... In the event that such a review were to show that HAL had not responded appropriately ... we would consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue. The existing Service Quality Rebates and Bonus scheme provides metrics that can help to give an early indication of any issues with service quality”*.³⁵⁹ The CAA further stated that any reduction in the RAB adjustment or offsetting reduction to revenues would not *“double count”* any Service Quality Rebate and Bonus (**SQRB**) scheme³⁶⁰ penalties that HAL might have incurred or disallow any efficient costs that HAL had incurred to meet the increased demand experienced, and indicated that it would *“look to provide further guidance on this review as part of the H7 price control review”*.³⁶¹
- (d) In terms of timing, the CAA stated:
- (i) *“... The approach we have decided to adopt does not require any immediate modifications to be made to the price control conditions in HAL’s licence and will*

³⁵³ VAA, Response to Heathrow RAB adjustment (CAP2098) [Vol A / Tab 103 / p.10,032 – 10,033].

³⁵⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 5].

³⁵⁵ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,390 / para 27].

³⁵⁶ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,388 - 3389 / paras 20 – 22].

³⁵⁷ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,390 / para 28].

³⁵⁸ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,423 / para 4.16].

³⁵⁹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 32].

³⁶⁰ The Service Quality Rebate and Bonus Scheme was introduced by the CAA to identify the service standards that airlines and passengers could expect from Heathrow in return for the regulatory charges they paid. Where performance falls below a certain level, Heathrow must repay a proportion of charges levied back to the airlines. It is a Licence Condition in Q6. See [Vol A / Tab 34 / p.2,569].

³⁶¹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,424 / para 4.25].

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not have any impact on airport charges in 2021. ... This decision will, however, be reflected in the modifications we make to HAL's licence to implement the H7 price control, which we anticipate will come into effect in 2022,³⁶² and

- (ii) *"It would be undesirable for us to reverse interventions we make now during the H7 process unless HAL were to manifestly fail to deliver on investment or quality of service. This could undermine both investor expectations and our credibility."*³⁶³

6.16 **H7 Initial Proposals:** On 19 October 2021, the CAA's H7 Initial Proposals confirmed the April 2021 RAB Adjustment Decision to apply a targeted £300 million RAB adjustment, and concluded that no further RAB adjustment was appropriate.³⁶⁴ The CAA also stated that it did not *"propose to adopt the suggestions made by airlines that we reverse the RAB adjustment set out in our April 2021 RAB Adjustment Decision..."*.³⁶⁵

6.17 **Response to H7 Initial Proposals:** The CAA received a significant number of responses to its H7 Initial Proposals, including responses from the Appellant and VAA noting their disagreement with the RAB adjustment and their request for it to be *"reversed in a structured manner"*.³⁶⁶ The airline community made a number of requests for the CAA to initiate a review of the RAB adjustment.

6.18 **H7 Final Proposals:** On 28 June 2022, the CAA published its H7 Final Proposals.

- (a) The CAA retained the £300 million RAB adjustment and concluded that any further RAB adjustment would not further the interest of consumers regarding the range, availability, continuity, cost and quality of AOS or be necessary to support the efficient financing of HAL.

- (b) Of particular relevance, the CAA stated:

- (i) *"We have considered the suggestion made by some airlines that we should reverse the £300m RAB adjustment we applied in the April 2021 RAB Adjustment Decision. For the avoidance of doubt, the April 2021 RAB Adjustment Decision was intended to be our final decision to give effect to the inclusion of the £300m in HAL's opening RAB for H7 RAB. Bearing this in mind, there is a relatively high evidential threshold for us to consider reversing this decision. We would, for example, need to consider the adverse impact that this would have on investor confidence and hence on HAL's cost of capital and the level of airport charges. Nonetheless, this change will be put into effect through the same licence modifications that will introduce the H7 price control. As such, airline stakeholders will be able to appeal this decision to the CMA if they disagree with our reasoning and approach to these matters. We also note that the reversal of amounts previously included in the RAB has also been explicitly proscribed in a previous CMA [sic] appeal. In the appeal by Phoenix Gas Networks of its price control in 2021 [sic], the CMA [sic] was clear that it would not be appropriate for a regulator to seek to reverse, ex post, amounts previously added to the RAB"*.³⁶⁷
- (ii) *"We reached the April 2021 RAB Adjustment Decision with the expectation that HAL would be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during 2021 in the event of a stronger than expected recovery in passenger traffic. The recovery in passenger numbers was, in fact, relatively subdued during 2021. As such, it is not clear to us that it would have been in consumers' interests for HAL to have undertaken a materially greater volume of capital expenditure in that year than it did in practice. Nonetheless, it*

³⁶² April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 6].

³⁶³ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,437 / para C20].

³⁶⁴ H7 Initial Proposals Section 2 [Vol A / Tab / p.659 / para 6.18 and p.671 / para 6.72].

³⁶⁵ H7 Initial Proposals Section 2 [Vol A / Tab / p.659 / para 6.14].

³⁶⁶ VAA (and Delta), Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 111] and Delta, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 109].

³⁶⁷ The [sics] in the quote are included as the correct date of the decision referred to is 2012 and the decision maker was the Competition Commission not the CMA. H7 Final Proposals Section 3 [Vol A / Tab 4 / p.341 - 342 / para 10.87].

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was important to have allowed HAL the flexibility to respond to changing circumstances and, on this basis, we continue to consider that the £300m RAB adjustment was warranted”³⁶⁸ and

- (iii) *“If it is appropriate, we will review HAL’s operational performance in ... Autumn [2022], with a view to ensuring that the interests of consumers are properly protected.”³⁶⁹*

6.19 **Response to H7 Final Proposals:** In response to the H7 Final Proposals, the Appellant and VAA noted their disappointment at the CAA’s decision not to reverse the £300 million adjustment *“particularly in light of recent events whereby HAL has unilaterally acted to restrict the capacity of airlines due to its failure to put in place sufficient resources and /or to build adequate resilience within its infrastructure to meet passenger demand”³⁷⁰* They acknowledged *“the CAA’s comments that it will undertake a review of the validity of the £300 million RAB adjustment if it considers it appropriate to protect the interests of consumers”³⁷¹* and urged *“the CAA to commence this review in the interests of consumers, to complete its assessment before the CAA’s Final Determination is taken, and to publish its decision to provide clear accountability and transparency to consumers.”³⁷²*

6.20 **H7 Final Decision:** On 8 March 2023, the CAA published its H7 Final Decision, which *“retained”* the position on the RAB adjustment as set out in the H7 Final Proposals and *“preserved”* the £300 million adjustment set out in the April 2021 RAB Adjustment Decision and the H7 Final Proposals.³⁷³ The modifications that the CAA decided to make to the Licence are set out in Appendix C to the H7 Final Decision and will come into effect on 1 May 2023.³⁷⁴ The RAB adjustment is embedded in New Licence Condition C1.4, as more fully described in Annex A1 to the RAB Report.³⁷⁵

C. The RAB Adjustment error

6.21 In this section, the Appellant describes the RAB Adjustment error made by the CAA. The Appellant submits that the CAA erred in making the RAB adjustment because it is unjustified, unnecessary and harmful to consumers.

Error 1(a): The CAA’s RAB adjustment is unjustified

6.22 First, the RAB adjustment is wrong as a matter of regulatory principle and having regard to its practical consequences. This is because:

- (a) HAL’s RAB is a financial and regulatory construct intended to represent the value of efficient investments made by HAL in its regulated business which investors can expect – although, as the CAA notes in the H7 Final Decision, there is no guarantee³⁷⁶ – to recoup and earn a return on (consistent with the concept of ‘return of the RAB, return on the RAB’). These investments will include capital assets with long lifetimes, such as new terminal space.
- (b) Rather than recovering these capex costs in a single period – which could result in sharp increases in airport charges and volatility – they are incorporated into HAL’s RAB and recovered over time through regulatory depreciation included in the airport charge calculation. As such, HAL’s depreciation charges in any given price control period partly relate to capital investments made in previous periods (which continue to be depreciated) and partly relate to new capital investments made during that price control period.

³⁶⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.80].

³⁶⁹ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.345 / para 10.87].

³⁷⁰ H7 Final Proposals – Joint Response [Vol A / Tab 115 / p.10,468 / para 1.19.2].

³⁷¹ H7 Final Proposals – Joint Response [Vol A / Tab 115 / p.10,470 / para 1.19.9].

³⁷² *Ibid.*

³⁷³ H7 Final Decision Summary [Decision / Tab 1 / p.17 / para 54].

³⁷⁴ H7 Final Decision Appendix C [Decision / Tab 6 / p.260 / para C9].

³⁷⁵ RAB Report, Annex A1 [Vol A / Tab 122 / p.11,052 / Annex A1].

³⁷⁶ H7 Final Decision Section 3 [Decision / Tab 4 / p.184 / para 10.1].

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- (c) HAL is thus incentivised to grow the RAB rather than be efficient. However, the CAA scrutinises HAL's capital investment delivery so that only capex deemed to have been incurred efficiently is incorporated into HAL's RAB (see further paragraphs 2.2.3 to 2.2.6 of the RAB Report).³⁷⁷ Examples of this can be seen in the H7 Final Decision.³⁷⁸
- (d) The Appellant notes that this is also the approach in other regulated sectors, including in relation to nuclear energy, where the government has recently made clear that costs can only be incorporated into the RAB where they meet specific criteria.³⁷⁹
- (e) The importance attached to the RAB reflects its role as a key component of the CAA's economic regulation of HAL and the regulated airport charge. Specifically:
- (i) Allowed return: The CAA determines an allowed return for HAL each year on the undepreciated part of HAL's efficient investments that remain in the RAB.³⁸⁰ This is because, as airports require a significant amount of capital investment, HAL needs to be able to raise finance from investors. The return is calculated as a percentage rate of return on the value of the RAB; so the size of HAL's allowed return varies in proportion to the size of the accumulated RAB.
 - (ii) Regulated airport charge: The CAA's airport price cap is defined in terms of a maximum amount of revenue per passenger passing through the airport. The CAA uses a 'single till' covering both regulated and non-regulated (commercial) activities such as car parking and retail outlets. To arrive at the regulated airport charge, the CAA deducts HAL's forecast commercial revenues before dividing HAL's forecast total cost in each year (two elements of which are regulatory depreciation and the allowed return on the RAB) by the forecast passenger volumes in each year.
- (f) Appropriate use of the RAB is therefore critical in ensuring that HAL is only compensated for the efficient costs of assets it has paid for, and that compensation is spread over the useful life of assets in a manner that is fair to consumers. As set out at paragraph 2.2.7 of the RAB Report,³⁸¹ the integrity of the RAB – as an instrument of incentivisation that operates to the benefit of consumers – must be maintained.
- (g) Making any ex post adjustment to the value of the RAB is thus a significant step – both as a matter of regulatory principle and having regard to the practical consequences which flow from such adjustment. It also goes against the principles of good ex ante regulation because it is, necessarily, backward looking and poorly targeted.
- (h) Against this backdrop, the Appellant makes the following submissions:
- (i) The CAA's £300 million upward adjustment of HAL's RAB is not, contrary to the CAA's assertion, "*reasonable and appropriate*"³⁸² as it artificially inflates HAL's RAB with the result that it no longer represents the value of efficient investments that HAL has made in its regulated business.
 - (ii) This is, as stated at paragraph 2.6.2 of the RAB Report,³⁸³ entirely contrary to the key principle of the RAB and incentive regulation. It dismantles the financial and

³⁷⁷ RAB Report [Vol A / Tab 122 / p. 11,031 / para 2.2.3 – 2.2.6].

³⁷⁸ For example, in Appendix D to the Final Decision (Q6 Capex Review), the CAA – pursuant to an ex post review, including an efficiency assessment, of the capex incurred by HAL during the Q6 period – reduces HAL's opening RAB by £12.7m to reflect inefficiencies identified in relation to spending on the Cargo Tunnel project [Decision / Tab 7 / Appendix D].

³⁷⁹ Department for Business, Energy & Industrial Strategy, Guidance on development costs and the nuclear Regulated Asset Base model [Vol A / Tab 35].

³⁸⁰ As the CAA stated, the RAB "*reflects the value of the investments that HAL has made in the regulated business. We set price controls on the basis that HAL can expect (but does not have a guarantee) that it will: recover its efficiently incurred investments over the life of the relevant assets, through the allowances we make for regulatory depreciation; and earn a return on that investment each year on the undepreciated part of that investment that remains in the RAB.*" [Vol A / Tab 4 / p.328 / para 10.1]

³⁸¹ RAB Report [Vol A / Tab 122 / p.11,031 / para 2.2.7].

³⁸² H7 Final Decision Section 3 [Decision / Tab 4 / p.189 / para 10.22].

³⁸³ RAB Report [Vol A / Tab 122 / p.11,043 / para 2.6.2].

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regulatory construct in order to allow HAL to recover a greater amount – as the per passenger charge, calculated on the basis of the inflated RAB, is artificially increased.

- (iii) The CAA's decision to make and retain the RAB adjustment therefore benefits HAL – and its investors – at the expense of consumers, despite traffic risk being a cost for HAL to bear and no identifiable benefit for consumers being delivered. Indeed, whilst the CAA does not characterise the RAB adjustment as compensation for pandemic losses – which, as set out at paragraph 2.2.8 of the RAB Report,³⁸⁴ would be a wholly invalid use of the RAB – the Appellant notes that is, in effect, what it becomes, particularly when permitted to be retained despite HAL's manifest failure to deliver on its specified investment commitments.
- (iv) In fact, as explained more fully below, this is a 'bad regulatory bargain' for consumers on any analysis, as they have neither received nor will receive anything equivalent in return for their £300 million investment. It is akin to "*a value transfer from consumers to HAL, with no offsetting benefit ... for consumers*",³⁸⁵ which is how the CAA correctly categorised HAL's requests for a RAB adjustment to compensate it for its historic pandemic related losses.
- (v) The unjustified "*transfer of value from consumers to shareholders*",³⁸⁶ is contrary to the CAA's statement in the H7 Final Decision that: "*To further the interests of consumers, we have sought to ensure that HAL's future charges will be 'no higher than necessary' in the sense of representing appropriate value for money.*"³⁸⁷ This is important to the Appellant, not least because Heathrow Airport is already more expensive than all relevant comparator airports (as more fully detailed in the joint presentation to the CAA Board on behalf of the airline community on 4 May 2022).³⁸⁸
- (vi) It is also, notably, contrary to the approach being taken by other regulators around the world.³⁸⁹
- (vii) The result of the CAA's RAB adjustment is that airlines, and ultimately consumers, will be 'compensating' HAL for many years to come. It will cost consumers £338.48 million in NPV terms³⁹⁰ – and even more in cash terms – with payments being made over multiple price control periods.
- (viii) This undermines the long-term predictability of and confidence in the RAB model as a whole – which is utilised across a range of regulated sectors – and consumer legitimacy.
- (ix) As set out in paragraph 2.2.5 of the RAB Report,³⁹¹ adjustments to the RAB must be strictly justified in order not to distort its primary purpose. The Appellant submits that this requirement was not satisfied in respect of the CAA's £300 million adjustment which is "*retained*" and "*preserved*" in the H7 Final Decision.³⁹²

6.23 Second, insofar as the RAB adjustment becomes, in effect, a compensation for historic pandemic losses, the RAB adjustment is inconsistent with the Q6 price control and amounts to an unjustified 'double recovery' from consumers. This is because:

³⁸⁴ RAB Report [Vol A / Tab 122 / p.11,031 / para 2.2.8].

³⁸⁵ H7 Final Decision Section 3 [Decision / Tab 4 / p.204 / para 11.31].

³⁸⁶ H7 Final Decision Section 3 [Decision / Tab 4 / p.197 / para 10.62].

³⁸⁷ H7 Final Decision Summary [Decision / Tab 1 / p.6 – 7 / para 5].

³⁸⁸ VAA, BA, IATA and AOC, Airline community views: Heathrow H7 Pre-Final Proposals [Vol A / Tab 36 / Page 2,589 – 2,590].

³⁸⁹ IATA, Rising airport charges threaten recovery (webpage), accessed 16 April 2023 [Vol A / Tab 37].

³⁹⁰ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.349 / Table 10.2].

³⁹¹ RAB Report [Vol A / Tab 122 / p. 11,031 / para 2.2.5].

³⁹² H7 Final Decision Summary [Decision / Tab 1 / p.17 / para 54].

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- (a) The Q6 price control was concluded on the basis that HAL assumed all traffic volume risk.³⁹³ This is confirmed by the CAA in the H7 Final Decision – which states that it “*unambiguously and explicitly allocated all traffic risk to HAL*”³⁹⁴ – and is also clear on a review of the underlying documentation.
- (b) More particularly:
- (i) The H7 Final Proposals state: “*The Q6 review took place after a period in which traffic volumes had been adversely affected by a number of downside events (such as the 2010 volcanic eruption in Iceland). During this review, HAL once again asked the CAA to consider the regulatory treatment if what HAL saw as an asymmetry in traffic risks. In its Q6 final proposals, the CAA accepted that the evidence from the preceding two decades indicated that HAL was exposed to risks relating to external downside shocks. The CAA responded to this evidence by including a shock factor within its Q6 traffic forecasts. The CAA was also clear that the financial consequences that could subsequently arise from differences between actual and forecast volumes would sit with HAL’s shareholders.*”³⁹⁵ (emphasis added)
 - (ii) The Q6 Final Proposals state: “*The risk that the out-turn is different is borne by the company and its shareholders. The CAA therefore allows a higher rate of return for the company than would otherwise be the case to compensate for this risk.*” (emphasis added). Near-identical language was also included in the CAA’s notice of the proposed licence³⁹⁶ and notice granting the licence³⁹⁷.
 - (iii) The clarity and extent of the risk allocation was underlined by the CAA in its H7 Final Proposals as follows: “... we consider that the CAA was clear, and that HAL’s investors should have understood, that downside risks, including pandemic-related risks, were expected to be borne by HAL in accordance with the risk allocation set out in the CAA’s Q6 final proposals document. We also note that HAL had the option of appealing the Q6 price control settlement to the CMA and chose not to exercise that option.”³⁹⁸ (emphasis added)
- (c) It is also clear from the documents referenced above that HAL’s assumption of traffic volume risk was reflected, in particular, through an elevated WACC relative to that of other network utilities facing less volume volatility and a shock factor adjustment applied to artificially reduce passenger forecasts.
- (d) The Appellant submits that, logically, this means consumers have already paid HAL for holding traffic volume risk during the Q6 control period and that the crystallisation of that risk results in a loss which is properly for HAL to bear in accordance with its agreed regulatory settlement.
- (e) In circumstances where the RAB adjustment has become, in effect, a compensation for Covid-19 related losses, the CAA’s RAB adjustment therefore amounts to an unjustified ‘double recovery’ from consumers.
- 6.24 Third, there are other, more appropriate and proportionate regulatory tools and mechanisms at the CAA’s disposal to mitigate uncertainty for investors arising out of the Covid-19 pandemic.
- 6.25 In the H7 Final Decision, the CAA has taken a number of significant steps to manage and address heightened investor perceptions of risk in HAL. For example:

³⁹³ CAA, Economic regulation at Heathrow from April 2014: Notice granting the licence (CAP1151) [Vol A / Tab 39 / p. 3211 / para B14].

³⁹⁴ H7 Final Decision Section 3 [Decision / Tab 4 / p.190 / para 10.30].

³⁹⁵ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.333 / para 10.27].

³⁹⁶ CAA, Economic regulation at Heathrow from April 2014: Notice of the proposed licence (CAP1138) [Vol A / Tab 38 / p.2,795 / para B14].

³⁹⁷ CAA, Economic regulation at Heathrow from April 2014: Notice granting the licence (CAP1151) [Vol A / Tab 39 / p.3,211 / para B14].

³⁹⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.333 / para 10.29].

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- (a) **TRS mechanism:** The CAA has introduced a new TRS mechanism – forming part of HAL’s Licence³⁹⁹ – which seeks to address the impact of heightened traffic risk and reduce HAL’s exposure to future shocks.
- (i) Under the TRS mechanism, if passenger volumes in each individual year are lower than those forecast by the CAA, then HAL is protected against lower revenues. If volumes exceed those assumed by the CAA, then any benefits will be shared with customers through lower airport charges.⁴⁰⁰
 - (ii) The CAA states that the TRS mechanism “*is intended to provide HAL with a relatively high degree of protection from the impact of extreme events*”⁴⁰¹ and “*offers much more protection to shareholders than was available under the Q6 arrangements*”.⁴⁰²
 - (iii) Indeed, the assumption in the H7 Final Decision is that the TRS mechanism mitigates approximately 50% of HAL’s overall volume risk.⁴⁰³ More particularly, it estimates that the risk sharing factors will protect HAL from around 43-45% of the expected impact on its EBITDA of traffic changes in the central band, and between 91-94% of the expected impact on its EBITDA of traffic changes in the outer band⁴⁰⁴, which is a material level of additional support for shareholders.
- (b) **Asymmetric risk allowance:** The CAA has introduced a new price control building block for H7 in the form of an allowance for asymmetric risk designed to ensure that the ‘notional’ company faces a “*fair bet*”.⁴⁰⁵ It aims to compensate HAL for bearing the downside financial risks around future pandemic-scale events (i.e. low frequency, high impact shocks that cause major disruption to traffic).⁴⁰⁶
- (c) **Higher asset beta:** The CAA has determined a higher asset beta (and correspondingly higher WACC) to reflect its view that HAL, even with a TRS mechanism, is a higher risk investment than conventional network businesses.⁴⁰⁷
- (d) **Inclusion of ‘shock factor’:** The CAA has included a ‘shock factor’ of 0.87% to the years where the number of passengers is a forecast (2023 to 2026) to cover temporary and difficult to predict non-economic downside risks (such as adverse weather, volcanic eruptions, terrorist events and international conflicts).⁴⁰⁸
- (e) **Guidance on price control reopening:** The CAA has issued guidance – set out at Appendix G to the H7 Final Decision – on its approach to responding to any future request to reopen HAL’s price control.⁴⁰⁹

6.26 By contrast, a RAB adjustment is a blunt and unfocused tool. Given that, at the time of the April 2021 RAB Adjustment Decision, the long-term impacts of the Covid-19 pandemic and the likely timing and return of passenger demand were unclear, it is difficult to understand how a RAB adjustment – with its long-term impact on price controls and ultimately on consumers, and its poor incentive properties (see further below) – could ever have been considered an appropriate or proportionate response to any shorter-term issues HAL may have been facing.

³⁹⁹ H7 Final Decision Appendix C [Decision / Tab 4 / p.263 / para C21] setting out a new Condition C1.5. For calculation of the value of the TRS mechanism, see Condition C1.20 to C1.21 [Decision / Tab 6 / p.275], Table C.6 (Traffic Risk Sharing Adjustment) [Decision / Tab 6 / p.275], Table C.7 (Annual Risk Share) [Decision / Tab 6 / p.276], and Table C.8 (Traffic Risk Sharing Adjustment) [Decision / Tab 6 / p.277].

⁴⁰⁰ H7 Final Decision Section 1 [Decision / Tab 2 / p.54 / para 2.20].

⁴⁰¹ H7 Final Decision Section 1 [Decision / Tab 2 / p.55 / para 2.21].

⁴⁰² H7 Final Decision Section 3 [Decision / Tab 4 / p.223 / para 13.40].

⁴⁰³ H7 Final Decision Section 3 [Decision / Tab 4 / p.161 / para 9.85].

⁴⁰⁴ Final Decision Section 1 [Decision / Tab 2 / p.55 / para 2.21].

⁴⁰⁵ H7 Final Decision Section 3 [Decision / Tab 4 / p.60 / para 11.3 and p.205 / para 11.38].

⁴⁰⁶ H7 Final Decision Section 3 [Decision / Tab 4 / p.199 – 200 / para 11.5].

⁴⁰⁷ H7 Final Decision Section 3 [Decision / Tab 4 / p.183 / para 9.213].

⁴⁰⁸ H7 Final Decision Section 1 [Decision / Tab 2 / p.35 / para 1.23 and p.45 / para 1.66].

⁴⁰⁹ H7 Final Decision Section 1 [Decision / Tab 2 / p.49 – 50 / para 2.5 and p.56 and para 2.25].

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- 6.27 In addition, there was another approach that would undoubtedly have led to a fairer and better outcome for consumers. The Appellant notes that it was frequently raised with the CAA during the H7 process that an injection of equity by HAL's shareholders would be appropriate.⁴¹⁰ As set out in CW1, HAL over-achieved regulatory WACC by £844 million and paid dividends totalling £3,597 billion during the Q6 period. However, as the CAA itself noted in the H7 Final Decision, "*during the pandemic, HAL's ultimate owners have not supported the group with additional equity finance, in contrast to the shareholders of many aviation businesses*".⁴¹¹
- 6.28 There is also recent precedent for other sector regulators effectively requiring injections of equity from shareholders, e.g. the case studies of Southern Water, Yorkshire Water and Thames Water are referenced in Ofwat's financial resilience licence modification decision dated 20 March 2023.⁴¹²
- 6.29 In conclusion, the Appellant submits that the CAA's decision to make the RAB adjustment was unjustified and wrong. It was based on errors of fact, wrong in law and an erroneous exercise of a discretion.

Error 1(b): The CAA's RAB Adjustment is unnecessary

- 6.30 The H7 Final Decision states that the CAA has "*retained the position on the RAB adjustment as set out in the Final Proposals and so have preserved the £300 million adjustment set out in the April 2021 RAB Adjustment Decision and the Final Proposals*".⁴¹³ The CAA's rationale for making the RAB adjustment is set out in the April 2021 RAB Adjustment Decision, Section 3 (Chapter 10) of the H7 Final Proposals and Section 3 (Chapter 10) of the H7 Final Decision.
- 6.31 In summary:
- (a) In the April 2021 RAB Adjustment Decision:
 - (i) The CAA stated that "*a RAB adjustment of £300 million (in 2018 prices) ... is a transparent and proportionate intervention that is needed now to further the interests of consumers*" (in accordance with section 1(1) of the Act).⁴¹⁴
 - (ii) It stated that it had reached this decision having regard to:
 - (A) The need to secure that all reasonable demands for AOS at Heathrow Airport are met (in accordance with section 3(b) of the Act). It stated: "*[w]e consider that this intervention will do this by incentivising additional investment by HAL during 2021 that would further the interests of consumers. We expect HAL to be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic*";⁴¹⁵ and

⁴¹⁰ H7 Final Decision: Section 3 [Decision / Tab 4 / p.220 / para 13.26]. in which the CAA acknowledges VAA's submission "*that an injection of cash from shareholders would be beneficial*" and the April 2021 RAB Adjustment Decision which notes [at Vol A / Tab 40 / p.3,397 / para 1.17] the airlines' submissions that HAL has paid significant dividends to its shareholders during Q6 and those shareholders should inject new equity to remedy any financeability issues. See also Letter from AOC and LACC to HAL regarding Airline Community feedback re HAL's Application for RAB Adjustment dated 4 August 2020 [Vol A / Tab 126].

⁴¹¹ H7 Final Decision Summary [Decision / Tab 1 / p.22 / para 74].

⁴¹² Ofwat, Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers [Vol A / Tab 41 / p.3,482 – 3,483]. See also Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report, [Vol A / Tab 42 / p.4,704 / para 10.134]: "*Whilst our financeability analysis is based on the notional company, the water companies also have a licence condition to maintain an investment grade credit rating for their debt, and we consider that if any of the Disputing Companies were facing a financeability constraint, they would be in a position to consider a range of mitigating actions to address impact. This could include absorbing headroom in credit ratios, or requiring a contribution in equity, eg to forego dividends or inject fresh capital.*"

⁴¹³ H7 Final Decision Summary [Decision / Tab 1 / p.17 / para 54].

⁴¹⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 4].

⁴¹⁵ *Ibid.*

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(B) The need to secure that an efficiently (or 'notionally') financed company can finance its licensed activities at Heathrow Airport (in accordance with section 3(a) of the Act). It stated: “[t]his should avoid a higher cost of debt finance for HAL that could increase charges to consumers in the future. We consider that this intervention will do this by providing a strong signal that the regulatory framework is consistent with enabling a notionally financed company to continue to access cost effective grade debt finance”.⁴¹⁶ It further stated: “This intervention should also provide HAL with additional financial flexibility and incentives to carry out appropriate further investment, including the £218 million of capex that HAL set out to maintain service quality across a full range of demand scenarios and provide necessary capacity during 2021”.⁴¹⁷

(b) In the H7 Final Proposals – and in the face of evidence that the RAB adjustment had not in fact been necessary (see further below) – the CAA sought to fall back on a justification of flexibility. Specifically, it stated: “[w]e reached the April 2021 RAB Adjustment Decision with the expectation that HAL would be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during 2021 in the event of a stronger than expected recovery in passenger traffic. The recovery in passenger numbers was, in fact, relatively subdued during 2021. As such, it is not clear to us that it would have been in consumers’ interests for HAL to have undertaken a materially greater volume of capital expenditure in that year than it did in practice. Nonetheless, it was important to have allowed HAL the flexibility to respond to changing circumstances and, on this basis, we continue to consider that the £300m RAB adjustment was warranted ...”.⁴¹⁸ (emphasis added)

(c) In the H7 Final Decision, the CAA stated that it continued to view its approach to the RAB adjustment in the H7 Final Proposals as “reasonable and appropriate”.⁴¹⁹

6.32 The Appellant submits that the CAA erred in reaching the conclusion that the RAB adjustment was necessary for any of these reasons and addresses each of them in turn (noting, as set out at paragraphs 2.3.2 to 2.3.5 of the RAB Report that, to the extent to which they are individually weak or mistaken, they cannot become legitimate in combination).⁴²⁰

Error 1(b)(i) The CAA was wrong to conclude that the RAB adjustment was necessary to ensure notional financeability

6.33 In the April 2021 RAB Adjustment Decision, the CAA – consistent with its own long-standing approach and the approach adopted by other regulators⁴²¹ – declined to take account of HAL’s actual financing and based its analysis of financeability on the notional company structure.⁴²²

6.34 The CAA ultimately concluded that a £300 million RAB adjustment was necessary to “provide a strong signal that the regulatory framework is consistent with enabling a notionally financed company to continue to access cost effective grade debt finance”.⁴²³ However, the CAA recognised elsewhere in the April 2021 RAB Adjustment Decision that, viewed on an actual basis, the evidence suggested that “an early RAB adjustment [was] not necessary to support HAL being able to access investment grade debt or prevent a substantial short term increase in the cost of debt.”⁴²⁴

⁴¹⁶ *Ibid.*

⁴¹⁷ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,390 / para 28].

⁴¹⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.80 – 10.81].

⁴¹⁹ H7 Final Decision Section 3 [Decision / Tab 4 / p.189 / para 10.22].

⁴²⁰ RAB Report [Vol A / Tab 122 / p. 11,033 / para 2.3.2 – 2.3.5].

⁴²¹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,438 / para C25], where the CAA stated: “The use of a notional financial structure is a fundamental principle that has underpinned economic regulation since privatisation, as well as every price control determination we have made in the last 20 years. We, therefore, intend to base our assessment of HAL on a notional financial structure for H7. This is also consistent with our own, and other regulators’ practice in setting price controls.”

⁴²² April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,422 / para 4.14].

⁴²³ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 4].

⁴²⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,409 / para 3.26].

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- 6.35 The Appellant submits that these two CAA statements are contradictory, and further that there is no rational basis why the 'notional' company should have any issues accessing investment grade debt finance if the evidence suggested that the much more highly geared 'actual' HAL did not.⁴²⁵
- 6.36 In any event, the Appellant considers that the CAA was wrong to conclude that the RAB adjustment was necessary to ensure notional financeability for the following reasons:
- (a) Whilst the CAA stated that “a RAB adjustment of £300 million will reduce HAL’s notional gearing below an important threshold used to assess consistency with strong investment grade finance”⁴²⁶, it failed to carry out the necessary analysis and quantification to substantiate this. Specifically:
- (i) The figure of £300 million appears to have been determined by the CAA as the amount required to keep HAL’s financial ratios in a range that would avoid an “undue or inefficient” increase in the cost of debt finance if HAL’s credit rating was to deteriorate.⁴²⁷ However, despite stating that it had followed a “robust evidence-led process”⁴²⁸, the CAA did not quantify whether the expected saving in interest payments would outweigh the cost of the RAB adjustment. As set out in paragraph 2.5.23 of the RAB Report,⁴²⁹ the RAB adjustment could only have been justified if the cost of new debt for a notionally efficient company would otherwise have increased by a material amount over H7 by around 144bps. In fact, the CAA could not reasonably have concluded that there would be anything like such an effect (which would significantly exceed even its estimated impact of a two-notch credit downgrade).
- (ii) The CAA estimated that the gearing for the 'notional' company would have increased from 60% prior to the Covid-19 pandemic to just over 70% in 2021, and stated that this took the 'notional' company above the guideline levels set by some rating agencies for a strong investment grade credit rating.⁴³⁰ The Appellant disagrees with the CAA’s 60% starting point (as it fails to take into account HAL’s significant outperformance during the Q6 period), the CAA’s unjustified assumption that there would have been a significant change in gearing for the notional company arising from the pandemic, and the CAA’s focus on strong investment grade finance (which is not required under the statutory framework). It is also the case, as the CMA has previously noted, that credit rating agencies do not make decisions on financial metrics alone.⁴³¹ In addition, analysis of the CAA’s Price Control Model showed that the 70% gearing threshold would not have been breached even in the absence of a RAB adjustment (rising only to a peak of 64.8% in 2021 and 65.5% in 2022), and the CAA has itself conceded that its projections were “superseded”.⁴³²
- (b) The CAA’s own analysis suggested that, contrary to HAL’s suggestion, it was plausible that the notionally financed company could “return notional gearing to 60% ...: without a RAB adjustment; over a reasonable period; while also allowing for substantial depreciation reprofiling; assuming no dividends during H7; and maintaining reasonable credit metrics” (emphasis added).⁴³³

⁴²⁵ The CAA notes in the H7 Final Decision that “the notional company is more conservatively funded, with a materially lower gearing” than HAL, see H7 Final Decision Section 3 [Decision / Tab 4 / p.221 / para 13.32].

⁴²⁶ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,390 / para 28].

⁴²⁷ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,400 / para 2.5].

⁴²⁸ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,384 / para 2].

⁴²⁹ RAB Report [Vol A / Tab 122 / p. 11,042 / para 2.5.23].

⁴³⁰ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,421 – 3,422 / para 4.12].

⁴³¹ Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations Final report [Vol A / Tab 42 / p.4693 / para 10.94]: “While financial ratios play an important role in the assessment of credit ratings, these are not applied mechanistically by agencies, not in isolation from a wide range of other relevant factors”.

⁴³² H7 Final Proposals Section 3 [Vol A / Tab 4 / p.343 / para 10.72].

⁴³³ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,407-3,4085 / para 3.20].

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- (c) Actually, despite being highly geared, HAL was financeable without the RAB adjustment (which, as set out above, should have provided comfort as to the 'notional' position). More particularly:
- (i) HAL's Financing Group (comprising Heathrow Finance plc, Heathrow (SP) Limited, HAL and Heathrow Funding Limited) consistently made public statements that they had good liquidity and would not breach the debt covenants in their financing platform. For example (and see also paragraph 2.5.10 of the RAB Report):⁴³⁴
 - (A) Heathrow Finance plc's Annual Report and Financial Statements for the year ended 31 December 2020 stated: "*we have good liquidity and have been able to maintain a positive net current asset position*"⁴³⁵ and "*[w]e ended the year with £3.9bn of liquidity enough to see us through until 2023*";⁴³⁶
 - (B) HAL stated in its results for the year ended 31 December 2020 that "*there will be funds available to meet the group and the company's funding requirements for at least 12 months*" and "*the underlying credit quality of the business means that it can secure, if necessary, in the event of severe but plausible downsides, the timely support of its debtholders as it successfully secured in 2020*".⁴³⁷ It also stated: "*[u]nder our current traffic scenario, we do not forecast any covenant breach in 2021. As part of our going concern assessment, we have also considered a severe but plausible downside scenario ... we concluded that sufficient mitigations would be within management control to avoid any covenant breach*".⁴³⁸
 - (ii) As set out in more detail in paragraphs 2.5.8 and 2.5.9 of the RAB Report,⁴³⁹ Heathrow Funding Limited's Senior (Class A) and Junior (Class B) debt maintained investment-grade credit ratings, including having ratings confirmed by S&P and Fitch shortly before publication of the April 2021 RAB Adjustment Decision⁴⁴⁰ and subsequently.
 - (iii) HAL continued to be able to raise significant amounts of debt during the pandemic, including in 2020 and 2021, as more fully detailed in paragraphs 2.5.12 and 2.5.13 of the RAB Report.⁴⁴¹ For example, Heathrow (SP) Limited stated in its results for the year ended 31 December 2020 (published on 24 February 2021, shortly before publication of the April 2021 RAB Adjustment Decision) that "*[d]espite a much more challenging market backdrop given the COVID-19 pandemic, continued confidence and support for our credit enabled the wider Heathrow group to raise £2.5 billion of debt in 2020 across the capital structure in bond and loan format*".⁴⁴²
 - (iv) Whilst the CAA stated in the February 2021 Consultation that "*the covenant in HAL's financing platform for which compliance is likely to come under the most pressure is the Group RAR covenant*",⁴⁴³ HAL remained financeable without the £300 million RAB adjustment, with sufficient headroom on its gearing ratios to raise effective investment grade debt finance (see paragraphs 2.5.14 and 2.5.15 of the RAB Report).⁴⁴⁴ This headroom had risen to 10.2% as at 31 December 2022 – a

⁴³⁴ RAB Report [Vol A / Tab 122 / p. 11,039 / para 2.5.10].

⁴³⁵ Heathrow Finance plc, Annual Report and Financial Statements for the year ended 31 December 2020 [Vol A / Tab 43 / p.4,861].

⁴³⁶ Heathrow Finance plc, Annual Report and Financial Statements for the year ended 31 December 2020 [Vol A / Tab 43 / p.4,814].

⁴³⁷ HAL, Annual Report and Financial Statements 2020 [Vol A / Tab 44 / p.5,134].

⁴³⁸ HAL, Annual Report and Financial Statements 2020 [Vol A / Tab 44 / p.4,860].

⁴³⁹ RAB Report [Vol A / Tab 122 / p. 11,039 – 11,040 / para 2.5.8 – 2.5.9].

⁴⁴⁰ S&P Global Ratings, Heathrow Funding Class A 'BBB+' And Class B 'BBB-' Ratings Taken Off CreditWatch Negative And Affirmed; Outlook Negative [Vol A / Tab 45 / p.5172] and Fitch Ratings, Fitch Affirms Heathrow Funding and Heathrow Finance Notes, Outlook Negative [Vol A / Tab 46 / p.5,181].

⁴⁴¹ RAB Report [Vol A / Tab 122 / p. 11,042 / para 2.5.12 – 2.5.13].

⁴⁴² Heathrow (SP) Limited and Heathrow Finance Plc, Investor Report December 2020 [Vol A / Tab 49 / p.5,325].

⁴⁴³ CAA, Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment - Appendices (CAP2098A) [Vol A / Tab 48 / p.5,241 / para E7].

⁴⁴⁴ RAB Report [Vol A / Tab 122 / p. 11,041 / para 2.5.14 – 2.5.15].

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higher level of headroom than at any point during the Q6 price control period.⁴⁴⁵ In addition, as set out in paragraph 2.5.16 of the RAB Report,⁴⁴⁶ the CAA was wrong to seek to justify the RAB adjustment on the risk to the headroom on HAL's actual debt gearing covenants. Even HAL did not explicitly justify its request for intervention on this basis and the CAA acknowledged that "*shareholders could remedy the issues with HAL's RAR covenant by making a suitable injection of new equity finance*".⁴⁴⁷

- (d) Given the CAA's position that "*HAL's actual financing choices are a matter for the company and its shareholders*"⁴⁴⁸, it was relevant to take into account the fact that HAL's higher financing costs were due to its high gearing practices and dividend payments and significant over-achievement of regulatory WACC over the Q6 period.

6.37 Based on the above, the Appellant submits that the CAA was wrong to conclude that the RAB Adjustment was necessary because HAL was at risk of an increase in debt costs of an order to justify a £300 million RAB adjustment, and this was based on errors of fact and wrong in law.

Error 1(b)(ii) The CAA was wrong to conclude that an adjustment to HAL's RAB was necessary to secure that all reasonable demands for AOS at Heathrow Airport are met.

6.38 The CAA's conclusion that a RAB adjustment was necessary to secure that all reasonable demands for AOS at Heathrow Airport are met was wrong for the following reasons:

- (a) The CAA stated that the RAB adjustment was "*designed to ensure that HAL has both the capacity and incentives to invest in a way that fully meets the needs of consumers*".⁴⁴⁹
- (b) The Appellant contends that it is an extra-ordinary justification to suggest that an adjustment to the RAB – which, as already set out, is intended to reflect efficiently incurred investments – is necessary to incentivise HAL to be proactive in making investments required but not yet made.
- (c) In the April 2021 RAB Adjustment Decision, the CAA agreed that the "*primary purpose*" of the RAB is "*to determine the future remuneration of HAL's efficient investments*", but stated that "*where there are clear advantages to consumers of using the RAB to smooth the impact on charges from adjustments and incentives*", it saw no reason in principle why the RAB cannot be used in this way (and it gave the example of using the RAB to help smooth any upward pressure on charges that might be created by traffic/revenue risk sharing mechanisms).⁴⁵⁰ However, as set out at paragraph 2.2.11 of the RAB Report,⁴⁵¹ this was in the context of smoothing otherwise volatile charges via the RAB, which is reasonable if done on a NPV neutral basis (such as in the TRS). In contrast, the RAB adjustment increases the NPV of HAL (by £300m). In addition, the Appellant submits, that there are no 'clear advantages to consumers' of the RAB adjustment.
- (d) The CAA's attempt to use a RAB adjustment as an incentive mechanism is unnecessary, ineffective and disproportionate:

⁴⁴⁵ Heathrow (SP) Limited Q4 2022 Results Release [Vol A / Tab 121] Indeed, the headroom at 31 December 2022 (10.2%) is **treble** the headroom in 2020 (3.3%) and 2017 (3.4%); **double** the headroom in 2021 (5.1%), 2018 (3.7%), 2016 (4.6%), and 2015 (5.1%); and **more than 50% greater** than the headroom in even the highest years of the Q6 price control period (inclusive of Q6+1 and iH7): 2019 (6.0%) and 2014 (5.5%). Further detail is set out in Table 3 of the RAB Report [Vol A / Tab 122 / p.11,042 / Table 3].

⁴⁴⁶ RAB Report [Vol A / Tab 122 / p. 11,041 / para 2.5.16].

⁴⁴⁷ CAA, Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment - Appendices (CAP2098A) [Vol A / Tab 48 / p.5242-5243 / paras E8-E12].

⁴⁴⁸ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3422 / para 4.14].

⁴⁴⁹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3412 / paras 3.39 and 3.40].

⁴⁵⁰ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3420 / paras 4.5 and 4.6].

⁴⁵¹ RAB Report [Vol A / Tab 122 / p. 11,032 / para 2.2.11].

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- (i) A RAB adjustment is not required to encourage efficient investment. Indeed, in considering the RAB adjustment, the CAA explicitly noted that efficient capex investment would be added to HAL's RAB in any case.⁴⁵²
- (ii) As set out in paragraph 2.4.4 of the RAB Report,⁴⁵³ granting a lump sum RAB adjustment in advance of any additional expenditure being made will not incentivise the realisation of that additional investment, unless there are controls to ensure such investment is made. HAL's return from making the investment is simply its WACC on the investment made; whereas if HAL makes no investment whatsoever the NPV of its profits will increase by £300 million. This clearly contradicts the CAA's suggestion that the RAB adjustment will incentivise new action and investment by HAL.
- (iii) The limits of the RAB adjustment as an incentive mechanism are clearly demonstrated by the fact that the capex investments which the CAA sought to incentivise have not taken place. On the contrary, HAL spent less on capex in 2021 than in 2020, failed to open Terminal 4 in a timely way (despite this being a specific expectation of the CAA), and failed to ensure that it had sufficient staff to meet demand during 2022. These aspects are addressed more fully below.
- (iv) Effective incentive regulation would have used rewards and/or penalties to induce HAL to achieve set objectives rather than simply providing a lump sum adjustment to the RAB. Alternatively, the CAA should, as set out in paragraph 2.4.5 of the RAB Report,⁴⁵⁴ have put in place a clearly defined process for tracking incremental efficient expenditure, and its failure to do so was contrary to good regulatory design.
- (v) The CAA appeared to recognise this latter point to some degree when it built "*additional protections for consumers*" – in the form of the review mechanism – in to the April 2021 RAB Adjustment Decision.⁴⁵⁵ However, the CAA's failure to activate those "*additional protections*" – and its corresponding willingness to allow HAL to retain the RAB adjustment despite a manifest failure to deliver what it had promised – has further undermined the RAB adjustment's already poor incentive properties.

6.39 The CAA's RAB adjustment was therefore not necessary to secure – and has not in fact secured – that all reasonable demands for AOS at Heathrow Airport are met. As set out in paragraph 2.4.10 of the RAB Report,⁴⁵⁶ it had "*at most*" minimal impact on incentives for HAL to make investment (and any possible incentives were reliant on a review that the CAA has refused to undertake). There were also clearly superior alternatives available. The CAA's decision was therefore wrong as being based on errors of fact, wrong in law, and an erroneous exercise of a discretion.

Error 1(b)(iii) The CAA was wrong to conclude that an adjustment to HAL's RAB had been necessary to allow HAL the flexibility to respond to changing circumstances.

6.40 In the face of mounting evidence that the RAB adjustment was neither necessary to ensure notional financeability nor had secured that all reasonable demands for AOS at Heathrow Airport were met, the CAA looked to "*flexibility*" as a justification in its H7 Final Proposals.⁴⁵⁷

6.41 The Appellant contends that this was erroneous, and another missed opportunity by the CAA to hold HAL to account for its failure to deliver. More particularly:

⁴⁵² April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,423 / para 4.17].

⁴⁵³ RAB Report [Vol A / Tab 122 / p.11,034 / para 2.4.4].

⁴⁵⁴ RAB Report [Vol A / Tab 122 / p. 11,034 / para 2.4.5].

⁴⁵⁵ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 32].

⁴⁵⁶ RAB Report [Vol A / Tab 122 / p. 11,036 / para 2.4.10].

⁴⁵⁷ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.81].

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- (a) The CAA sought to rely on “a stronger than expected recovery in passenger traffic” as the trigger for HAL’s additional expenditure.⁴⁵⁸ However, this is clearly at odds with the expectation that HAL would be “proactive”, “maintaining appropriate investment and service quality levels ahead of the start of H7”,⁴⁵⁹ investing to ensure that “there is sufficient terminal capacity ready and available to deal with any increases in traffic above the levels currently expected for the summer of 2021”⁴⁶⁰ and “that the re-opening of terminal capacity is carried out in a timely way”.⁴⁶¹
- (b) The CAA asserts, without any supporting evidence or analysis, that “it is not clear to us that it would have been in consumers’ interests for HAL to have undertaken a materially greater volume of capital expenditure in that year than it did in practice”.⁴⁶² However, as already noted and more fully detailed below, HAL’s out-turn capital expenditure was lower in 2021 than in 2020⁴⁶³ and it manifestly failed to make additional investment in 2021 in order to support service quality and capacity going forward, with significant consequences for airlines and consumers. The Appellant submits that it would clearly have been in consumers’ interests to make further investments in 2021 insofar as they might have mitigated the issues that arose in 2022.
- (c) The CAA’s belated “flexibility” justification renders worthless the explicit “additional protections for consumers” – in the form of the review mechanism – which the CAA chose to include in case “the RAB adjustment ... might turn out not to have been required”.⁴⁶⁴
- 6.42 The CAA’s conclusion that the RAB adjustment remains “warranted” as it “was important to have allowed HAL the flexibility to respond to changing circumstances” was therefore without foundation and wrong.⁴⁶⁵ It was based on errors of fact and wrong in law.

Error 1(c): The CAA’s RAB Adjustment is harmful to the interests of consumers

- 6.43 The Appellant contends that, far from being “needed ... to further the interests of consumers”⁴⁶⁶, the RAB Adjustment has and will continue to cause consumer harm.
- 6.44 In terms of the CAA’s rationale:
- (a) In the April 2021 RAB Adjustment Decision, the CAA stated:
- (i) “While any RAB adjustment would directly increase costs to consumers from 2022, we consider it could mitigate some potential short term risks to consumers from lower service quality and higher cost of debt if appropriately calibrated.”⁴⁶⁷
- (ii) “We estimate that a RAB adjustment of £300 million would increase consumer charges from 2022 onwards by only around £0.30 per passenger (around 1.5%) ... We consider it is reasonable to expect the benefits to consumers from a lower cost of capital and greater service quality in H7 to outweigh these costs from the RAB adjustment.”⁴⁶⁸
- (iii) “To protect consumers, we consider that additional protections should be put in place to mitigate the risks that consumers do not benefit from an early targeted RAB adjustment.”⁴⁶⁹

⁴⁵⁸ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.80].

⁴⁵⁹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3389 / para 24].

⁴⁶⁰ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3240 / para 4.8].

⁴⁶¹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3407 / para 3.16].

⁴⁶² H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.81].

⁴⁶³ Heathrow (SP) Limited, Annual Report and Financial Statements for the year ended 31 December 2021 [Vol A / Tab 50 / section 2].

⁴⁶⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,424 / paras 4.21-4.25].

⁴⁶⁵ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.81].

⁴⁶⁶ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 4].

⁴⁶⁷ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,415 / para 3.49].

⁴⁶⁸ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 30].

⁴⁶⁹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,418 / para 3.63].

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- (b) In the H7 Final Proposals, the CAA stated that it did not consider that the reversal of the RAB adjustment would further the interests of consumers (as it would tend to increase investor perceptions of risk, increase the cost of capital and put upward pressure on airport charges) and that the adjustment was justified and appropriately calibrated given the information available at the time.⁴⁷⁰
- (c) In the H7 Final Decision, the CAA stated that it continued to view its approach to the RAB adjustment in the H7 Final Proposals as “reasonable and appropriate”.⁴⁷¹ It further stated that “[t]o further interests of consumers, we have sought to ensure that HAL’s future charges will be ‘no higher than necessary’ in the sense of representing appropriate value for money”.⁴⁷²
- 6.45 The Appellant considers that the CAA’s conclusion – and its decision to retain the £300 million RAB adjustment in the H7 Final Decision – is wrong for the following reasons:
- (a) The RAB adjustment is, as already explained, contrary to the key principle of the RAB and incentive regulation – namely that only efficient incurred capex should be added to the RAB. As set out in paragraph 2.6.2 of the RAB Report,⁴⁷³ this should have been the CAA’s starting point.
- (b) This was not an issue that fell – or should have been made to fall – to consumers to ‘fix’ because:
- (i) HAL bore traffic volume risk under its regulatory settlement and made its own financing choices (which clearly deviated from the ‘notional’ company). Its shareholders had no right to expect any ex post bail out; and
- (ii) As set out in paragraphs 2.7.1 to 2.7.3 of the RAB Report,⁴⁷⁴ even if there was a financeability issue with the notionally structured company (which, as already explained, there was not), requiring consumers to pay more is not a reasonable response because it effectively provides more value to shareholders who are already benefiting from the expectation of earning the allowed cost of equity on their investment and equity investors could provide cash injections if necessary.
- (c) The RAB adjustment was always a ‘bad bargain’ for consumers, even had HAL delivered on its promises. This is because:
- (i) As set out in paragraph 2.6.6 of the RAB Report,⁴⁷⁵ HAL’s expected total expenditure (£218 million capex and £9 million opex) added up to £227 million – which was always materially less than £300 million. The RAB adjustment is therefore a net loss to consumers.
- (ii) The CAA has indicated that the £218 million efficient capex investment would “in any case” be added to HAL’s RAB⁴⁷⁶ – with the result that the RAB adjustment is duplicative and consumers would pay twice. After the RAB adjustment, if this capex had been made, HAL’s RAB would have increased by £518 million. This sum represents the present value of what consumers will be required to pay in future. Therefore, even in the case where HAL had spent an additional £227 million, consumers would be worse off by £291 million (£518 million - £227 million).

⁴⁷⁰ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.348 / para 10.99].

⁴⁷¹ H7 Final Decision Section 3 [Decision / Tab 4 / p.189 / para 10.22].

⁴⁷² H7 Final Decision Summary [Decision / Tab 1 / p.13 / para 5].

⁴⁷³ RAB Report [Vol A / Tab 122 / p. 11,043 / para 2.6.2].

⁴⁷⁴ RAB Report [Vol A / Tab 122 / p. 11,044 – 11,045 / para 2.7.1 – 2.7.3].

⁴⁷⁵ RAB Report [Vol A / Tab 122 / p. 11,043 / para 2.6.6].

⁴⁷⁶ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,407 / para 3.15 and p.3,423 / para 4.17].

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- (iii) There was, as set out above, no reasonable basis for the CAA to assume that HAL was at risk of an increase in debt costs of an order to justify a £300 million RAB adjustment.
 - (iv) As explained in paragraph 2.6.11 of the RAB Report,⁴⁷⁷ even had HAL received a two-notch downgrade, consumers would effectively be paying 2.5 to 3.7 times what is necessary to maintain HAL's credit rating (e.g. £0.08 – £0.12 per passenger for a £0.30 cost).
- (d) The RAB adjustment has delivered no additional value for consumers and, despite the “*additional protections for consumers*” built in by the CAA – and concerted attempts by the Appellant and others to activate such protections – there have there been no consequences for this non-delivery.⁴⁷⁸
- (e) It is illogical for the CAA to suggest that the reversal of the RAB adjustment would not further the interests of consumers and that the RAB adjustment was justified and appropriately calibrated given the information available at the time when:
- (i) the review mechanism was included in the April 2021 RAB Adjustment Decision precisely because the CAA was not able on the basis of the information available at the time to be sure that the RAB adjustment was justified and appropriately calibrated; and
 - (ii) the CAA expressly managed the expectations of investors by the clearly contingent manner in which the RAB adjustment was made.
- (f) The CAA's unjustified and unnecessary RAB adjustment will have a lasting impact on the airport charge – and therefore on consumers – over multiple price control periods. HAL's future charges will, contrary to the CAA's positioning in the H7 Final Decision, be higher than necessary and will categorically not represent appropriate value for money.
- (g) The RAB adjustment has not met any of the six key consumer interest objectives identified by the CAA in its final assessment framework.⁴⁷⁹ Namely, it has not: (i) protected efficient investment and service quality levels; (ii) promoted economy and efficiency, including affordable charges; (iii) protected consumers by avoiding undue increases in the cost of equity finance; (iv) protected consumers from the consequences of HAL experiencing difficulties with raising debt, including by avoiding undue or inefficient increases in the cost of debt finance; (v) promoted competition; or (vi) had regard to the “better regulation principles” set out in the Act, including proportionality and consistency.
- 6.46 Based on the above, the Appellant submits – as set out in the joint presentation to the CAA Board on behalf of the airline community on 4 May 2022 – that the RAB adjustment is harmful and the CAA's “[d]ecisions ... have overly benefited HAL's shareholders at the expense of the consumer”.⁴⁸⁰ It requires consumers to pay for something that provides no equivalent benefit and is based on errors of fact, is wrong in law, and an erroneous exercise of a discretion.
- 6.47 In conclusion, the Appellant submits that the CAA erred both at the time of the April 2021 RAB Adjustment Decision and when it chose to “*preserve*” and “*retain*” the RAB adjustment in the H7 Final Decision. The CAA's decision to make the RAB adjustment was unjustified, unnecessary, harmful and wrong. It was based on errors of fact, wrong in law and erroneous exercises of discretion.

⁴⁷⁷ RAB Report [Vol A / Tab 122 / p. 11,044 / para 2.6.11].

⁴⁷⁸ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 32].

⁴⁷⁹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,387 / para 19].

⁴⁸⁰ VAA, BA, IATA and AOC, Airline community views: Heathrow H7 Pre-Final Proposals [Vol A / Tab 36 / p.2,588 / slide 2].

D. The Failure to Review error

6.48 In this section, the Appellant describes the errors made by the CAA in failing to review its £300 million RAB adjustment prior to making the H7 Final Decision and to reverse or reduce that adjustment in light of evidence of HAL's failure to deliver on its specified investment commitments and on capacity and quality of service.

Error 2(a): The CAA was wrong to refuse to conduct a review of its RAB adjustment prior to making the H7 Final Decision, despite clearly stating that it would do so if evidence were to emerge of HAL failing to deliver on investment or quality of service

6.49 In the April 2021 RAB Adjustment Decision, the CAA expressly stated that it would conduct a review of the £300 million RAB adjustment if evidence emerged that HAL was failing to deliver on quality of service, and that the outcome of such review could be a reduction in the RAB adjustment.

(a) *"If evidence were to emerge of HAL failing to deliver on quality of service then we will take steps to further protect the interest of consumers by conducting a review of these matters (and we would seek to protect consumers from the costs of any such failures)"* (emphasis added);⁴⁸¹ and

(b) *"...This [review] would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in a timely way and maintained service quality. In the event that such a review were to show that HAL had not responded appropriately, including in respect of service levels where this is within HAL's control, we would look to introduce additional protections around service quality in H7 and we would consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue"*(emphasis added).⁴⁸²

6.50 Against this backdrop, the Appellant submits that the CAA erred in failing to conduct a review prior to making the H7 Final Decision despite clear evidence emerging of HAL's failures and numerous explicit requests for the CAA to take action stretching over a period of ten months from October 2021.

6.51 More particularly, the Appellant contends as follows:

(a) The evidence that emerged and was placed before the CAA by airlines demonstrated that HAL failed both to prepare and invest in 2021 for the eventual increase in passenger numbers following the Covid-19 pandemic and to provide sufficient capacity to meet forecasted demand. Ultimately, HAL delivered an extremely poor level of service quality following the re-opening of international travel. This is more fully detailed below and in CW1.

(b) The Appellant is aware of a number of explicit requests for the CAA to initiate a review as follows, spanning the period from December 2021 to October 2022:

(i) BA's response to the Initial Proposals dated 17 December 2021 stated: *"... we now call on the CAA to act given abundant evidence that Heathrow has not made any additional capital investment, and in fact has reduced its capital investment in 2021 compared to 2020. ... since the adjustment has not reduced the cost of capital, we call on the CAA to invoke the additional protections that were promised"*;⁴⁸³

(ii) A letter from VAA to the CAA dated 25 April 2022 stated: *"I am writing to formally request a review of the £300m RAB adjustment, in light of HAL's unpreparedness to meet the consumer demand that accompanies the recovery of UK aviation this spring and summer. ... Clearly, investment in enhancements has not been made*

⁴⁸¹ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 4].

⁴⁸² April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 32].

⁴⁸³ BA, Response to H7 Initial Proposals (CAP2265) [Vol A / Tab 110].

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in a 'timely' manner and it certainly hasn't been 'appropriate' in order to meet the passenger demand projected by the industry. Service quality data, specifically in the areas of central search and PRS services should demonstrate the degree to which the requisite 'quality of operation services' has not been met. ... IATA have confirmed that London Heathrow remains the only hub airport in Europe with a closed terminal, yet HAL were the only UK airport granted a concession in the form of a £300m RAB Adjustment by the regulator. ... we request that the CAA now takes steps to protect the interests of consumers, by conducting an immediate review of the £300m RAB adjustment and correcting this situation within the upcoming H7 outcome";⁴⁸⁴

- (iii) A joint presentation to the CAA Board on behalf of the airline community dated 4 May 2022 stated that *"the CAA must reassess its £300m RAB decision; HAL has not done enough to prepare for the return of passengers to Heathrow"* and *"The CAA has an obligation to consumers to review the £300m RAB adjustment"*. It further noted that, 12 months on from the April 2021 RAB Adjustment Decision, HAL's liquidity remained strong with gearing decreasing to pre-pandemic levels, HAL's shareholders were still not required to invest any permanent equity (unlike airlines), HAL was failing in its licence obligations to meet adequate service levels, HAL was going to limit capacity, Terminal 4 remained the only terminal in Europe that was closed due to Covid-19 cost savings and, overall, the consequence of HAL having failed to respond to airlines' warnings regarding demand, including the earlier reopening of Terminal 4, is that airlines and consumers were suffering. It concluded that the RAB adjustment – *"that has been gamed by Heathrow and not delivered promised operational support"* – should be removed;⁴⁸⁵
- (iv) A letter from the CEOs of BA, VAA, AOC and IATA to Sir Stephen Hillier (CAA Chair) dated 11 May 2022 stated: *"HAL's failure to open T4 for Easter and enforcing capacity reductions of up to 25% on airlines because of its inept peak readiness preparations, means that consumers and airlines are suffering, despite paying more. HAL should not be rewarded for its incompetence. The CAA should reverse the £300m RAB adjustment awarded ...";⁴⁸⁶*
- (v) The H7 Final Proposals - Joint Response to the Final Proposals dated 9 August 2022 urged *"the CAA to commence this review in the interests of consumers, to complete its assessment before the CAA's Final Determination is taken, and to publish its decision to provide clear accountability and transparency to consumers."* It stated that it was not only *"manifestly appropriate for the CAA to conduct such a review, but [that] the CAA would fail consumers if it did not do so";⁴⁸⁷*
- (vi) BA's response to the Final Proposals dated 9 August 2022 stated that *"Heathrow has not delivered the incremental investments to support service quality as promised for its £300m RAB adjustment"* and *"[t]he CAA must revisit its £300m RAB adjustment to enforce consumer protections"*.⁴⁸⁸ Further: *"[i]t is imperative ... that the CAA correct for this error by reference to the investment promises that Heathrow made to the CAA in advocating for the RAB adjustment, which have not been delivered";⁴⁸⁹*
- (vii) AOC,LACC and IATA's response to the Final Proposals dated 9 August 2022, on behalf of the airline community, stated: *"[i]t is imperative that the CAA conclude on*

⁴⁸⁴ Letter from VAA to CAA dated 25 April 2022 [Vol A / Tab 133].

⁴⁸⁵ VAA, BA, IATA and AOC, Airline community views: Heathrow H7 Pre-Final Proposals [Vol A / Tab 36 / p.2597 / slide 11 and p.2600 / Appendix].

⁴⁸⁶ Letter from BA, VAA, IATA and AOC to the CAA regarding Economic regulation of HAL: H7 Final Proposals Position dated 11 May 2022 [Vol A / Tab 134].

⁴⁸⁷ H7 Final Proposals - Joint Response (CAP2365) [Vol A / Tab 115 / p.10,502 / para 10.8 – 10.9]

⁴⁸⁸ BA, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 116 / p.10,631 / para 10.11].

⁴⁸⁹ BA, Response to H7 Final Proposals (CAP2365) [Vol A / Tab 116 / p.10,634 / para 10.25].

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*its proposed review which we firmly believe warrants the removal of the proposed £300m RAB adjustment...*⁴⁹⁰; and

- (viii) An email from Simon Laver (Assistant Director, IATA) to the CAA dated 17 October 2022 requested “a timetable for the service quality review of the £300m RAB Adjustment”.⁴⁹¹
- (c) In purported answer to some of these requests, the CAA has attempted to reposition its RAB adjustment as relating only to outcomes in 2021.⁴⁹² For example, the CAA explained in the H7 Final Decision that: “... *the focus of the RAB adjustment made under the April 2021 Decision was on outcomes, namely, service quality and investment in 2021: that is, before we were able to take account of such outcomes in our H7 price control proposals. As such, we do not consider that it would be appropriate to revisit our April 2021 RAB Adjustment Decision on the basis of outcomes in 2022.*”⁴⁹³
- (d) The Appellant submits that this is inconsistent with previous statements made by the CAA. For example, in the April 2021 RAB Adjustment Decision, the CAA stated:
- (i) “... *on the evidence that HAL has provided, we consider it is plausible that there may be some additional investment in the short term which is appropriate. This would support service quality over 2021 and into 2022, including investment necessary for ensuring that the re-opening of terminal capacity is carried out in a timely way*” (emphasis added).⁴⁹⁴
- (ii) “*HAL also reports that Terminal 4 requires investment which will take approximately 9 to 12 months before it can reopen (which is currently planned for the second half of 2022). As a result we consider it is plausible that there may be some additional investment in the short term which is necessary to support: service quality being maintained over 2021 and into 2022; and such investment in critical maintenance for Terminal 4 to be carried out in a timely way*” (emphasis added).⁴⁹⁵ and
- (iii) “*HAL has set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 and beyond” (emphasis added).⁴⁹⁶*
- (e) Having regard to the above, the Appellant considers it was clear that the CAA wanted to ensure that HAL was appropriately prepared for the return of demand – whenever that came.⁴⁹⁷ Consistent with the nature of capital investment, it expected HAL to make additional investment in 2021 to prepare for the return of demand and to support service quality and capacity going forward.
- (f) This is also consistent with what HAL requested. Specifically, HAL’s Application stated that a RAB adjustment “*will ... enable continued investment, not only in 2021 but also in HZ, in the long-term interests of consumers*” (emphasis added).⁴⁹⁸

6.52 In the H7 Initial Proposals, the CAA stated that its initial view was that “*HAL has reopened terminal capacity in a way that has allowed airline demand to be met, and that service quality*

⁴⁹⁰ LACC, AOC and IATA, Response to H7 Final Proposals [Vol A / Tab 112].

⁴⁹¹ Email exchange between the CAA and BA, VAA, IATA and AOC regarding ORCs, OBR and the service quality review of the RAB Adjustment [Vol A / Tab 137].

⁴⁹² H7 Final Proposals Summary [Vol A / Tab 1 / p.30 / para 77], Holding Price Cap 2023 Decision [Vol A / Tab 52 / p.5,747 / para 2.42] H7 Final Decision Section 3 [Decision / Tab 4 / p.194 / para 10.56].

⁴⁹³ H7 Final Decision Section 3 [Decision / Tab 4 / p.196 / para 10.68].

⁴⁹⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,407 / para 3.16].

⁴⁹⁵ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,412 / paras 3.37 and 3.38].

⁴⁹⁶ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,422 / para 4.15].

⁴⁹⁷ Indeed, the Appellant notes that it was stated in ACI Europe’s Note for the Thessaloniki Forum working group on ‘Airport Charges in Times of Crisis’ [Vol A / Tab 51 / p.5,721] which has been referred to by HAL – that the main contribution airports could make to post-Covid recovery was to ensure that their airport facilities were fully ready for any resurgence of passengers.

⁴⁹⁸ HAL’s application [Vol A / Tab 32 / p.2,493].

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performance has been good when measured against the metrics".⁴⁹⁹ Subsequently, in the H7 Final Proposals, the CAA disagreed that it had made an error in its assessment of HAL's investment and operational performance but stated: "*If it is appropriate, we will review HAL's operational performance in the Autumn of this year, with a view to ensuring that the interests of consumers are properly protected.*"⁵⁰⁰

- 6.53 Despite urging from relevant stakeholders, the CAA also refused to initiate this review. On 3 November 2022, the CAA stated: "*The context of the RAB adjustment was the interim period before the start of H7 and the focus of our attention was investment and service quality primarily in relation to 2021. We understand that there have been a range of service issues across the sector in 2022 and have encouraged both airlines and airports to take appropriate steps to minimise the disruption to passengers. The focus of our current work programmes in relation to HAL is finalising the H7 price control arrangements in a way consistent with the interests of consumers and taking into account our other statutory duties. In due course, this process will provide key stakeholders with the right to appeal the licence modification, which will encompass our decisions on HAL's regulatory asset base (including in relation to the interim RAB adjustment). Given this focus, the wider process and the advantages of prioritising our work so to make best use of our limited resources we are not currently planning to engage in a separate review of service quality in 2022*" (emphasis added).⁵⁰¹
- 6.54 In the H7 Final Decision, the CAA went further. It stated: "*We did not subsequently consider that a review of HAL's operational performance was necessary, and that it would distract from our primary focus of reaching a decision in respect of the H7 price control. In any case, it is not clear that the reversal of the April 2021 RAB Adjustment would have been the appropriate remedy in the context of such a review*".⁵⁰²
- 6.55 The Appellant contends that this was wrong. In particular:
- (a) Rather than being a "*distraction*", a review was an essential part of reaching a decision in respect of the H7 price control in which "*HAL's future charges will be 'no higher than necessary*".⁵⁰³ Put another way, a review was not extraneous to the H7 price control exercise but rather a key part of it in terms of ensuring a proper calibration of the RAB.
 - (b) The H7 Final Decision provides no reasons why a review was deemed unnecessary by the CAA, and the assertion that "*it is not clear that the reversal of the [RAB adjustment] would have been the appropriate remedy in the context of such review*" is opaque and ill-founded (as the CAA had not conducted a review that would enable it to consider properly the appropriate outcome).
- 6.56 In conclusion, the Appellant submits that the CAA's refusal to conduct a review was wrong. It was based on errors of fact, wrong in law and an erroneous exercise of a discretion. In particular, failing to conduct a review of the RAB adjustment prior to making the H7 Final Decision was contrary to the CAA's previous commitment to do so and, in the circumstances, an essential part of properly calibrating the RAB for the H7 price control.

Error 2(b): As a result, the CAA failed properly to consider the evidence before it and erred in its conclusion that "it is not clear ... that it would have been in consumers' interests for HAL to have undertaken a materially greater volume of capital expenditure in [2021] than it did in practice"⁵⁰⁴

- 6.57 The Appellant submits that the CAA's refusal to conduct a review prior to making the H7 Final Decision led it into further error.

⁴⁹⁹ H7 Initial Proposals Section 2 [Vol A / Tab 9 / p.659 / para 6.16].

⁵⁰⁰ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.345 / paras 10.86-10.87].

⁵⁰¹ Email exchange between the CAA and BA, VAA, IATA and AOC regarding ORCs, OBR and the service quality review of the RAB Adjustment – see email from CAA in response dated 3 November 2022 [Vol A / Tab 137].

⁵⁰² H7 Final Decision Section 3 [Decision / Tab 4 / p.196 / para 10.71].

⁵⁰³ H7 Final Decision Summary [Decision / Tab 1 / p.6-7 / para 5].

⁵⁰⁴ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.81].

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- 6.58 It was a key part of HAL's submissions to the CAA in favour of a RAB adjustment that such adjustment, if made, would "*unlock additional investment*",⁵⁰⁵ allow HAL to restart a number of opex initiatives, and "*help to deliver more benefits for consumers*".⁵⁰⁶
- 6.59 More specifically:
- (a) In its response to the February 2021 Consultation, HAL stated that a RAB adjustment would "*[u]nlock additional investment in the airport delivering significant benefits to consumers earlier and helping mitigate service risks as passenger numbers recover*".⁵⁰⁷
 - (b) In particular, it stated: "*In our response to the CAA's request for information, we confirmed that if the CAA were to make an adjustment to the RAB in January 2021 in line with our proposals we could finance an accelerated programme of investment through 2021 and into the start of H7. This amounted to a portfolio of £221m of investment and included investment in programmes to deliver on consumers' key priorities. Due to the additional time being taken by the CAA to reach a decision on an adjustment for 2021, the restart or acceleration of these projects would be delayed versus the programme set out in our RBP. However, starting in 2021 would still help to deliver more benefits for consumers earlier than an adjustment as part of the H7 process would allow.*"⁵⁰⁸
 - (c) HAL's list of the key programmes of work that – if a RAB adjustment was made – could be accelerated or restarted included: (i) commencing work on the Security Transformation programme earlier than scheduled; (ii) increasing spend on asset replacement; (iii) commencing work on key paused projects to deliver additional automation; (iv) completing critical maintenance in Terminal 4 to ensure a safe return to passenger service earlier than planned; (v) bringing forward investment in sustainability; and (vi) accelerated work on the CTA tunnel.⁵⁰⁹
 - (d) HAL stated that the "*accelerated delivery of these programmes will generate increased benefits for consumers more quickly. Programmes such as Security Transformation, Automation, Terminal 4 maintenance and increased asset replacement spend will also help to avoid consumer detriment caused by longer queue times, increased congestion, decreased capacity or reduced punctuality*".⁵¹⁰ It further noted that the investments proposed "*have value to consumers beyond 2021*"⁵¹¹ and, in total, the accelerated delivery of these programmes could drive additional benefits of up to £1.45 billion for passengers through the H7 period.⁵¹² This, it said, was a "*clear consumer benefit of facilitating the delivery of these schemes through a RAB adjustment*".⁵¹³
 - (e) HAL also noted that a RAB adjustment would allow it to restart a number of operational initiatives with clear benefits for consumers, including an earlier commencement of recruitment of security colleagues in order to ensure that we have the capacity to serve a larger number of passengers should demand recover faster than expected or peaks occur over the next year.⁵¹⁴
 - (f) The clear link between such additional investment and the RAB adjustment was reflected in the April 2021 RAB Adjustment Decision as follows: "*HAL has set out that with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 and beyond. This includes investment to provide appropriate capacity at the airport if there is a particularly strong recovery in demand. We*

⁵⁰⁵ HAL, Economic regulation of Heathrow: response to CAA consultation on Covid-19 related RAB adjustment (CAP2098) (**Heathrow's response to February 2021 Consultation**) [Vol A / Tab 91 / p.9632].

⁵⁰⁶ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,656 / para 117].

⁵⁰⁷ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,634].

⁵⁰⁸ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,658 / para 117].

⁵⁰⁹ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,656-9,657 / para 118].

⁵¹⁰ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,658 / para 119].

⁵¹¹ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / 9,658 / para 121].

⁵¹² Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,659 / para 123].

⁵¹³ *Ibid.*

⁵¹⁴ Heathrow's response to February 2021 Consultation [Vol A / Tab 91 / p.9,659 / para 124].

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*consider that an intervention that provides gearing headroom above its level of planned investment, for example, in the range £230 million to £300 million, would provide a clear and strong incentive for HAL to: undertake any necessary investment; maintain service quality; and provide necessary capacity during 2021.*⁵¹⁵

- (g) As previously noted, the CAA included the review mechanism as an additional protection for consumers in the event that such investment did not materialise.
- 6.60 It is the Appellant's submission that, had the CAA commenced a review before making the H7 Final Decision and properly considered all available evidence before it, it would have been clear that:
- (a) HAL had not kept pace with needs across Heathrow Airport in its provision of AOS. It had not delivered on its specified investment commitments, nor on capacity and quality of service in 2021 and beyond;
- (b) HAL's failure to make additional investment in 2021 in order to provide sufficient capacity to meet returning demand, despite repeated warnings, had a significant negative impact on airlines and consumers, including in relation to the serious operational issues which arose in 2022; and
- (c) In such circumstances, it was inappropriate for HAL to retain the benefit of (some or all of) the RAB adjustment.
- 6.61 Key aspects of the relevant evidence in support of this submission is summarised below and more fully detailed in CW1:
- (a) No additional expenditure: There is no evidence of HAL making any incremental expenditure due to the RAB adjustment. In fact, not only did HAL not make a significant amount of additional capital expenditure in 2021, its out-turn capital expenditure in that year (£289m) was lower than in 2020 (£423m).⁵¹⁶
- (b) Late reopening of Terminal 3: There was a protracted delay in opening Terminal 3, which was not reopened until July 2021.
- (c) Late reopening of Terminal 4: HAL did not then act quickly to reopen Terminal 4 to alleviate issues at Terminal 3 (despite this being a specific expectation of the CAA in connection with the RAB adjustment). More particularly:
- (i) In late 2021, the airline community requested that Terminal 4 be opened well in advance of the 2022 summer schedule, and by Easter 2022 at the latest.
- (ii) HAL's position was to "*stay within 3 terminals for as long as capacity allows*"⁵¹⁷ and it would not commit to making a decision on reopening Terminal 4 until February 2022 (with a number of months' lead time then required for implementation). When the airlines' forecasted demand was proved not only credible but accurate, Terminal 4 was not open in time to cater to this demand. HAL initially planned to reopen Terminal 4 by 4 July 2022 but, under pressure from airlines,⁵¹⁸ it reopened on 14 June 2022.
- (iii) HAL's late reopening of Terminal 4 led to widespread negative consequences for airlines and consumers. The Appellant notes that the most significant issues arose between April 2022 and June 2022 when (as the airlines had correctly identified) passenger numbers started to increase significantly but Terminal 4 remained closed (and HAL had not taken steps to prepare for higher passenger traffic, e.g.

⁵¹⁵ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,422 / para 4.15].

⁵¹⁶ HAL, Annual Report and Financial Statements 2021 "*Capital Expenditure*" [Vol A / Tab 54 / p.5,853].

⁵¹⁷ Minutes of Joint Heathrow Planning Group dated 12 January 2022 and associated slide deck [Vol A / Tab 55 / p.5,987].

⁵¹⁸ Minutes of Joint Heathrow Planning Group dated 2 March 2022 and associated slide deck [Vol A / Tab 56 / p.6,002].

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by recruiting and training security staff etc.). These problems mainly centred around check-in at Terminal 2 (which was also housing airlines that usually operated from Terminal 4) as there was insufficient space in the terminals for passengers and queues were very long, with substantial impacts on passenger experience.

- (d) Baggage: There were significant resilience issues in the baggage system due to HAL's lack of maintenance on Hold Baggage Screening machines, as more fully described in CW1.
- (e) Staffing: HAL failed to ensure that it had sufficient staff to meet demand during 2022. For example:
- (i) Security: Published SQRB performance data, which the CAA highlighted in the April 2021 RAB Adjustment Decision as “*useful information to signal any potential issues with service quality*”, indicated – for the period from April 2022 to December 2022 – that HAL did not meet its target for security queue performance at any terminal other than Terminal 4, and that in July 2022 and August 2022 in particular, security queue wait times only met the proposed target 50-60% of the time in many of the terminals.⁵¹⁹ Passenger satisfaction in relation to security also declined throughout 2022. Issues with security were highlighted by VAA repeatedly on bilateral calls with the CAA throughout summer 2022, in a letter from VAA to the CAA dated 25 April 2022⁵²⁰, and were summarised in the presentation by Airline CEOs to members of the CAA Board on 11 October 2022.⁵²¹ In addition, the Appellant conducted a study in August 2022 which concluded that HAL's throughput at security should be higher.⁵²²
- (ii) HAL ID Centre: HAL failed to address significant bottlenecks in the infrastructure, including the processing of security clearances at the HAL ID centre. During 2022, the HAL ID centre did not process applications efficiently and effectively, and was under-resourced. This failure led to various outcomes, including: (i) significant impact on the ability of groundhandlers to deploy the new staff they had recruited, as groundhandlers need full security clearance to work airside and staff with temporary ID badges are limited in the duties they can perform; and (ii) wheelchair assistance staff on temporary security passes could not take the passenger airside without being escorted by staff with a full security pass. These resourcing issues led to passenger and departure delays, and the HAL ID centre continues to be a significant point of failure, as more particularly described in CW1.
- 6.62 In addition, the capacity restrictions on airlines at Heathrow Airport under **Local Rule A** between July and October 2022 were a further demonstration that HAL failed to “*maintain and improve quality of services to consumers in 2021 and beyond*” including “*investment to provide appropriate capacity at the airport if there is a particularly strong recovery in demand*”, in line with the conditions of the RAB adjustment.⁵²³ As set out in section H of CW1, the overall impact of the unilateral daily passenger cap was that airlines were forced to reduce their operations at a critical point in time for their recovery from the Covid-19 pandemic.
- 6.63 Indeed, the Appellant notes that this outcome is exactly what the CAA stated the RAB adjustment should avoid. In the April 2021 RAB Adjustment Decision, the CAA stated: “*In normal times, HAL faces incentives to undertake necessary investment through including efficient investment in the RAB and earning an allowed cost of capital. In these unprecedented circumstances, we can see that HAL has significantly reduced its investment, focusing on*

⁵¹⁹ Note that Terminal 4 opened part way through June 2022. See Heathrow, Operational update - June 2022 [Vol A / Tab 57 / p.6,020].

⁵²⁰ Letter from VAA to the CAA regarding HAL's late reopening of Terminal 4 in 2022 causing consumer harm [Vol A / Tab 133].

⁵²¹ VAA, BA, IATA and AOC, Airline community joint views: Heathrow H7 Final Proposals, Airline presentation to the CAA Board [Vol A / Tab 58 / p.6,022].

⁵²² Delta, LHR Security Analysis (draft) [Vol A / Tab 59].

⁵²³ See letter from BA/VAA/IATA/AOC to the CAA dated 11 May 2022 which notes HAL's “*inept peak readiness preparations*” meaning that “*consumers and airlines are suffering, despite paying more*”. [Vol A / Tab 135 / p.11,226].

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*minimum safety requirements. This could also mean that HAL takes a slower and more reactive approach if traffic recovers, which might not provide capacity in a timely way in the event of a faster than expected recovery in traffic. This suggests that, in the exceptional circumstances of the covid-19 pandemic, a targeted regulatory intervention may be appropriate. This would be designed to ensure that HAL has both the capacity and incentives to invest in a way that fully meets the needs of consumers” (emphasis added).*⁵²⁴

- 6.64 Despite HAL’s suggestions to the contrary, the Appellant therefore submits that HAL was not prepared for the return in passenger demand when it came and failed to act “*in line with the outcomes [it] said could be delivered*” as a result of a RAB adjustment.⁵²⁵
- 6.65 The Appellant further submits that the CAA was wrong to conclude: “*it is not clear ... that it would have been in consumers’ interests for HAL to have undertaken a materially greater volume of capital expenditure in [2021] than it did in practice*”.⁵²⁶
- 6.66 In conclusion, the Appellant submits that the CAA’s decision was based on errors of fact and wrong in law because the CAA failed properly to consider the evidence before it. As a result, it reached an illogical and erroneous conclusion.

Error 2(c): The CAA was wrong in law when it suggested that the Competition Commission’s price determination in PNGL meant that it could not reverse or reduce the RAB adjustment.

- 6.67 The CAA stated: “*we ... note that the reversal of amounts previously included in the RAB has ... been explicitly proscribed in a previous CMA [sic] appeal. In the appeal by Phoenix Gas Networks of its price control in 2021 [sic], the CMA [sic] was clear that it would not be appropriate for a regulator to seek to reverse, ex post, amounts previously added to the RAB.*”⁵²⁷
- 6.68 The Appellant makes the following points in this regard:
- (a) In PNGL, the Competition Commission stated: “*In line with normal regulatory practice, our view is that any revision of previous regulatory determinations should be: well reasoned, properly signalled, subject to fair and effective consultation, clear and understood, and, normally, forward-looking. We consider that some changes are more serious than others, and that to reduce ex post and without clear signalling the opening value of a RAB is a step that should not normally be taken without very good justification, and only then after an appropriate period of consultation on the proposals. The RAB is an important aspect of the credibility of a regulatory regime in that it provides investors with a qualified assurance that they will be able to earn an assured return. Having said that, our own decision in the reference indicates that RABs can and should be changed where justified in the public interest. Regulators are free to depart from previous decisions where appropriate in pursuit of their statutory objectives, but they should consider carefully whether their actions may be considered to lead to regulatory instability that will add to uncertainty in the industry*”.⁵²⁸

⁵²⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,412 / para 3.39 and 3.40].

⁵²⁵ Heathrow Airport, H7 Revised Business Plan – Update 1 [Vol A / Tab 60 / p.6095] which states: “*The interim £300m adjustment in 2021 has had a positive impact on consumer outcomes in 2021 and 2022 relative to no adjustment at all, even though the decision was taken by the CAA later than anticipated. It has provided Heathrow with the ability to begin the minimum required critical maintenance in Terminal 3 and Terminal 4. This has supported the opening of a red list country dedicated arrivals facility and helped planning for both terminals, particularly Terminal 3, to be ready for when passenger demand returns. This in turn means we are better placed to reassure consumers that they are receiving the safe and secure experience they desire and the capacity they might need in 2021. This is in line with the outcomes we said could be delivered if the CAA were to take a decision to make an adjustment in 2021 In our response to CAP2098.*”

⁵²⁶ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.344 / para 10.80 – 10.81].

⁵²⁷ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.342 / para 10.63]. We note the decision to which the CAA refers in this statement is in fact a decision of the Competition Commission in 2012 (rather than a decision of the CMA in 2021).

⁵²⁸ Competition Commission, Phoenix Natural Gas Limited price determination [Vol A / Tab 61 / p.6,511 – 6,512 / para 9.112].

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- (b) The Appellant submits that it is clearly wrong to suggest that this general, principled position proscribes or otherwise renders inappropriate the reversal of amounts previously added to a RAB by a regulator, regardless of the merits of the adjustment.
- (c) The context of the PNGL price determination is also very important. This is considered in detail in paragraphs 3.1.6 to 3.1.15 of the RAB Report,⁵²⁹ but the key points can be summarised as follows:
- (i) In PNGL, the Competition Commission was considering changes made at a prior price review. Specifically, it had to decide whether it would be appropriate to reduce, ex post, amounts previously included in PNGL's Total Regulatory Value (or RAB). By contrast, the RAB adjustment arises from a policy decision taken by the CAA outside the H7 price control process and the necessary licence modifications have not yet taken effect.
- (ii) Unlike in PNGL, the RAB adjustment has nothing to do with being rewarded for historic outperformance and capex deferrals under a historic price control regime. The historic price control regime for HAL was, as already set out, that HAL would bear volume risk, and HAL has been allowed to earn a higher WACC as a result.
- (iii) As the CAA itself notes in the April 2021 RAB Adjustment Decision:
- "We do not consider that the precedent of Phoenix Gas Networks is directly applicable in the current context. In the 2012 CC appeal, the Utility Regulator was intentionally seeking to reduce the RAB in consumers' interest... we are not seeking to reduce HAL's RAB. Rather, HAL is "simply experiencing the crystallisation of a commercial risk". We are not persuaded that the nature of the risk, "normal" or otherwise, restores the analogy with the case of Phoenix: it remains the case that HAL has been subject to an external shock, which is fundamentally different to a discretionary reduction in the RAB".*⁵³⁰
- (iv) The scope for review and potential reduction of the RAB adjustment was clearly signalled at the time of the April 2021 RAB Adjustment Decision. Indeed, the CAA is arguably not being asked to 'reverse' the April 2021 RAB Adjustment Decision but rather to act in accordance with it, as that decision contains an undertaking to "consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue" if "evidence were to emerge of HAL failing to deliver on an appropriate quality of service". As explained in paragraph 3.1.6 of the RAB Report,⁵³¹ as the April 2021 RAB Adjustment Decision was always contingent, a justified disallowance would not be reneging on the 'regulatory contract'.
- (v) It is telling that the Competition Commission decided that PNGL should not retain the benefit of the relevant capex deferrals as PNGL had revised its investment policy such that these projects were not needed in the foreseeable future. The Competition Commission stated: "It would appear unreasonable to offer a regulated company a return on an allowance to undertake a project that it has never undertaken and that it is not going to undertake. Therefore we consider that retention of seriously delayed, or irrelevant and superseded projects in the portfolio of intended investments is no longer appropriate and they should be removed and only reinstated when they are immediately relevant to the current strategy."⁵³² As set out in paragraph 3.1.16 of the RAB Report,⁵³³ this highlights that regulatory stability is not a limitless consideration, even as regards sums added to the RAB, and supports the proposition that HAL should not retain any financial benefit for projects not carried out.

⁵²⁹ RAB Report [Vol A / Tab 122 / p. 11,046 – 11,048 / para 3.1.6 – 3.1.15].

⁵³⁰ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3442 / para C46].

⁵³¹ RAB Report [Vol A / Tab 122 / p. 11,046 / para 3.1.6].

⁵³² Competition Commission, Phoenix Natural Gas Limited price determination [Vol A / Tab 61 / p.6335 / para 27].

⁵³³ RAB Report [Vol A / Tab 122 / p.11,049 / para 3.1.16].

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- (d) The PNGL determination is not, in any event, binding precedent on the CAA or the CMA.
- (e) If the CMA disagrees with the Appellant as to the application and interpretation of the PNGL redetermination, it follows that – in the alternative – the CAA must instead have been in error when it stated that it “*would consider reducing the £300 million RAB adjustment*”⁵³⁴ and made other equivalent statements during the H7 process.
- 6.69 In conclusion, the Appellant submits that the CAA’s decision was wrong in law regarding the application and interpretation of the PNGL price determination or, in the alternative, when it stated that it would “*consider reducing the £300 million RAB adjustment*”.

Error 2(d): The CAA’s failure to reverse or reduce the RAB adjustment has caused, and will continue to cause, consumer harm

- 6.70 The CAA’s failure to reverse or reduce the RAB adjustment has and will continue to cause consumer harm.
- 6.71 The Appellant has already addressed the consumer harm arising from the RAB adjustment. All of those points remain equally relevant here.
- 6.72 The RAB adjustment will cost the Appellant on average an additional £0.17 per passenger in airport charges over the H7 price control period.⁵³⁵ Further details of the effect on Delta are set out in Section J of CW1. The impact will continue beyond 2026 at levels dependent on the depreciation rate and the WACC in force in future price controls. More generally, it will cost consumers £338.48 million (in 2021 prices) in NPV terms⁵³⁶ – and even more in cash terms – with payments being made over multiple price control periods. The RAB adjustment is also damaging to regulatory integrity, and there are important points of economic and regulatory principle at stake which have the potential to affect future price controls.
- 6.73 In addition, in refusing to conduct a review and allowing HAL to retain the £300 million RAB adjustment despite its failure to deliver, the CAA has undermined the incentive properties of the review mechanism (designed to “*help further incentivise HAL in delivering an appropriate level of investment and quality service to consumers*”)⁵³⁷ and inevitably increased the likelihood that consumers will continue to pay for and receive poor customer service, operational disruption and inconvenience at Heathrow Airport.
- 6.74 In conclusion, and based on the above, the Appellant submits that the CAA’s failure to review the RAB adjustment and to reverse or reduce it has resulted in clear error. The H7 Final Decision is based on errors of fact, wrong in law and reflects erroneous exercises of discretion. It will cause direct and enduring harm to consumers, both financially and in terms of the industry’s recovery from the effects of the Covid-19 pandemic.

E. Legal consequences

- 6.75 In summary, the Appellant submits that the H7 Final Decision, insofar as it retains the RAB adjustment, was wrong on the following statutory grounds:
- (a) It was based on errors of fact, pursuant to section 26(a) of the Act. This is for reasons including that the CAA: (i) relied on flawed evidence and assumptions (e.g. that the 70% gearing threshold would have been breached absent the RAB adjustment, that the RAB adjustment would incentivise additional investment, that reversal of the RAB adjustment would not be the appropriate remedy in the context of a review, that the PNGL price determination proscribed the reversal of amounts previously added to a RAB); (ii) made false comparisons (e.g. in relation to using the RAB to smooth the impact on charges from adjustments and incentives); (iii) had the wrong facts or interpreted them incorrectly (e.g. concluding that a review would be a distraction); and (iv) reached conclusions without

⁵³⁴ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,391 / para 32].

⁵³⁵ Calculated by AlixPartners on the basis of the CAA’s PCM.

⁵³⁶ H7 Final Proposals Section 3 [Vol A / Tab 4 / p.349 / Table 10.2].

⁵³⁷ April 2021 RAB Adjustment Decision [Vol A / Tab 40 / p.3,385 / para 4].

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reasonable basis (e.g. concluding that the RAB adjustment was necessary to secure notional financeability, that HAL was at risk of an increase in debt costs sufficient to justify a £300 million RAB adjustment, and that it would not have been in consumers' interests for HAL to have undertaken more investment in 2021).

- (b) It was wrong in law, pursuant to section 26(b) of the Act. This is for reasons including that the CAA: (i) acted contrary to its primary duty under section 1(1) of the Act to further the interests of consumers regarding the range, availability, continuity, cost and quality of AOS; (ii) acted contrary to its duties to have regard to the need to secure that all reasonable demands for AOS are met and to promote economy and efficiency on the part of HAL in its provision of AOS at Heathrow Airport under sections 1(3)(b) and (c) of the Act respectively; (iii) acted inconsistently with its duty to have regard to the principles of best regulatory practice under section 1(3)(g) of the Act, namely that regulatory activities should be carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; (iv) failed properly to inquire (e.g. not carrying out the necessary analysis and quantification in relation to the potential increase in debt costs, not properly assessing the impact of the RAB adjustment on HAL's investment incentives, not considering relevant precedent from other regulators); (v) failed to take proper account of relevant considerations (e.g. HAL's Q6 outperformance and dividends, high gearing practices, and lack of equity support, and the clear evidence of HAL's failure to make additional investment and to deliver on what it had promised); (vi) acted in defiance of logic (e.g. seeking to use a lump sum RAB adjustment as an incentive mechanism, making 'double recoveries', and otherwise reaching illogical conclusions); (vii) acted disproportionately (e.g. in using a long-term solution for a potentially short-term issue); (viii) failed to review the RAB adjustment despite its commitment to do so in the circumstances which arose; and (ix) misinterpreted and misapplied the PNGL price determination (or, in the alternative, indicated that the RAB adjustment could be reversed or reduced) and the contingent nature of the RAB adjustment.
- (c) There were errors made in the exercise of a discretion, pursuant to section 26(c) of the Act. This is for reasons including that the CAA: (i) failed to utilise the most appropriate regulatory mechanism, to consider all alternative options, and to prefer clearly superior approaches (such as an equity injection); (ii) failed to take relevant factors into account (e.g. that Heathrow Airport is already more expensive than all relevant comparator airports) and/or took into account irrelevant factors (e.g. the risk to the headroom on HAL's actual debt gearing covenants); (iii) put in place "*additional protections*" for consumers, but unreasonably sought to limit and refuse to use them; (iv) failed to meet any of its own key consumer interest objectives; (v) failed to provide proper reasons; and (vi) has created a significant and lasting distortion to airport charges which unreasonably benefits HAL's investors at consumers' expense.

6.76 These statutory grounds are set out and explained in more detail in Annex 3.

F. Relief sought

6.77 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the Act insofar as it implements the RAB adjustment and that the RAB adjustment be removed from HAL's Licence.

6.78 To assist the CMA in providing the necessary directions to the CAA to give effect to this relief, Annex A1 to the RAB Report explains the changes required.

6.79 In accordance with the overriding objective, the Appellant will provide all such assistance to the CMA as is necessary to secure the implementation of the required relief within the CMA's statutory timetable.

SECTION 7: KEY DOCUMENTS

7.1 The Appellant has provided a list of the key CAA documents to this NOA below. To assist the CMA has also indicated which sections of the documents the Appellant considers are particularly relevant for the purposes of its appeal.

No.	Document	Date	Relevant section(s)
1.	H7 Final Decision	8 March 2023	<ul style="list-style-type: none"> • Summary [Decision / Tab 1] • Section 1, Chapter 1 Passenger forecasts [Decision / Tab 2 / p.30] • Section 1, Chapter 2 Regulatory Framework [Decision / Tab 2 / p.49] • Section 3, Chapter 9 Weighted Average Cost of Capital [Decision / Tab 2 / p.146] • Section 3, Chapter 10, The H7 Regulatory Asset Base [Decision / Tab 4 / p.184] • Appendix A, Our duties [Decision / Tab 5 / p.248] • Appendix B, Glossary [Decision / Tab 5 / p.250] • Appendix C, Notice of the CAA's decision to modify HAL's licence [Decision / Tab 6] • Appendix H, Rolling forward the RAB [Decision / Tab 7] • H7 Forecast Update Review, Final Report, Skylark [Decision / Tab 13 / p.439]
2.	Interim charge decision for 2023	1 February 2023	<ul style="list-style-type: none"> • Summary [Vol A / Tab 52 / p.5733] • Chapter 2, The level and other aspects of the holding price cap for 2023 [Vol A / Tab 52 / p.5740]
3.	H7 Final Proposals	28 June 2022	<ul style="list-style-type: none"> • Summary [Vol A / Tab 1 / p.9] • Section 1, Chapter 1 Passenger forecasts [Vol A / Tab 2 / p.45] • Section 3, Chapter 9 Weighted Average Cost of Capital [Vol A / Tab 4 / p.249] • Section 3, Chapter 10, The H7 Regulatory Asset Base [Vol A / Tab 4 / p.328] • Appendix A, Our Duties [Vol A / Tab 5 / p.425] • Appendix B, Glossary [Vol A / Tab 5 / p.427] • Appendix C, Notice of the CAA's proposal to modify HAL's licence [Vol A / Tab 6 / p.540] • Appendix K, Rolling forward the RAB [Vol A / Tab 7 / p.621]
4.	Interim charge decision for 2022	16 December 2021	N/A, document available at [Vol A / Tab 81]

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No.	Document	Date	Relevant section(s)
5.	H7 Initial Proposals	19 October 2021	<ul style="list-style-type: none"> • Summary [Vol A / Tab 8 / p.625] • Section 2, Chapter 6 The H7 Regulatory Asset Base and HAL's request for a RAB adjustment [Vol A / Tab 9 / p.656] • Section 2, Chapter 9, Weighted Average Cost of Capital [Vol A / Tab 9 / p.692]
6.	2021 RAB Adjustment Decision	4 May 2021	<ul style="list-style-type: none"> • Summary and introduction (page 6) [Vol A / Tab 40 / p.3384] • Chapter 4, Details on early intervention [Vol A / Tab 40 / p.3419]

SECTION 8: CHRONOLOGY

- 8.1 This chronology details the key steps the CAA took in setting the H7 price control, culminating in the H7 Final Decision. Relevant aspects of this chronology are more fully detailed in CW1.

Date	Event
8 March 2023	H7 Final Decision CAP 2524 Final decision made by the CAA to modify the conditions of HAL's Licence, which will operate from 1 January 2022 to 31 December 2026 contained in a notice under section 22(6) of the Act
1 February 2023	Holding Price Cap 2023 Decision CAP 2515 Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023
8 December 2022	Holding Price Cap 2023 Consultation Document CAP 2488 Economic regulation of Heathrow Airport Limited: setting a holding price cap for 2023
28 June 2022	H7 Final Proposals CAP 2365 Economic regulation of Heathrow Airport Limited: H7 Final Proposals
December 2021	Holding Price Cap 2022 CAP2305 Economic Regulation of Heathrow Airport Limited from January 2022: notice of licence modifications (implementing the holding price cap)
November 2021	Draft Licence Consultation CAP2275 Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – draft licence modifications
November 2021	OBR Working Paper CAP2274 Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Working paper on outcome based regulation
October 2021	H7 Initial Proposals CAP2256 Economic Regulation of Heathrow Airport Limited: H7 Initial Proposals
April 2021	April 2021 Working Paper CAP1996 Economic regulation of Heathrow Airport Limited: working paper on Q6 capital expenditure and early expansion costs
April 2021 (amended 4 May 2021)	April 2021 RAB Adjustment Decision CAP2140 Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment
April 2021	April 2021 Way Forward Document CAP2139 Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward

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February 2021	February 2021 Consultation CAP2098 Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment
October 2020	October 2020 Consultation CAP1966 Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment
September 2020	September 2020 Working Paper CAP1964 Economic regulation of Heathrow Airport Limited: working paper on the efficiency of HAL's capital expenditure during Q6
August 2020	August 2020 Working Paper CAP1951 Economic regulation of Heathrow Airport Limited: working paper on capital expenditure efficiency incentives
June 2020	June 2020 Consultation CAP1940 Economic regulation of Heathrow Airport Limited: policy update and consultation (including the June 2020 Business Plan Guidance)
April 2020	April 2020 Update CAP1914 Economic regulation of Heathrow: programme update

SECTION 9: GLOSSARY

9.1 Abbreviations marked * have been extracted from the CAA's glossary which can be found in Appendix B of the H7 Final Decision.

Abbreviation	Meaning
Act	The Civil Aviation Act 2012 (as amended) – used interchangeably with CAA12
AOC*	Airline Operators' Committee (for Heathrow)
AOS*	Airport Operation Services as defined in section 68 of the Act
Appellant	Delta Air Lines, Inc.
BA/IAG*	British Airways plc/International Airlines Group (owner of British Airways)
Better Regulation Principles*	The principles to which the CAA (and the CMA) must have regard under section 1(3)(g) of the Act and set out in subsection 1(4) of the Act
Building blocks*	Price control building blocks, including passenger numbers, operating costs, capital expenditure and commercial revenues
CAA*	The Civil Aviation Authority
CAA12*	The Civil Aviation Act 2012
CAA Consumer Panel*	A non-statutory body established to act as a 'critical friend' to the CAA
Capex*	Capital Expenditure
CAPM*	Capital Asset Pricing Model
CE*	Constructive Engagement: a CAA-mandated process that requires the airport operator to discuss its business plan with the airlines before the CAA develops its proposals for the relevant price control. For H7, CE took place between August 2020 and October 2020
CMA*	The Competition and Markets Authority
CMA Guide	Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) dated 27 October 2022
CMA Rules	Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) dated 27 October 2022
Consumers*	"Users" are defined in section 69 of the Act as passengers and those with "a right in property" (cargo) carried by air transport services and include future users
CPI*	Consumer Price Index

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EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
Equity beta*	Company specific estimate of risk relative to the whole market
Foreign Carrier Permit	Air operators based outside the EEA require a Foreign Carrier Permit from the CAA before operating flights, in accordance with Article 250 of the Air Navigation Order 2016
H7*	The next price control for Heathrow from 1 January 2022 until 31 December 2026
H7 Final Decision	Final decision made by the CAA to modify the conditions of HAL's Licence which will operate from 1 January 2022 to 31 December 2026, contained in a notice under section 22(6) of the Act dated 8 March 2023
H7 Final Proposals / FPs	CAA's Final Proposals for the H7 price control review dated 28 June 2022
HAL*	Heathrow Airport Limited, the licence holder and operator of Heathrow Airport
HBS*	Hold Baggage Screening
Holding Price Cap 2022	Holding Price Cap for 2022 set at £30.19 per passenger in 2022 prices (expired 31 December 2022)
Holding Price Cap 2023	Holding Price Cap for 2023 set at £31.57 (nominal prices) per passenger
IATA*	International Air Transport Association, a global trade association representing airlines
iBoxx indices*	The Markit iBoxx Corporates Indices represent investment grade fixed-income bonds issued by public or private corporations and are produced by public or private corporations and are produced by HIS Markit.
iH7*	The interim H7 price control, running from 1 January 2020 until 31 December 2021
ILG*	Index-Linked Gilt
Initial Proposals	The CAA's Initial Proposals for H7, published in October 2021
LACC*	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow Airport
Licence	Airport Licence granted to HAL by the CAA under section 15 of the Act on 13 February 2014
Notional financial structure*	Financial structure of the regulated company that reflects the CAA's views on the efficient balance between debt and equity finance
NPV*	Net Present Value

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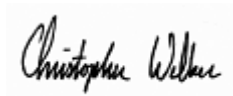
OBR*	Outcome Based Regulation
OLS*	Ordinary least squares
Opex*	Operational Expenditure
Phoenix Gas	CC price redetermination in Phoenix Natural Gas Limited dated 2012
P0*	The price per passenger at the beginning of a price control
Price Control Model*	The financial model developed by the CAA to calculate HAL's revenue requirements for H7
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
Q6 Final Proposals	CAA's Final Proposals for the Q6 price control review
RAB*	Regulatory Asset Base
Revenue risk sharing*	A mechanism that allows HAL to share the impact to aeronautical and non-aeronautical revenues due to the difference between outturn and forecast passenger traffic
RORE*	Return on Regulatory Equity
RPI*	Retail Price Index
SQRB	Service Quality Rebate and Bonus scheme
TMR*	Total Market Return
TRS*	Traffic Risk Sharing
VAA*	Virgin Atlantic Airways
WACC*	Weighted Average Cost of Capital

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SECTION 10: STATEMENT OF TRUTH

The Appellant believes that the facts stated in this Notice of Appeal are true.

Signed:

A handwritten signature in black ink that reads "Christopher Walker". The signature is written in a cursive style and is contained within a light gray rectangular box.

Dated: 18 April 2023

Christopher Allen Walker, Director of Regulatory Affairs

For and on behalf of Delta Air Lines, Inc.

ANNEX 1: STATUTORY GROUNDS ENGAGED BY GROUND 1 – PASSENGER FORECAST

Section 4 (Ground 1: Passenger Forecast)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
The CAA made errors in its methodology for setting the H7 passenger forecast			
4 (C)	1(a) The CAA has failed to adequately explain its methodology for setting the H7 passenger forecast.	N/A	<p>The CAA’s decision was wrong:</p> <p>(a) in law, because it:</p> <p>(i) breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by (1) adopting an approach that lacked transparency; (2) failing to adequately explain its methodology; and (3) failing to carry out its activities in the way that is both transparent and accountable);</p> <p>(ii) failed properly to inquire (e.g. because key stakeholders were not able to scrutinise or comment on the HAL model);</p> <p>(iii) was procedurally unfair (e.g. because key stakeholders were not able to scrutinise or comment on the HAL model); and</p> <p>(b) the CAA made errors in the exercise of its discretion by failing to provide proper reasons (e.g. by failing to</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				explain clearly its four step methodology).
4 (C)	1(a)(i) To the extent that the CAA has relied on the HAL model, the CAA is wrong to have done so.	N/A	<p>Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; breached the CAA's duty to have regard to the principles of best regulatory practice; relied on flawed evidence and assumptions; made methodological errors; failed to take proper account of relevant considerations) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by relying on flawed evidence and assumptions (e.g. the CAA unjustifiably relied on the HAL model which was wrong and not fit for purpose);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by wrongly relying on the HAL model, and as a result setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA's duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. by setting the H7 passenger forecast too low and, as a result, failing to incentivise HAL to ensure efficiency);</p> <p>(iii) breached the CAA's duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in</p>

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Section 4 (Ground 1: Passenger Forecast)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by relying on a model which has not been subjected to scrutiny by stakeholders);</p> <p>(iv) relied on flawed evidence and assumptions (e.g. wrongly relied on the HAL model despite evidence that it is not fit for purpose);</p> <p>(v) made methodological errors (e.g. relied on erroneous inputs from HAL's model to arrive at its passenger forecast); and</p> <p>(vi) failed to take proper account of relevant considerations (e.g. the CAA failed to deal appropriately with the shortcomings in the HAL model).</p>
<p>4(C)</p>	<p>1(a)(ii) In Step 1, the CAA is wrong to have ignored the impact of Local Rule A and threatened capacity restrictions in coming to a conclusion for passenger numbers in 2022 and in constructing the appropriate baseline of demand for 2023 onward.</p>	<p>(a) The CAA failed to consider the impact of Local Rule A and threatened capacity restrictions on passenger numbers in 2022.</p>	<p>Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; relied on flawed evidence and assumptions; failed to take proper account of relevant considerations) [26(b) CAA12]</p> <p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by relying on flawed assumptions and evidence (e.g. the CAA was wrong to consider that HAL would be 'penalised' if the CAA took account of Local Rule A and threatened capacity restrictions);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA's duty to further the interests of users of</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>air transport services (section 1(1) CAA12) (e.g. by wrongly ignoring the impact of the Local Rule A and threatened capacity restrictions, and as a result setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA’s duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p> <p>(iii) relied on flawed evidence and assumptions (e.g. the CAA was wrong to consider that HAL would be ‘penalised’ if the CAA took account of Local Rule A and threatened capacity restrictions); and</p> <p>(iv) failed to take proper account of relevant considerations (e.g. of the depressive impact of Local Rule A and threatened capacity restrictions on passenger forecasts for 2022).</p>
		(b) The CAA should have taken account of the depressive impact of Local Rule A threatened	Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]	The CAA’s decision was wrong:

Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
		capacity restrictions when setting the baseline for 2023.	Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; relied on flawed evidence and assumptions; failed to take proper account of relevant considerations; made methodological errors) [26(b) CAA12]	<p>(a) because it was based on errors of fact in the CAA's analysis by relying on flawed evidence and assumptions (e.g. the CAA based its calculations for the 2023 baseline on the wrong 2022 figures);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) (by wrongly ignoring the impact of the Local Rule A and threatened capacity restrictions, and as a result setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA's duty to promote economy and efficiency (section 1(3)(c) CAA12) (by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p> <p>(iii) relied on flawed evidence and assumptions (by assuming that the impact of Local Rule A and threatened capacity restrictions is not relevant to the calculation of the 2023 baseline);</p> <p>(iv) failed to take proper account of relevant considerations (i.e. of the depressive impact of Local Rule A</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				and threatened capacity restrictions on the 2023 baseline); and (v) made methodological errors (by adopting a wrong starting point when calculating the 2023 baseline).
4(C)	1(a)(iii) In Step 1, the CAA is wrong to have found 2023 traffic levels would be 92% of 2019 levels.	(a) the CAA was wrong to choose a lower bound which assumed only a one percentage point growth in passenger numbers as compared to the 2019 position.	Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12] Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; relied on flawed evidence and assumptions; acted in defiance of logic; failed to take proper account of relevant considerations) [26(b) CAA12]	The CAA's decision was wrong: (a) because it was based on errors of fact in the CAA's analysis, by having the relied on flawed evidence and assumptions (e.g. the CAA has incorrectly adopted a lower bound implying passenger growth of just one percentage point across 2023); (b) in law , because it: (i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by wrongly selecting a lower bound which materially underestimates the number of passengers likely to fly to and from Heathrow Airport, and therefore by setting the H7 passenger forecast too low); (ii) breached the CAA's duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>failing to incentivise HAL to ensure efficiency);</p> <p>(iii) relied on flawed evidence and assumptions (e.g. by incorrectly adopting a lower bound implying passenger growth of just one percentage point across 2023 despite evidence of increasing passenger demand);</p> <p>(iv) acted in defiance of logic (e.g. as it was illogical to assume only one percentage point growth across 2023 given evidence to the contrary); and</p> <p>(v) failed to take proper account of relevant considerations (e.g. (1) the data suggesting that passenger growth in 2023 will outperform the CAA's forecasts; and (2) its own conclusions about the likely rate of growth).</p>
		(b) the CAA was wrong to treat forward booking data for 2023 as an upper bound.	<p>Error of fact (e.g. had the wrong facts or interpreted them incorrectly) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; breached the CAA's duty to</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by having the wrong facts or interpreting them incorrectly (e.g. the CAA has wrongly concluded that forward bookings data represented the upper bound of passenger traffic in 2023);</p> <p>(b) in law, because it:</p>

Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>have regard to the principles of best regulatory practice; relied on flawed evidence and assumptions; made methodological errors; failed to take proper account of relevant considerations) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. failed to meet any of its own key consumer interest objectives) [26(c) CAA12]</p>	<p>(i) breached the CAA’s duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by wrongly selecting an upper bound which materially underestimates the number of passengers likely to fly to and from Heathrow Airport, and therefore by setting the 2023 passenger forecast too low);</p> <p>(ii) breached the CAA’s duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. by setting the 2023 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p> <p>(iii) breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (by failing to properly explain what ‘downside risks’ result in it not being appropriate to use forward bookings as a lower bound);</p> <p>(iv) relied on flawed evidence and assumptions (the CAA has wrongly concluded that forward bookings</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>data represented the upper bound of passenger traffic in 2023);</p> <p>(v) made methodological errors (by double-counting ‘downside risks’);</p> <p>(vi) failed to take proper account of relevant considerations (i.e. the reasons why forward bookings did not represent a lower bound); and</p> <p>(c) the CAA made errors in the exercise of its discretion by failing to meet any of its own key consumer interest objectives (e.g. by (1) failing to keep the maximum passenger charge at a level no higher than necessary; and (2) adopting an unduly pessimistic and unreasonable approach).</p>
4(C)	1(a)(iv) In Step 2, the CAA is wrong to have downgraded its forecast for 2023 in response to macroeconomic forecasts.	N/A	<p>Error of fact (e.g. reached conclusions without reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA’s duty to further the interests of users of air transport services; breached the CAA’s duty to promote economy and efficiency; breached the CAA’s duty to have regard to the principles of best regulatory practice; failed to take proper account of relevant considerations; failed properly to inquire;</p>	<p>The CAA’s decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA’s analysis by reaching conclusions without reasonable basis (e.g. the CAA has wrongly concluded that adjustments were required for macroeconomic factors without engaging with the downside skew inherent in the forecast);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA’s duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by wrongly</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			acted in defiance of logic; made methodological errors) [26(b) CAA12]	<p>making a downwards adjustment, and as a result setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA’s duty to promote economy and efficiency (section 1(3)(c) CAA12) (by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p> <p>(iii) breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by failing to explain adequately how the latest GDP forecast have been translated to adjustments to the forecasts);</p> <p>(iv) failed to take proper account of relevant considerations (i.e. (1) the evidence that HAL’s business is reasonably well insulated from UK macroeconomic factors; (2) the interaction between the adjustments and the continued reliance on the HAL model; and (3) other mechanisms applied by</p>

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Section 4 (Ground 1: Passenger Forecast)				
	Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>the CAA which reflect a 'pessimistic' approach);</p> <p>(v) failed properly to inquire (i.e. by not inquiring either transparently or in detail as to the effect of macroeconomic factors on HAL's likely performance);</p> <p>(vi) acted in defiance of logic (i.e. by applying multiple downward adjustments despite evidence that its forecasts were already too low and where HAL is protected from downside risk by the TRS); and</p> <p>(vii) made methodological errors (i.e. due to the double-counting).</p>
4(C)	1(a)(v) In Step 3, the CAA is wrong not to have uplifted its forecasts further to its cross checks against external forecasts.	N/A	<p>Error of fact (e.g. made false comparisons) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of users of air transport services; breached the CAA's duty to promote economy and efficiency; breached the CAA's duty to have regard to the principles of best regulatory practice; failed to take proper account of relevant considerations; made methodological errors;</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by making false comparisons (e.g. between its own forecasts and independent external forecasts);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) (i.e. by wrongly deciding not to uplift its forecasts, and as a result</p>

Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>failed properly to inquire) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. made erroneous methodological choices) [26(c) CAA12]</p>	<p>setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA’s duty to promote economy and efficiency (section 1(3)(c) CAA12) (by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p> <p>(iii) breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by failing to explain adequately how the latest GDP forecast have been translated to adjustments to the forecasts);</p> <p>(iv) failed to take proper account of relevant considerations (i.e. the independent forecasts indicating that passenger growth in 2023 will outperform the CAA’s forecasts);</p> <p>(v) made methodological errors (e.g. failed to compare its shocked forecast with external forecasts);</p> <p>(vi) failed properly to inquire (i.e. has not properly considered the evidence</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>available from external forecasts); and</p> <p>(c) the CAA erred in the exercise of its discretion, by making erroneous methodological choices (i.e. because the CAA chose not to uplift its forecast despite strong evidence this was required).</p>
4(C)	<p>1(a)(vi) In Step 4, the CAA is wrong to apply a shock factor of 0.87% and wrong to apply a shock factor in full to 2023 when some months of 2023 have already elapsed.</p>		<p>Error of fact (e.g. reached conclusions without reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duties; failed to take proper account of relevant considerations; made methodological errors; reached conclusions without adequate supporting evidence) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by reaching conclusions without reasonable basis (i.e. the CAA wrongly considered that a full shock factor was appropriate);</p> <p>(b) in law, because it:</p> <p>(i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by wrongly applying a shock factor, and as a result setting the H7 passenger forecast too low);</p> <p>(ii) breached the CAA's duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. by setting the H7 passenger forecast too low and, as a result, setting the per passenger charge too high and failing to incentivise HAL to ensure efficiency);</p>

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>(iii) breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by failing to explain adequately the reasons behind applying the shock factor);</p> <p>(iv) failed to take proper account of relevant considerations (i.e. of the forward booking data and external forecasts showing the forecast to be pessimistic);</p> <p>(v) made methodological errors (e.g. as the shock factor duplicates the adjustments already made at other stages of the CAA’s methodology); and</p> <p>(vi) reached conclusions without adequate supporting evidence (i.e. (1) failed to support the decision by any robust evidence; and (2) applied the adjustment to the whole of 2023 although the decision was taken partway through the year).</p>
The CAA erred by failing to adjust the asymmetric risk allowance				
4(C)	1(b) Having updated its passenger forecast for 2022, the CAA erred by		Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]	The CAA’s decision was wrong:

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Section 4 (Ground 1: Passenger Forecast)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
	failing to make a consequential adjustment to the asymmetric risk allowance.		Wrong in law (e.g. failed to take proper account of relevant considerations) [26(b) CAA12]	<p>(a) because it was based on errors of fact in the CAA’s analysis, by relying on flawed evidence and assumptions (i.e. it was based on out-dated outturn projections for 2022); and</p> <p>(b) in law, because it:</p> <p>(i) failed to take proper account of relevant considerations (i.e. that the allowance for asymmetric risk should be updated to reflect higher outturn traffic in 2022).</p>

ANNEX 2: STATUTORY GROUNDS ENGAGED BY GROUND 2 – WACC

Section 5 (Ground 2: WACC)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
1. Asset beta error – The CAA set HAL’s asset beta too high			
5(C)	1(a) The CAA erred in setting the pre-pandemic asset beta.	N/A	<p>Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed to take proper account of relevant considerations; relied on flawed evidence and assumptions; made methodological errors; acted in defiance of logic; reached conclusions without adequate supporting evidence) [26(b) CAA12]</p> <p>The CAA’s decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA’s analysis by relying on flawed evidence and assumptions (e.g. the CAA relied on the Q6 asset beta of 0.5 to establish HAL’s pre-pandemic asset beta, despite far more recent pre-pandemic asset beta data for the comparator being available);</p> <p>(b) in law because it:</p> <p>(i) failed to take proper account of relevant considerations (e.g. failed to update the pre-pandemic asset beta data for the comparator set with up-to-date information);</p> <p>(ii) relied on flawed evidence and assumptions (i.e. relied on the Q6 asset beta of 0.5 which was out of date);</p> <p>(iii) made methodological errors (i.e. selected the wrong data when setting the pre-pandemic asset beta);</p> <p>(iv) acted in defiance of logic (relied on asset beta values for the comparator set estimated in 2013</p>

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Section 5 (Ground 2: WACC)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>despite more up-to-date figures being available); and</p> <p>(v) reached conclusions without adequate supporting evidence (i.e. failed to take into account up to date, and therefore more relevant, data).</p>
<p>5(C)</p>	<p>1(b) The CAA erred in calculating the impact of the pandemic on HAL's asset beta.</p>	<p>(i) The CAA was wrong to increase HAL's asset beta when making an adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports.</p> <p>Wrong in law (e.g. failed properly to inquire, failed to take proper account of relevant considerations; relied on flawed evidence and assumptions; made methodological errors; acted in defiance of logic; reached conclusions without adequate supporting evidence) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by:</p> <p>(i) relying on flawed evidence and assumptions (e.g. the CAA relied on out-dated pre-pandemic figures for the comparator set as an input when making the adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports);</p> <p>(ii) reaching conclusions without a reasonable basis (e.g. the CAA wrongly assumed that the pandemic neutralised the effect of the capacity constraint on HAL's beta relative to comparator airport betas);</p> <p>(b) in law because it:</p> <p>(i) failed properly to inquire (e.g. the CAA failed to conduct analysis on whether there had been a</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>relaxation in HAL’s capacity constraints since Q6 relative to comparator airports);</p> <p>(ii) failed to take proper account of relevant considerations (e.g. the CAA failed to consider its own analysis of the projected passenger numbers throughout H7 when considering the impact of the pandemic on HAL’s capacity constraints);</p> <p>(iii) relied on flawed evidence and assumptions (e.g. (1) the CAA relied on out-dated pre-pandemic figures for the comparator set as an input when making the adjustment to account for the impact of the pandemic on the risk differential between HAL and comparator airports; and (2) wrongly assumed that the pandemic neutralised the effect of the capacity constraint on HAL’s beta relative to comparator airports’ betas);</p> <p>(iv) made methodological errors (e.g. selected the wrong data when setting the pre-pandemic asset beta);</p> <p>(v) acted in defiance of logic (relied on asset beta values for the comparator set estimated in 2013</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>despite more up-to-date figures being available); and</p> <p>(vi) reached conclusions without adequate supporting evidence (e.g. failed to take into account up to date and therefore more relevant data; made erroneous assumptions when drawing comparisons).</p>
		<p>(ii) The CAA erred in calculating the impact of the pandemic on comparator airports.</p>	<p>Error of fact (e.g. had the wrong facts or interpreted them incorrectly) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed to take proper account of relevant considerations; relied on flawed evidence and assumptions; made methodological errors; reached conclusions without adequate supporting evidence) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. made erroneous methodological choices) [26(c) CAA12]</p>	<p>The CAA’s decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA’s analysis, because the CAA had the wrong facts or interpreted them incorrectly (e.g. the CAA (1) considered that all increases in comparator airports’ asset beta over the pandemic period was due to the pandemic; and (2) relied on analysis by Flint which contained methodological errors);</p> <p>(b) in law because it:</p> <p>(i) failed to take proper account of relevant considerations (e.g. the relevance of debt gearing having increased during the pandemic);</p> <p>(ii) relied on flawed evidence and assumptions (e.g. reliance on the WLS estimator and distorted data);</p> <p>(iii) made methodological errors (e.g. relying on Flint’s analysis which used a WLS estimator and which</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<p>wrongly combined pandemic and non-pandemic periods);</p> <p>(iv) reached conclusions without adequate supporting evidence (e.g. relying on Flint’s analysis which contained methodological errors); and</p> <p>(c) because the CAA made errors in the exercise of its discretion, by making erroneous methodological choices (e.g. as there was no good reason for the departure in methodology from the standard econometric practises of using ‘slope dummy’ or separate regression models when calculating the impact of the pandemic on comparator airports).</p>
5(C)	1(c) The CAA erred in calculating the TRS adjustment.	N/A	<p>Error of fact (e.g. relied on flawed evidence and assumptions; reached conclusions without a reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed properly to inquire; failed to take proper account of relevant considerations; relied on flawed evidence and assumptions; made methodological errors; reached conclusions without adequate supporting</p>	<p>The CAA’s decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA’s analysis, by:</p> <p>(i) relying on flawed evidence and assumptions (e.g. the CAA wrongly assumed that 50% - 90% of the asset beta differential between HAL and network utilities was due to traffic risk);</p> <p>(ii) reaching conclusions without a reasonable basis (e.g. the CAA wrongly considered that other factors mentioned by CEPA could account</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			evidence; acted in defiance of logic) [26(b) CAA12]	<p>for the asset beta differential between HAL and network utilities);</p> <p>(b) in law because it:</p> <ul style="list-style-type: none"> (i) failed properly to inquire (e.g. the CAA failed to analyse factors mentioned by CEPA that could account for the asset beta differential between HAL and network utilities); (ii) failed to take proper account of relevant considerations (i.e. of its own analysis that the principal distinction between HAL's and network utilities' asset betas is HAL's exposure to volume risk); (iii) relied on flawed evidence and assumptions (i.e. the erroneous assumption that there were factors other than traffic risk accounting for the difference in risk between HAL and other regulated utilities); (iv) made methodological errors (e.g. relied on erroneous assumptions); (v) reached conclusions without adequate supporting evidence (i.e. considered that there were factors other than traffic risk accounting for the difference in risk between HAL and regulated utilities without supporting evidence); and (vi) acted in defiance of logic (i.e. failed to conclude that traffic risk accounts for a higher percentage of

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				the asset beta differential between HAL's and network utilities' asset betas than 50% - 90% despite strong evidence to the contrary).
2. Index-linked Premium error - The CAA erred by adding a 15bps premium on index-linked debt				
5(C)	The CAA wrongly included a premium when calculating the cost of index-linked debt.	(i) The CAA was wrong to add a premium on index-linked debt.	<p>Error of fact (e.g. had the wrong facts or interpreted them incorrectly, reached conclusions without a reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed to take proper account of relevant considerations; relied on flawed evidence and assumptions; made methodological errors; reached conclusions without adequate supporting evidence) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis, by:</p> <p>(i) the CAA having the wrong facts or interpreting them incorrectly (e.g. the CAA incorrectly interpreted the bonds data when calculating the cost of index-linked debt);</p> <p>(ii) reaching conclusions without a reasonable basis (e.g. the CAA added a premium to calculate the cost of index-linked debt despite investors' expectation that index-linked debt carries lower risk);</p> <p>(b) in law because it:</p> <p>(i) failed to take proper account of relevant considerations (i.e. placed no weight on the simple average difference between HAL's index-linked bonds and iBoxx spreads);</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<ul style="list-style-type: none"> (ii) relied on flawed evidence and assumptions (e.g. incorrectly interpreting the bonds data); (iii) made methodological errors (i.e. based its assessment on the weighted average of the spreads); and (iv) reached conclusions without adequate supporting evidence (i.e. based its conclusions on a flawed methodology).
		(ii) The CAA misstated the magnitude of the adjustment required to calculate the cost of index-linked debt.	Wrong in law (e.g. made methodological errors) [26(b) CAA12]	<p>The CAA's decision was wrong:</p> <p>(a) in law because it:</p> <ul style="list-style-type: none"> (i) made methodological errors (i.e. did not follow the correct methodology to calculate the adjustment to the cost of the index-linked debt).
3. Point estimate error – The CAA wrongly chose the mid-point of the WACC range when selecting a point estimate				
5 (C)	3(a) The CAA's decision not to aim down is unjustified, because it has ignored or misjudged relevant factors.	(i) The CAA has failed to adequately consider the asymmetry of costs and benefits.	<p>Error of fact (e.g. had the wrong facts or interpreted them incorrectly; reached conclusions without a reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of users of air</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis, by:</p> <ul style="list-style-type: none"> (i) the CAA having the wrong facts or interpreted them incorrectly (e.g. the CAA overestimated the importance of investment incentives in H7);

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>transport services; failed to take proper account of relevant considerations; made methodological errors;) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. failed appropriately to balance competing considerations) [26(c) CAA12]</p>	<p>(ii) reaching conclusions without a reasonable basis (e.g. the CAA failed to consider the specific circumstances of the H7 price control when considering the trade-off between welfare effects and investment considerations);</p> <p>(b) in law because it:</p> <p>(i) breached the CAA’s duty to further the interests of users of air transport services (section 1(1) CAA12) (by wrongly concluding that the trade-off between welfare effects and investment considerations warrants aiming up);</p> <p>(ii) failed to take proper account of relevant considerations (e.g. (1) that there is a clear imperative to secure affordable prices in H7; (2) the consumer harm caused by aiming straight; and (3) that there is little pressing need for large scale capex investment in H7);</p> <p>(iii) made methodological errors (i.e. when considering the trade-off between welfare effects and investment considerations); and</p> <p>(c) because the CAA made errors in the exercise of its discretion because it failed appropriately to balance competing considerations (e.g. decided that the balance of welfare</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				effects and investment considerations warranted aiming up).
		(ii) The CAA has failed to adequately consider the asymmetry of pandemic events.	Wrong in law (e.g. failed to take proper account of relevant considerations; made methodological errors;) [26(b) CAA12]	The CAA's decision was wrong: (a) in law because it: (i) failed to take proper account of relevant considerations (i.e. the impact of the asymmetry of pandemic events); and (ii) made methodological errors (i.e. wrongly used the mid-point to measure central tendency when calculating the risk of pandemic events).
		(iii) The CAA has failed to adequately consider the information asymmetries between HAL and the CAA.	Error of fact (e.g. reached conclusions without a reasonable basis, made false comparisons) [26(a) CAA12] Wrong in law (e.g. failed to take proper account of relevant considerations; made methodological errors) [26(b) CAA12]	The CAA's decision was wrong: (a) because it was based on errors of fact in the CAA's analysis, by: (i) reaching conclusions without a reasonable basis (e.g. the CAA considered that there were no uncompensated asymmetries in the price control); (ii) making false comparisons (e.g. the CAA considered that the CMA final determination in RIIO-T2/GD2 was a relevant regulatory precedent justifying not aiming down for information asymmetry); (b) in law because it:

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				<ul style="list-style-type: none"> (i) failed to take proper account of relevant considerations (i.e. the impact of information asymmetry on the appropriate WACC point estimate); and (ii) made methodological errors (i.e. failing to make adjustments for the impact of information asymmetry).
		(iv) The CAA has failed to adequately consider the effect of distortions created by the outer band of the TRS.	Wrong in law (e.g. failed to take proper account of relevant considerations; made methodological errors; reached conclusions without adequate supporting evidence) [26(b) CAA12]	<p>The CAA’s decision was wrong:</p> <p>(a) in law because it:</p> <ul style="list-style-type: none"> (i) failed to take proper account of relevant considerations (i.e. failed to consider the asymmetric impact of the TRS mechanism, and its impact on consumers and HAL); (ii) made methodological errors (i.e. not adequately considering the distortions created by the outer band of the TRS); and (iii) reached conclusions without adequate supporting evidence (i.e. by ignoring the impact of the TRS mechanism in reaching conclusions).
		(v) Failed to correctly consider other relevant factors.	Wrong in law (e.g. failed properly to inquire; failed to take proper account of relevant considerations; made methodological errors) [26(b) CAA12]	<p>The CAA’s decision was wrong:</p> <p>(a) in law because it:</p> <ul style="list-style-type: none"> (i) failed properly to inquire (i.e. failed to consider the holistic impact of the

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			Error in the exercise of discretion (e.g. failed to take relevant factors into account) [26(c) CAA12]	<p>numerous layers of protection that the CAA has afforded HAL);</p> <p>(ii) failed to take proper account of relevant considerations (i.e. HAL's financial position);</p> <p>(iii) made methodological errors (i.e. failed to take into account the protections afforded to HAL in other building blocks when selecting the point estimate; and</p> <p>(b) the CAA made errors in the exercise of its discretion, by failing to take relevant factors into account (e.g. because it failed to fully consider (1) the cumulative impact of the building blocks within the price control and therefore the degree to which HAL was afforded multiple layers of protection against risk when choosing the point estimate; and (2) HAL's financial position).</p>
5(C)	3(b) The CAA's decision not to aim down when selecting the point estimate for the WACC is harmful.	N/A	<p>Error of fact (e.g. reached conclusions without a reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. breached the CAA's duty to further the interests of air transport services; breached the CAA's duty to promote economy and efficiency; failed to take proper account of relevant considerations; made</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis, by reaching conclusions without a reasonable basis (e.g. that the conditions under which aiming down is needed to prevent consumer harm are not present in H7 when in fact they are);</p> <p>(b) in law because it:</p>

Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>methodological errors) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. failed to take relevant factors into account; failed to appropriately balance relevant considerations; failed to achieve its stated intent) [26(c) CAA12]</p>	<p>(i) breached the CAA’s duty to further the interests of users of air transport services (section 1(1) CAA12) (e.g. by setting the point estimate too high giving rise to material harm to consumers by requiring them to pay charges which are higher than necessary);</p> <p>(ii) breached the CAA’s duty to promote economy and efficiency (section 1(3)(c) CAA12) (e.g. (1) by failing to consider the protections afforded to HAL across each building block in a holistic way when selecting the point estimate; and (2) by over-compensating HAL’s investors at the expense of consumers and setting a significantly over-inflated WACC);</p> <p>(iii) failed to take proper account of relevant considerations (i.e. by failing to consider the material harm that consumers will suffer by setting the H7 WACC too high);</p> <p>(iv) made methodological errors (i.e. by prioritising investment considerations over welfare effects);</p> <p>(c) the CAA erred in the exercise of its discretion, because it:</p> <p>(i) failed to take relevant factors into account (e.g. the consumer harm of setting the WACC too high);</p>

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Section 5 (Ground 2: WACC)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
				(ii) failed to meet any of its own key consumer interest objectives because the decision to aim straight in the WACC range harms the interests of consumers; and (iii) failed to achieve its stated intent of ensuring that passenger charges were " <i>no higher than necessary</i> ".

ANNEX 3: STATUTORY GROUNDS ENGAGED BY GROUND 3 – RAB ADJUSTMENT

Section 6 (Ground 3: RAB Adjustment)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
1. RAB Adjustment error – The CAA erred in making an ex post £300 million upward adjustment to HAL’s RAB because it is unjustified, unnecessary and harmful to consumers.			
6(C)	(1)(a)The CAA’s RAB adjustment is unjustified.	(i) The CAA’s RAB adjustment was wrong as a matter of regulatory principle and having regard to its practical consequences. Wrong in law (e.g. acted in defiance of logic) [26(b) CAA12] Error in the exercise of discretion (e.g. failed to take relevant factors into account) [26(c) CAA12]	The CAA’s decision was wrong: (a) in law because it breached the CAA’s duty to have regard to the principles of best regulatory practice e.g. transparency, accountability, proportionality, consistency, with regulation targeted only at cases in which action is needed (section 1(3)(g)-(4) CAA12) (e.g. by: (1) dismantling the financial and regulatory construct of the RAB; (2) ignoring without good reason the responsible practices adopted by other regulators in relation to price increases by airports; and (3) undermining the long-term predictability of, and confidence in, the RAB model); and (b) because the CAA made errors in the exercise of its discretion by failing to take relevant factors into account (e.g. that Heathrow Airport is already more expensive than all relevant comparator airports).

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Section 6 (Ground 3: RAB Adjustment)			
Headline arguments	Sub-arguments	Statutory ground(s) of appeal	Summary
	(ii) The CAA's adjustment of HAL's RAB is inconsistent with the Q6 price control and amounts to an unjustified 'double recovery' from consumers.	Wrong in law (e.g. acted in defiance of logic) [26(b) CAA12]	The CAA's decision was wrong in law because it acted in defiance of logic (e.g. making 'double recoveries' as the Q6 price control was concluded on the basis that HAL assumed all traffic volume risk).
	(iii) There are other, more appropriate and proportionate regulatory tools and mechanisms at the CAA's disposal to mitigate uncertainty for investors arising out of the Covid-19 pandemic.	Wrong in law (e.g. failed properly to inquire, failed to take proper account of relevant considerations) [26(b) CAA12] Error in the exercise of discretion (e.g. failed to utilise the most appropriate regulatory mechanism) [26(c) CAA12]	The CAA's decision was wrong: (a) in law because it – (i) failed properly to inquire (e.g. by not considering relevant precedent from other regulators); (ii) failed to take proper account of relevant considerations (e.g. HAL's Q6 outperformance and dividends, high gearing practices, and lack of equity support); (b) because the CAA made errors in the exercise of its discretion by failing to utilise the most appropriate regulatory mechanism, to consider all alternative options, and to prefer clearly superior approaches (i.e. such as an equity injection).
6(C)	1(b) The CAA's RAB adjustment is unnecessary.	(i) The CAA was wrong to conclude that the RAB adjustment was necessary to ensure notional financeability.	Error of fact (e.g. relied on flawed evidence and assumptions, reached conclusions) The CAA's decision was wrong: (a) because it was based on errors of fact in the CAA's analysis:

Section 6 (Ground 3: RAB Adjustment)				
Headline arguments		Sub-arguments	Statutory ground(s) of appeal	Summary
			<p>without reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed to properly enquire) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. took into account irrelevant factors) [26(c) CAA12]</p>	<p>(i) by relying on flawed evidence and assumptions (e.g. that the 70% gearing threshold would have been breached absent the RAB adjustment);</p> <p>(ii) by reaching conclusions without a reasonable basis (e.g. that the RAB adjustment was necessary to secure notional financeability, that HAL was at risk of an increase in debt costs sufficient to justify a £300m RAB adjustment);</p> <p>(b) in law because it failed to properly enquire (e.g. by not carrying out the necessary analysis and quantification in relation to the potential increase in debt costs); and</p> <p>(c) because the CAA made errors in the exercise of its discretion by taking into account irrelevant factors (e.g. the risk to the headroom on HAL's <u>actual</u> debt gearing covenants).</p>
		(ii) The CAA was wrong to conclude that an adjustment to HAL's RAB was necessary to secure that all reasonable demands for AOS at Heathrow Airport are met.	Error of fact (e.g. relied on flawed evidence and assumptions, made false comparisons) [26(a) CAA12]	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis:</p> <p>(i) by relying on flawed evidence and assumptions (e.g. that the RAB</p>

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			Wrong in law (e.g. not necessary to secure that all reasonable demands for AOS at Heathrow Airport are met, failed to promote economy and efficiency, failed to properly enquire, acted in defiance of logic, acted disproportionately) [26(b) CAA12]	<p>adjustment would incentivise additional investment);</p> <p>(ii) by making false comparisons in relation to using the RAB to smooth the impact on charges from adjustments and incentives;</p> <p>(b) in law because it:</p> <p>(i) was not necessary to secure that all reasonable demands for AOS at Heathrow Airport are met (section 1(3)(b) CAA12) (e.g. HAL had not invested in sufficient capacity before the RAB adjustment, nor did the additional investments which the CAA intended the RAB adjustment to incentivise take place afterwards);</p> <p>(ii) breached the CAA’s duty to have regard to the need to promote economy and efficiency on the part of HAL in its provision of AOS at the Heathrow Airport (section 1(3)(c) CAA12);</p> <p>(iii) failed to properly enquire (e.g. by not properly assessing the impact of the RAB adjustment on HAL’s investment incentives);</p> <p>(iv) acted in defiance of logic (e.g. by seeking to use a lump sum RAB adjustment as an incentive mechanism); and</p>

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				(v) acted disproportionately (e.g. by using a long-term solution for a potentially short-term issue).
		(iii) The CAA was wrong to conclude that an adjustment to HAL's RAB had been necessary to allow HAL the flexibility to respond to changing circumstances.	Wrong in law (e.g. reached conclusions without adequate supporting evidence) [26(b) CAA12]	(c) in law because it reached conclusions without adequate supporting evidence (e.g. that the RAB adjustment could be belatedly justified on the basis of flexibility for HAL, contrary to the CAA's earlier reliance on evidence relating to notional financeability and securing all reasonable demands for AOS).
6(C)	1(c) The CAA's RAB Adjustment is harmful to the interests of consumers.	N/A	Wrong in law (e.g. failed to further the interests of the users of air transport services, acted in defiance of logic) [26(b) CAA12] Error in the exercise of discretion (e.g. failed to meet any of its own key consumer interest objectives) [26(c) CAA12]	The CAA's decision was wrong: (a) in law because it: (i) breached the CAA's duty to further the interests of users of air transport services (section 1(1) CAA12) by: (1) treating volume risk which HAL bore pursuant to the Q6 price control as an issue that fell to consumers to 'fix'; (2) increasing HAL's RAB by £300m when HAL's expected total expenditure (c.£227m) was always materially less; (3) failing to activate the "additional protections for consumers" when HAL failed to

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			<p>make the additional investments which the CAA intended the RAB adjustment to incentivise; and (4) imposing unjustified costs on consumers which will persist for multiple price control periods;</p> <p>(ii) acted in defiance of logic (as a review mechanism was included in the April 2021 RAB Adjustment Decision precisely because the CAA was not able at the time to be sure that the RAB adjustment was justified and appropriately calibrated);</p> <p>(b) because the CAA made errors in the exercise of its discretion (e.g. by failing to meet any of its own key consumer interest objectives).</p>
<p>2. Failure to Review error - The CAA erred in failing to review the £300 million RAB adjustment before reaching the H7 Final Decision and to reverse or reduce that adjustment in light of clear evidence of HAL’s failure to deliver on its specified investment commitments and on capacity and quality of service.</p>			
<p>6(D)</p>	<p>2(a) The CAA was wrong to refuse to conduct a review of its RAB adjustment prior to making the H7 Final Decision, despite clearly stating that it would do so if evidence were to emerge of HAL failing to deliver on investment or quality of service.</p>	<p>N/A</p>	<p>Error of fact (e.g. relied on flawed evidence and assumptions, having the wrong facts or interpreting them incorrectly) [26(a) CAA12]</p> <p>The CAA’s decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA’s analysis:</p> <p>(i) by relying on flawed evidence and assumptions (e.g. that reversal of the RAB adjustment would not be the appropriate remedy in the context of a review);</p>

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			<p>Wrong in law (e.g. failed to review despite committing to do so) [26(b) CAA12]</p> <p>Error in the exercise of discretion (e.g. unreasonably refused to use additional protections for consumers, failed to provide proper reasons) [26(c) CAA12]</p>	<p>(ii) by having the wrong facts or interpreting them incorrectly (e.g. concluding that a review would be distraction);</p> <p>(b) in law because it failed to review the RAB adjustment (e.g. despite the CAA's commitment to do so in the circumstances which arose);</p> <p>(c) because the CAA made errors in the exercise of its discretion:</p> <p>(i) by putting in place "<i>additional protections for consumers</i>", but unreasonably seeking to limit and refusing to use them; and</p> <p>(ii) by failing to provide proper reasons.</p>
6(D)	<p>2(b) As a result, the CAA failed properly to consider the evidence before it and erred in its conclusion that "<i>it is not clear ... that it would have been in consumers' interests for HAL to have undertaken a materially greater volume of capital expenditure in [2021] than it did in practice</i>".</p>	N/A	<p>Error of fact (e.g. reached conclusions without reasonable basis) [26(a) CAA12]</p> <p>Wrong in law (e.g. failed to take proper account of relevant considerations) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by reaching conclusions without reasonable basis (e.g. that it would not have been in consumers' interests for HAL to have undertaken more investment in 2021); and</p> <p>(b) in law because failed to take proper account of relevant considerations (e.g. the clear evidence of HAL's failure to make additional investment and to deliver on what it had promised).</p>

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6(D)	2(c) The CAA was wrong in law when it suggested that the Competition Commission's price determination in PNGL meant that it could not reverse or reduce the RAB adjustment.	N/A	<p>Error of fact (e.g. relied on flawed evidence and assumptions) [26(a) CAA12]</p> <p>Wrong in law (e.g. misdirected itself in law) [26(b) CAA12]</p>	<p>The CAA's decision was wrong:</p> <p>(a) because it was based on errors of fact in the CAA's analysis by relying on flawed assumptions and evidence (e.g. that the facts of the PNGL price determination were sufficiently similar to justify the CAA's reliance on it in its refusal to reverse the amounts previously added to the RAB); and</p> <p>(b) in law because the CAA misdirected itself in law (e.g. by misinterpreting and misapplying the PNGL price determination (or, in the alternative, indicating that the RAB adjustment could not be reversed or reduced) and the contingent nature of the RAB adjustment).</p>
6(D)	2(d) The CAA's failure to reverse or reduce the RAB adjustment has caused, and will continue to cause, consumer harm.	N/A	<p>Error in the exercise of discretion (e.g. created a significant and lasting distortion to airport charges) [26(c) CAA12]</p>	<p>The CAA's decision was wrong because the CAA made errors in the exercise of its discretion by creating a significant and lasting distortion to airport charges which unreasonably benefits HAL's investors at consumers' expense.</p>