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British Airways response to CAP2618
Setting future price controls – review of approach

Dear Stewart

This document sets out British Airways' response to the review by the Civil Aviation Authority (CAA) of the approach to setting the future price controls for Heathrow Airport Limited (HAL) and for NATS (En Route) plc (NERL), and the lessons learned from the recent H7 and NR23 price control reviews.

We welcome the review, which follows on from the recommendation of the Department for Transport's (DfT) 2023 Newman review for the CAA to evaluate, among other things, the process for conducting economic regulation.

Our response is structured in line with the questions raised by the CAA in its consultation document and makes proposals for targeted improvements and a more effective application of the current regulatory frameworks by the CAA, including for the next price controls starting in 2027 (H8) and 2028 (NR28).

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We use **bold** and underline text in our response to indicate our areas of emphasis and ease of reading. For the avoidance of doubt, unless expressly stated otherwise all of our comments should however be given equal weight whether or not they are in bold or underline.

We welcome further engagement as the CAA develops its approach in its planned method statements for the next price control for H8 and NR28.

Yours sincerely,

Michael Petrides

Head of Economic Regulation
British Airways Plc



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1. Executive Summary

- 1.1. British Airways welcomes the CAA's review of the lessons learned from the recently concluded H7 and NR23 price control reviews for Heathrow Airport Limited (HAL) and NATS (En Route) plc (NERL) respectively, and the economic licences granted to HAL and NERL. The CAA's review follows on from the recommendation of the Department for Transport's (DfT) 2023 Newman review for the CAA to evaluate, among other things, the process for conducting economic regulation. BA was extensively involved in both H7 and NR23, as well as previous price controls.
- 1.2. Both HAL and NERL represent key monopoly infrastructure in airport and air navigation services respectively that is essential to the operation of air services and connectivity of the UK. They should therefore be subject to effective economic regulation to ensure value for money and choice for consumers, alongside appropriate service levels and safety.
- 1.3. However, **passengers at Heathrow continue to receive poor value for money with poor consumer outcomes** by having to pay the highest airport charges in the world, without the equivalent level of world class service quality. We therefore believe that **fundamental reforms are needed to the system for economic regulation of monopoly aviation infrastructure in the UK to ensure it delivers in the consumer's interest.**
- 1.4. In the meantime, given the impending timelines for the CAA's subsequent price controls starting in 2027 (H8) and 2028 (NR28), **we advocate for key improvements to the application of the current regulatory framework to deliver on the regulator's primary duty to protect consumers.** Indeed, while the Competitions and Markets Authority (CMA) found that the CAA was not wrong in its approach for H7, which was significantly impacted by the Covid-19 pandemic, there are systemic issues with the application of the current framework resulting in perverse effects as explained throughout our response. In particular:

1. **Heathrow offers poor value for money to consumers.** It continues to be the most expensive airport in the world [...] while offering a poor quality of service as demonstrated by its low ranking in passenger satisfaction when compared to other European hubs.
2. **Heathrow lacks in efficiency [...].** This is further exacerbated by the fact that Heathrow is close to capacity and should benefit from economies of scale.
3. Despite its assertions to the contrary, **HAL has generated excess returns (and therefore super profits) over its allowed regulatory return of at least £1.6 billion between 2014-2023,** despite the Covid-19 pandemic representing a third of this period. This has in turn allowed HAL to earn excess returns of up to £5 per passenger at the expense of consumers.
4. **The ongoing sale by Ferrovial of its stake in HAL for a premium demonstrates an expectation that these excess returns will continue.**

5. Market evidence demonstrates that **the allowed return for H7 is inconsistent and higher to the level of risk faced by HAL**, further compounded by **the significant size of HAL's Regulated Asset Base** and **imbalanced incentives** in favour of the regulated monopoly.

1.5. We therefore support a **critical review by the CAA of the application of the framework during H7**. This will allow the regulator to identify the shortcomings and drive meaningful change for H8. This review **should also encompass the CAA's own role throughout the price determination and the lifecycle of the price settlement**.

1.6. In line with the recommendation by the Newman review and the CAA's questions in the present consultation, our proposals centre around **improving the process and governance of the price controls**, as well as **the approach to estimating the building blocks**. We set out the shortcomings experienced with H7 (and, where relevant, with NR23) followed by our proposals to improve each of those areas in the method statements for H8/NR28 that the CAA intends to publish.

1.7. **Our proposals for the CAA's method statement focus on three key pillars:**

- i. **Key improvements to the price control process and governance** to ensure transparency and meaningful consultation of users, including in **the development of the regulated entities' business plans** for the price control period and **the conduct of Constructive Engagement** with airlines to guarantee it is effective. Our proposed changes should lead to a more transparent and structured engagement with stakeholders by the CAA and the relevant licensee.
- ii. **Strengthening the CAA's proactiveness, monitoring and enforcement in economic regulation**, including **earlier, more targeted and meaningful involvement by the regulator** starting from the formation of the initial Business Plans, during Constructive Engagement, and subsequently in the implementation of the price control. **The CAA should make use of stronger guidance and its enforcement powers to secure information sharing by the licensees on their Business Plans**. It is critical that the CAA **strengthens its resourcing and improves governance** so that it delivers effectively against the tight timelines proposed for H8 in a way that discharges its statutory duties. To facilitate this, the CAA should consider publishing **a statement of policy intent** setting out clear objectives for how its economic regulation work will deliver against its duty to protect consumers.
- iii. **Improvements to the estimation of the key building blocks driving the level of charges**, notably the Regulated Asset Base (RAB), the Weighted Average Cost of Capital (WACC), tighter and more balanced incentives, and revisiting the approach to operational expenditure (opex). As the key building block driving over 90% of Heathrow's charges, and a key driver of HAL's excess profitability, **the CAA should look at the size and growth of HAL's RAB as a priority** – including the application of the inflation indexation and reviewing the continued ownership of potentially underperforming assets – to ensure it reflects efficient costs and drives efficient charges in the consumer interest. Indeed, the CAA itself recognises in the

consultation that HAL's large RAB makes significant contributions to the level of HAL's charges.

- 1.8. We believe that our proposed changes would:
- a. **Pre-empt the key process failures that users experienced during H7 and NR23**, notably the lack of transparency and meaningful consultation, and the information asymmetries in shaping the Business Plans for the price control period.
 - b. **Start addressing the high level of charges, particularly at Heathrow**, by ensuring truly efficient costs and streamlining the approach to estimating the building blocks having the largest impact on the level of charges (notably the RAB).
 - c. **Ensure that the regulatory settlement does not result in excess returns** that are above what would be obtained by an operator subject to competitive forces.
 - d. **Strengthen the role of the CAA in a targeted and proportionate way, both during the process leading to the price determination but also the implementation of the relevant price control.** This is because the CAA currently plays a limited role in monitoring and enforcing compliance with the result that airlines have essentially been overseeing compliance themselves, despite having limited information to do so effectively. It will also address reduced regulatory certainty.
 - e. **Tighten regulatory incentives and recognise that insulating a regulated firm from all eventualities is inconsistent with the risk of a regulated business** and, therefore, the cost paid by consumers.
 - f. **Avoid the potential for regulatory gaming by HAL** (such as in relation to the passenger forecast during H7) and ensure compliance with the economic licence granted by the CAA.
- 1.9. Given the length, complexity and shortcomings of the H7 process, our response focuses on the lessons learned for H8. Most of our proposals are also relevant for NERL's price control. We also specify where we have specific comments for NR23.
- 1.10. With respect to (most of) the **broader and strategic issues** raised by the CAA's consultation, we agree that these constitute longer-term questions requiring an extensive assessment by both the CAA and the DfT and **should be addressed outside the current lessons learned exercise.**
- 1.11. We advocate for longer-term reforms to ensure increased protection of airport users, and consumers, in the future and we look forward to engaging with the CAA and the DfT further on them, namely:
- a. **Shifting from a capital-focused model to an operational one.**
 - b. **A regulatory framework that could extend beyond the economic regulation of airports, potentially to economic regulation of transport.**
 - c. **Fundamentally addressing the size of the RAB at Heathrow.**



- d. Ensuring that the CAA is fulfilling its duty to protect consumers.
- e. Enabling users to legally trigger the regulator's intervention.

2. The need for improvements in H8: CAA's duties, ex post evaluation and the H7 shortcomings

Despite a focus on consumer protection, the application of the current regulatory framework for HAL has resulted in the highest charges in the world, low quality service levels, inefficiency and continued excess profits – all at the expense of the consumer. In view of the significant shortcomings of H7, key improvements are required for H8 to the process and governance of the price control, the role that the CAA plays in the process and the approach to the building blocks driving the level of charges, especially the RAB.

Civil Aviation Act 2012: inconsistent application with perverse effects

- 2.1. The current regulatory framework for Heathrow under the Civil Aviation Act 2012 (CAA12) provides the CAA with a number of duties and powers needed to discharge its role to protect consumers. **It places on the CAA a primary duty to carry out its 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 airport operation services. CAA12 also places secondary duties which the CAA must have regard to including, among other things, the need to ensure economy and efficiency by HAL and the need to secure that all reasonable demands for airport operation services are met.¹
- 2.2. As economic regulation aims to replicate the outcomes of a competitive market, the explanatory notes to CAA12 state that these needs are expected to be met where **airport operators provide the services demanded by passengers at minimum cost.**²
- 2.3. Similarly, **HAL is under a single till system**, where commercial revenues contribute to offset the airport's costs recoverable from users, most closely replicating the way in which a regulated monopoly would behave had it been in competition. **We strongly support single till regulation and support the CAA in its continued use of this system for subsequent price controls.**

High charges and low quality of service

- 2.4. However, Heathrow continues to be the world's most expensive airport. [...] ³ The CAA itself recognises in the consultation that HAL's charges are "relatively high" when compared to other UK and overseas airports.⁴

[...]

- 2.5. Notwithstanding being the most expensive airport worldwide, **Heathrow lags on service levels internationally.** [...]

¹ Section 1 of CAA12.

² See [note 36\(b\)](#).

³ [...]

⁴ See point 2.50 of CAP2618.

Lack of efficiency

2.6. **Heathrow equally appears to be lagging on efficiency⁵**, with its operating costs per passenger being the highest among European airports [...]⁶ This is further exacerbated by the fact that Heathrow is close to capacity and should benefit from economies of scale. We analyse Heathrow’s lack of efficiency further in section 14.

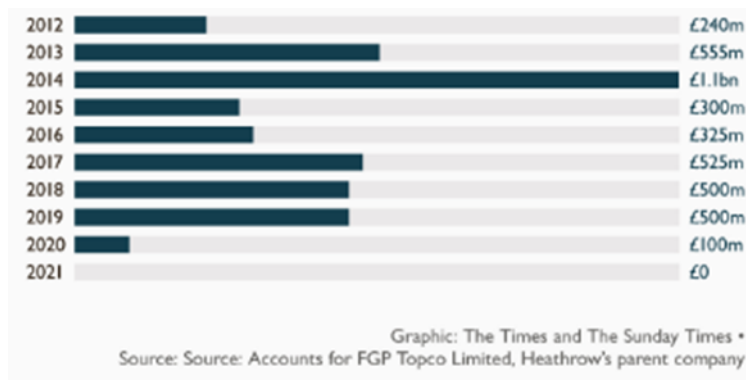
Excess profits

2.7. Despite HAL’s assertions to the contrary, its profitability over the past decade has outstripped its allowed return. A look back at HAL’s price control periods over the past 10 years suggests **an overall imbalance in favour of HAL**. Between 2014-2023, HAL has, on average, received returns in excess of the CAA’s allowed cost of capital despite the Covid-19 pandemic and its aftermath representing a third of this period.

2.8. **Indicatively, HAL’s profitability during that period outperformed its regulatory settlements by 104 basis points.⁷ This is equivalent to an overcharge of £1.6 billion, or £2.50 per passenger.⁸** Total outperformance of the regulatory settlement rises to £1.9 billion when adding the CAA’s £300m RAB adjustment in the H7 decision.

2.9. Moreover, considering the generosity of the settlements⁹ and the delays in implementing the H7 price control, **HAL potentially has received excess returns of up to £5 per passenger** – a transfer from passengers to Heathrow shareholders.

2.10. At the same time, £3.9 billion in shareholder dividends were paid out by HAL during 2013-2023. The figure below shows the estimates between 2012-2021.



Future profitability

⁵ [...]

⁶ [...]

⁷ Based on our analysis. The calculation is relative to the WACC set by the CAA including the CAA’s RPI assumption of 2.8% for Q6 (paragraph 6.60 of [CAP1115](#)). The indicative calculations are set out in Appendix A.

⁸ Based on 645m passengers during 2014-2023 at Heathrow.

⁹ The H7 settlement also provides for an asymmetric risk allowance (worth £25m per annum in the latter years of H7) and the creation of a Traffic Risk Sharing mechanism, both benefitting HAL.

- 2.11. It is possible that investors earn excess returns from price controls. The regulator sets a fair bet, but outcomes may deviate from those expectations.
- 2.12. However, **recent market evidence points to a continued outperformance under the H7 price control and beyond.** The sale by Ferrovial of its 25% equity stake in HAL in November 2023 for a higher-than-expected valuation of £2.4 billion¹⁰ represents a 23% premium on HAL's enterprise value relative to its RAB and **implies a significant level of excess profitability expected by shareholders in future years.**
- 2.13. In fact, assuming a 60% notional gearing, the airport's equity trades at a 56% premium to its regulated entity and indicatively implies an outperformance of between 201 and 520 basis points depending on the measure being looked at.¹¹
- 2.14. The Ferrovial transaction therefore clearly suggests the need for **tightening the regulatory regime to dampen windfall gains and ensure settlements are not imbalanced in favour of the regulated entity.**
- 2.15. It is not credible that the profits of a regulated monopoly continue to significantly outstrip its allowed return, thereby benefitting shareholders at the expense of consumers. This is against the CAA's primary statutory duty to further the interests of users of air transport services.

The shortcomings of H7

- 2.16. As to the H7 process, we have previously raised with the CAA the fundamental shortcomings which led to significant disagreement between users and HAL across almost all areas:
- a. **The lack of transparency and meaningful consultation with users** over most elements of HAL's Business Plan, including the biggest drivers such as the RAB, capital projects, opex and the passenger forecast.
 - b. **The failed Constructive Engagement process** and lengthy process delays which made for a protracted H7 process even before the pandemic.
 - c. **The paucity of CAA monitoring and enforcement activity** which results in users incurring undue and disproportionate costs by taking on 'de facto' regulatory responsibilities in monitoring the licensees, including legal and consultancy costs, and reduces regulatory certainty.
 - d. Our concerns over **potential 'regulatory gaming' by HAL** both in the lead up to the price control determination (such as in the traffic forecast) and during the implementation of the H7 price control (such as in the roll out of the CAA's ex ante capital efficiency incentives).

H8 method statement: Changes to deliver on the CAA's statutory duties

¹⁰ [More Heathrow shareholders plan to sell stakes alongside Ferrovial](#), Financial Times, January 2024.

¹¹ See Appendix B for an indicative assessment.

- 2.17. We firmly believe that **the CAA should employ the duties and powers under CAA12, as well as its enforcement policy, to ensure that future price controls deliver outcomes furthering the interest of users** of air transport services. This will involve the CAA taking steps to ensure that HAL's charges are truly efficient, that they deliver appropriate service levels, and that the regulatory settlement does not allow for excess returns above what would be obtained by an entity subject to competitive forces.
- 2.18. In addition, in performing its duties, the CAA must ensure that its regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent; and that they should be targeted only at cases in which action is needed.¹²
- 2.19. Ahead of the CAA's H8 method statement due by the end of 2024, **we propose improvements in three key areas:**
- i. **Key improvements to the price control process and governance to ensure transparency and meaningful consultation of users**, including in the development of HAL's Business Plan for the price control period **and the conduct of Constructive Engagement**. Our proposed changes should also lead to a more transparent, structured and timely engagement of stakeholders by the CAA and HAL.
 - ii. **The adoption by the CAA of a more proactive approach to monitoring and enforcement**, including **earlier and more targeted engagement** in the formation of HAL's initial Business Plan, during Constructive Engagement, and subsequently the implementation of the price control. The CAA should **make use of a stronger guidance and its enforcement powers** to secure information sharing by the licensees. Given the tight timelines for H8, it is critical that the CAA **strengthens its resourcing** and improves governance so that it delivers effectively against the timelines proposed and discharges its statutory duties. To facilitate this, the CAA should consider publishing a statement of policy intent setting out clear objectives for how its economic regulation work will deliver against its duty to protect consumers.
 - iii. **Improvements to the estimation of the key building blocks driving the level of charges, notably the RAB**, the WACC, tighter and more balanced incentives, and a revised approach to assessing cost efficiency, as summarised in the remainder of this section.
- 2.20. **The size and growth of the RAB in particular drives over 90% of the charge at Heathrow** (£8 billion out of £8.7 billion in aeronautical revenue for H7) and **should be reviewed by the CAA as a priority** to ensure it reflects efficient costs and drives efficient charges in the consumer interest. This includes **the RPI inflation indexation of the RAB**, which has allowed it to grow by more than 50% to £20 billion between 2014-2023 and has driven excess profits, as well as **reviewing the continued ownership of potentially underperforming assets** (totalling up to £2.2 billion).¹³

¹² Section 1 of CAA12.

¹³ See our analysis in section 11 of our response and Appendices A and C.

Indeed, the CAA itself recognises in the consultation that HAL's large RAB makes significant contributions to the level of HAL's charges.¹⁴

- 2.21. On the WACC, while CMA H7 determination constitutes a logical starting point for H8, the CAA should look at drawing lessons from market evidence for how the parameters retained for H7 have played out empirically. This review would allow the CAA to establish that **the allowed return for H7 is inconsistent and higher to the level of risk faced by HAL**. An assessment by the CAA of HAL's actual performance in terms of profitability and allowed return should allow the regulator to **draw targeted improvements to its approach**, including on the question of financeability.
- 2.22. We moreover propose to **revisit the CAA's approach to cost assessment to address HAL's inefficiencies** in operational and capital spend, and **changes to the approach on the passenger forecast** to avoid the regulatory gaming being experienced in H7. Our view is that the **CAA should not be using the licensee's estimates as a starting point in its assessment to avoid perverse incentives**.
- 2.23. As to incentives, we advocate for a change in risk allocation through a **tighter incentive package** to achieve consistency between the CAA's price control and the level of risk borne by HAL, thereby ensuring a 'fair bet'. We support the **continuation and tighter implementation of the CAA's ex ante capex efficiency incentives imposed in H7**, which we consider critical in promoting efficiency in capital spending and delivering projects with firm and measurable objectives, as well as positive outputs for users and consumers. We also advocate for the **tightening of the incentives on service quality, changes to the Traffic Risk Sharing mechanism and the introduction of an opex gain sharing mechanism** to ensure HAL behaves efficiently. The combined effect of those incentives should result in a system that recreates competitive pressures on HAL's monopoly and best protects the interests of consumer.
- 2.24. On **Other Regulated Charges**, we advocate for the CAA's intervention to ensure governance arrangements that guarantee appropriate consultation, transparency and dispute resolution. The CAA should also ensure that pricing respects the user pays principle.
- 2.25. On **Sustainability**, both BA and IAG have ambitious commitment to net zero emissions by 2050. Airport charges should be used to address environmental objectives that are related to the provision to airport infrastructure and that affect the local environment. Sustainability investments still need to demonstrate firm objectives and positive consumer outcomes, in line with the CAA's primary duty on consumers. On its part, NERL has a key role to play in improving airlines' environmental performance through the provision of more efficient flight paths and use of airspace. Indeed, the delivery of airspace modernisation by NERL and other relevant parties is a cornerstone in the pathway to net zero. Through its price controls, the CAA will need to appropriately incentivise NERL to deliver those outcomes.

¹⁴ Point 2.50 in CAP2618.



2.26. We consider that **our proposed changes are targeted and proportionate, can be implemented efficiently in the CAA's method statement and are essential to deliver the H8 timetable** set out by the CAA in a way that discharges the CAA's duties. These changes can equally be applied for the NR28 method statement to ensure an overarching robust approach to future price controls by the CAA and regulatory consistency.

THE PROCESS FOR SETTING PRICE CONTROLS

3. Market power assessments (Question 2.16): HAL continues to have significant market power and should be subject to effective economic regulation

We agree with the CAA that HAL continues to have significant market power and economic regulation is therefore appropriate. NERL's provision of en route traffic services is also a monopoly activity.

- 3.1. We agree with the CAA's view that HAL continues to have significant market power under CAA12 and that there has been no change in this regard since the market power determination (MPD) published in 2014. The CAA has correctly identified that the strong recovery in traffic levels since the progressive removal of the Covid-19 restrictions (99% of 2019 passenger numbers realised in 2023 and 102% expected in 2024) and the runway capacity constraints are likely to endure at least in the medium term.
 - 3.2. In fact, Heathrow continues to have all the characteristics present in the 2014 MPD, including high switching costs due to airline network effects, strong demand across all types of passengers and cargo, capacity constraints, good surface access options, the inherent attractiveness of the London market and the strategic importance to airlines. Therefore, there is no material change in circumstances since the 2014 MPD under section 7(6)(a) of CAA12 and the conclusion that HAL should be subject to ongoing economic regulation and price control.
 - 3.3. For NERL, we agree with the CAA that the provision of en route air traffic services is a monopoly activity and therefore price control is appropriate.
- ### 4. Outcomes, objectives and transparent regulation (Questions 2.18-2.19): Setting out clear actionable objectives for delivering against the CAA's duties in price controls

The CAA should set out its strategic vision for how economic regulation will deliver against its primary duty to protect consumers at Heathrow. This statement of policy intent, which should set out clear actionable objectives for the CAA, including how to balance its primary and secondary duties, would inform how the regulator approaches the different stages of its work by enabling it to resource and prioritise effectively. For NERL, the CAA should clarify how it will balance its primary duty to maintain safety against its secondary duties including furthering the interest of users.

- 4.1. In setting the foundations for its approach to H8, NR28 and subsequent price controls, we believe that **the CAA ought to clearly outline its strategic vision for how its economic regulation activity will deliver against its statutory duties.** For H8, this includes clearly setting out objectives and describing how each of them will further the interests of the consumers in line with the CAA's primary duty under

CAA12. The CAA's objectives should be set in a way that minimises the need for frequent revisions and be supported by specific performance indicators.

- 4.2. This strategic vision, which could take the form of a statement of policy intent accompanying the method statement, will inform how the CAA approaches all aspects of the price control, such as the proportionality of its regulation, for instance by allowing it to target those areas that are particularly problematic (be it process/governance-related or relating to the estimation of certain building blocks). The statement will also enable the CAA to resource and prioritise effectively and allow it to set its work in the relevant areas upfront.
- 4.3. Prior to the H7 process, the CAA had published a policy document titled "Strategic themes for the review of HAL charges – a discussion document"¹⁵ which outlined, amongst other things, the H7 programme milestones, strategic themes and constructive engagement principles which would inform the CAA's H7 methodology. Similar information and guidance were outlined by Ofgem and Ofwat prior to their respective price control processes.¹⁶
- 4.4. In response to the CAA policy document, our parent company International Airlines Group (IAG) had highlighted significant concerns regarding the adequacy of the proposed timelines for Constructive Engagement, the need for greater transparency in HAL's business planning, and the imperative for a more robust and detailed examination of HAL's cost efficiency.¹⁷ Unfortunately, IAG's concerns were not addressed, and, in our view, these matters remained significant issues throughout the H7 process.
- 4.5. Whilst IAG had agreed with the strategic themes outlined in the CAA's document, it had highlighted that the CAA had provided insufficient detail on how it would give effect to those themes in H7. For the H8 process, it is essential that the strategic themes and objectives are underpinned by a concrete action plan, complete with specific, actionable steps and robust mechanisms to ensure that the objectives are not only aspirational but also achievable.
- 4.6. The action plan should include clear milestones, performance indicators, and accountability measures to track progress and ensure that the strategic themes translate into tangible improvements in the price control process, thereby furthering the interests of consumers. For instance, the CAA may opt to commission consumer research to establish the key objectives to be achieved in a relevant price control in line with its primary statutory duty.
- 4.7. Setting clear, actionable objectives would enable the CAA to focus on each stage of the price control process, notably in its assessment of the Business Plans drawn up by the regulated entities (and its engagement with HAL and NERL in the lead up to those Business Plans), set the price control at the appropriate level, and monitor effectively the licensees' performance during the implementation of the price

¹⁵ See [CAP1383](#).

¹⁶ For example, see [Ofwat PR24 final methodology](#) and [Ofgem RIIO-2 Framework Decision](#).

¹⁷ See [IAG response](#) to CAP 1383.

control. Indeed, it is common for regulators to establish regulatory performance frameworks.¹⁸

HAL: Guidance on balancing the CAA's duties

- 4.8. It is equally critical that the statement of policy intent sets out how the CAA intends to balance its different duties under the respective frameworks for HAL and NERL. For HAL, this especially concerns the balancing of the CAA's primary duty to further the interest of users of air transport services against secondary duties such as HAL's financeability. While the Covid-19 pandemic made balancing these duties more challenging, we believe that the CAA's approach should be clearly defined ahead of subsequent price controls to strengthen regulatory transparency and avoid confusion and disagreements during the various stages of the price control process.
- 4.9. The CMA's Final Determinations on the H7 appeals rightly affirmed that the CAA's duties are hierarchical, with the primary duty being to further the interests of users of air transport services. While the CAA must take into account other statutory matters, such as financeability, economic efficiency, and environmental impacts, these do not override the primary consumer duty.¹⁹ This was also reflected in the CAA's Response filed in the CMA appeal.²⁰ This is because the secondary matters set out in section 1(3) of CAA12, which the CAA need to have regard to, do not individually or collectively override the duty to further the interests of users of air transport services.²¹
- 4.10. The CAA should provide clear guidance as part of its statement of regulatory intent on how it will approach this balancing exercise, particularly in instances where there may be a tension between the consumer duty and the financeability of airport operations. The guidance should detail the CAA's methodology for assessing the weighting of the various statutory considerations and how it will ensure that consumer interests remain at the forefront of its regulatory decisions. Other UK economic regulators provide similar guidance.²² For example, the guidance should:
- i. Emphasise the primacy of the consumer duty.

¹⁸ It is typical for regulators to provide clear performance indicators and monitor performance of regulated monopolies, such as [Ofwat's](#) monitoring of water companies' performance. There should be a clear indication of how performance will be monitored to limit ambiguity in respect of monitoring HAL's performance. See also: the [NAO Performance Measurement by Regulators 2016](#) for guidance on establishing regulatory performance frameworks.

¹⁹ See paragraph 5.122, [Final Determinations](#).

²⁰ [NON-CONFIDENTIAL - CAA Response](#)

²¹ <https://legislation.gov.uk/ukpga/2012/19/notes/data.pdf>

²² As an example, we note the guidance by Ofgem in respect of the [Sizewell C Nuclear Power Station](#). The purpose of the document is to outline "how Ofgem expects to approach the economic regulation of a nuclear licensee" and it "explains Ofgem's approach and the principles it expects to use when making decisions that affect the nuclear licensee, and where to find more information". Similarly, Ofwat has developed [guidance](#) on its approach to the economic regulation of the Infrastructure Provider for the Thames Tideway Tunnel.

- ii. Outline how the CAA will consult with stakeholders, including users and licensees, to understand the potential impact of a decision on consumers in the event of a conflict between its primary duty and subsidiary duties.
- iii. Describe the mechanisms the CAA will use to monitor the outcomes of its decisions and review them, if necessary, to ensure that the correct balance is maintained so that consumers remain protected.

NERL balance of duties

- 4.11. For NR28, the CAA should clarify how it intends to balance each of its secondary duties under the Transport Act 2000 (TA00) – notably furthering the interests of users, promoting efficiency and economy, ensuring financeability and taking account of environmental objectives advised by the Secretary of State – whilst ensuring its primary duty to maintain safety. The approach to balancing those duties, including when they are in tension, should be clearly linked to the objectives and outcomes sought from the price control.
- 4.12. Under TA00, the CAA has a clear requirement to exercise its functions in the manner it thinks best calculated. If in a particular case there is a conflict in the application of the provisions of its secondary duties, the CAA must apply them in the manner it thinks is reasonable having regard to them as a whole.²³
- 4.13. Similarly to HAL, the CAA should be consistent and promote transparency in its decision making by setting out a statement of policy intent with clear guidance on how it will balance these duties in NERL's price controls. For instance, during NR23, the CAA afforded a greater weight to NERL's financeability at the expense of affordability, cost efficiency and economy.²⁴

²³ See Section 2 of Chapter I, TA00, at <https://www.legislation.gov.uk/ukpga/2000/38/part/I/chapter/I>.

²⁴ As member of the Airline Group holding 41.9% of the shares in NATS, BA owns just over 7% of NATS. We hold this interest not for the primary purpose of receiving a commercial return on our investment, or to have operational say over NATS, but so as to have oversight and involvement with an organisation we see as an important strategic partner. As key players in the UK aviation industry we have similar interests, from ensuring safe and effective day to day operations, cost efficiency in the interest of the consumer, and delivering important improvements such as to airspace modernisation that will help us all meet our net zero carbon emissions targets.

5. Proportionality of regulation (Question 2.19): Enhancing the CAA's regulation in the key areas of the price control

The CAA should have a more active role in key areas of the price control impacting on the robustness of its determination. These include early involvement in the establishment of the licensee's Business Plan, Constructive Engagement and a more active role in monitoring and enforcement throughout the lifetime of the price control. Earlier involvement should allow the regulator to reduce the burden on its resources at a later stage and reduce the likelihood of disagreements, in turn reducing regulatory cost.

- 5.1. It is our position that the CAA should adopt a more proactive approach throughout the lifetime of the price control, including monitoring and enforcement and using its current regulatory powers. Consistent with the approach taken by other UK regulators, such as Ofgem and Ofwat, **the CAA should be involved upfront in areas which will have significant impact on the robustness of its price control determination.**
- 5.2. For example, as outlined in paragraphs 6.8 *et seq.*, the CAA ought to engage early with the regulated entity in the establishment of the initial Business Plan and, be prepared to, where appropriate, proactively intervene in discussions and disagreements during Constructive Engagement. We elaborate on this further in section 6 on Constructive Engagement, and section 8 on the CAA's Business Plan guidance and information gathering powers.
- 5.3. The CAA should also take steps to monitor and enforce compliance with the licence (including the Business Plan that underpins it) and attempts to circumvent the CAA's policy intent (including during the implementation of the price control). Such an approach is in line with recent regulatory enforcement in other sectors and the CAA's primary statutory duty as explained in section 4 of our response. We develop our positions further in section 10 of our response and address the issue of strengthening the CAA's governance and resourcing in section 9.
- 5.4. By enabling itself to step in earlier in the process, the CAA would effectively reduce the burden on its resources at a late stage in the process and allow it to have a clearer oversight on matters it will need to determine during its initial and final proposals. Similarly, earlier guidance and intervention by the CAA should strengthen transparency, reduce the likelihood of disagreement and therefore reduce the likelihood of possible appeals, in turn reducing regulatory cost.

6. Constructive Engagement (Question 2.24): Overhaul to enhance transparency, consultation and the CAA's early role

Constructive Engagement failed in H7 due to a lack of transparency, meaningful user consultation and the CAA's reluctance to intervene. For NR23, there was user frustration over the lack of transparency and scenario planning by NERL. We propose a targeted overhaul where **the CAA would have a tiered role in ensuring the quality of the licensee's Business Plan, providing timely guidance and administering a structured timeline during the Constructive Engagement discussions, while stepping in where an impasse occurs.** The CAA should make use of a stronger guidance and its enforcement powers to secure information sharing by the licensees. This approach is in line with previous statements by the CAA and will ensure that the upcoming Constructive Engagement provides users with a meaningful opportunity to influence the Business Plan, in turn offering the highest likelihood for agreement. It will also ensure the delivery of the H8 timelines proposed by the CAA and will avoid delays to NR28.

The failed H7 process

- 6.1. One of the most significant shortcomings of H7 was **the failed Constructive Engagement (CE) process**, notably due to a pronounced lack of transparency and meaningful user consultation by HAL over key elements of its Business Plan (BP) and a lack of early involvement by the CAA. In particular:
- a. There were lengthy process delays and constrained timelines which limited user opportunity to provide comprehensive input and scrutinise HAL's initial Business Plan and subsequent updates. This was evidenced by users in responses to the strategic themes considered by the CAA prior to H7.²⁵
 - b. HAL's "driver-based" BP provided little insight, lack of detail and no granularity as to the constituent elements (notably the capex plan, opex plan and the passenger forecast) and there was no engagement on the different options considered. For instance, HAL's passenger forecast was high-level and opaque throughout the H7 process, depriving users of the opportunity to cross-examine robustly the drivers, assumptions and any differences. This led to significant divergence and forecasts by HAL that defied commercial reality as proven by the sizeable discrepancies in actual passengers for 2023 and the revised forecast for 2024 (see paragraphs 15.2-15.3 below).
 - c. HAL did not consider views by users or reviewed elements following challenge, such as on what users considered to be an unrealistic capex plan and pessimistic commercial revenue forecasts.
 - d. HAL withheld information on the basis of intellectual property and confidentiality in respect of its passenger forecast model. This resulted in a complex and disputed passenger forecast model being used by the CAA as a starting point and, in the absence of transparency and airline understanding of the various inputs and

²⁵ See for instance IAG's [response to CAP1383](#) (see page 12).

adjustments, left the airlines with no other option but to raise it as a ground in the H7 CMA appeal.

- e. The CAA demonstrated a reluctance to intervene to ensure that HAL complied with its obligation to provide BP information in a comprehensive and timely manner. An example of this is the CAA not prescribing information sharing and failing to take action despite user complaints on the lack of detail in HAL's BP. This lack of enforcement greatly limited the time that the regulator had to examine or challenge the robustness of this information and assess the BP, which, coupled with the CAA's use of HAL's model as a starting point for elements such as the opex assessment (explained in paragraph 14.10), resulted in arbitrary estimates. We discuss our proposals to improve on the CAA's BP guidance, its information gathering and its approach to monitoring and enforcement in sections 8 and 10 of our response.

The NR23 process

- 6.2. Compared to H7, the NR23 Customer Engagement delivered several of areas of agreement between airlines and NERL. Areas where agreement could not be reached were mostly due to the lack of timely and complete information by the regulated entity.
- 6.3. We supported the CAA's attendance of the customer consultation working group (CCWG) sessions and would advocate for the CAA furthering its role by stepping in where there is an impasse or information disparities. For NR23, we note in particular:
 - a. The lack of an initial Business Plan premised on optioneering and meaningful scenario planning, which in turn impacted on the effectiveness of user engagement. There was insufficient information of the impact of options and scenarios on the relevant building blocks.
 - b. There was a lack of sufficient granularity to allow for an appropriate assessment of the cost drivers, particularly in relation to the impact of traffic, staffing levels, changes to capital expenditure plans, and airspace changes.
 - c. NR23 Customer Engagement meetings occurred simultaneously with the H7 CE, restricting the ability of users to be engaged in the process.

Proposed changes

- 6.4. To avoid a repeat of the failed H7 process, we are advocating for **an overhaul to ensure that CE provides users with a meaningful opportunity to influence the BP** and offers the highest likelihood for agreement. For this to happen, there needs to be **appropriate regulatory oversight by the CAA** during the various stages of the process to guarantee that the BP is robust, transparent, and reflects user views and appropriate optioneering.
- 6.5. Given that HAL's BP forms the foundation upon which the CAA bases its decisions around the setting of the price control, it is crucial that the CAA ensures that the BP

is of sufficient high standard to enable informed and effective regulatory oversight that furthers the interests of users. Our proposals should be viewed in conjunction with our recommendations on the CAA's guidance to licensees regarding the contents of the BP, information sharing and enforcement against incomplete information, explained in paragraphs 8.3 *et seq.*

- 6.6. We believe that the CAA's duty to users of air transport and the secondary duties to promote economy and efficiency and secure that all reasonable demands for airport services are met, require the CAA to:
- a. Actively engage with HAL and users to outline in its method statement the specific requirements and standards expected of HAL's BP, ensuring that it is comprehensive, evidence-based, and forward-looking. The CAA has previously outlined business criteria in its *Guidance for HAL in preparing its business plans for the H7 price control*²⁶ – however, currently there is no assurance that HAL produces a BP which aligns with the criteria outlined in that guidance.
 - b. Critically evaluate, at various stages at of the process, the robustness and credibility of the information provided in the BP, including financial projections, operational strategies, and investment programmes.
 - c. Provide clear feedback and, if necessary, mandate revisions to BPs that do not meet the requisite standards, ensuring that the plans are not only fit for the purpose of price control determinations but also for the broader strategic objectives of the CAA.
 - d. Consider the introduction of penalties for poor quality BPs, such as adapting Ofwat's and Ofgem's incentives on BP quality – see paragraphs 8.14 *et seq.*
 - e. Set out in the method statement clear timelines, the level of engagement and the type and quality of information expected of the regulated entity. The method statement should also clarify the CAA's role in the process.
- 6.7. We set out below the areas of the BP process in which the CAA could take a more active role in a proportionate and targeted manner, in line with its statutory duties.

Pre-initial Business Plan phase

- 6.8. In line with its statutory duties, and consistent with the approach taken by other regulators such as Ofgem and Ofwat, **the CAA ought to take a more proactive role during the development of HAL's initial Business Plan (iBP) and be willing to intervene to address potential issues.** These include the provision of insufficient detail, objectives and business cases for key projects. Specifically, between the draft method statement for H8 (spring 2024) and the issuance of HAL's iBP (Q1 2025), the CAA should consider having pre-notified and structured milestones to scrutinise the level of detail provided in HAL's iBP to ensure confidence in the quality of the document. The CAA should be setting clear expectations to the licensees on the

²⁶ See [CAP1540](#).

content and level of detail to be provided on the key drivers of their iBP and, if needed, provide templates on the type of information expected.

- 6.9. In doing so, the CAA may opt to focus on the key elements impacting on price, such as: (i) justification for each key projects driving the majority of capex and opex (e.g. security programmes), (ii) the commercial revenue forecasts, (iii) the RAB make-up and reviewing property leases with an impact on the RAB/depreciation (e.g. non-value adding assets to empty, vacate, demolish), (iv) the capacity forecasts and (v) HAL's procurement strategy.
- 6.10. The CAA should also consider how and when to facilitate meaningful airline input on those key elements ahead of the issuance of the iBP.

During Constructive Engagement

- 6.11. To deliver on the tight 6-month CE period for H8 proposed by the CAA, key improvements ought to be implemented in the process in terms of transparency, consultation and the CAA's role. Any delays to the price control timelines should not truncate the CE process which is critical to the regulatory outcome.
- 6.12. The method statement should set out the fundamental principles of the CE process. We believe these should include:

- i. **Ensuring structured and meaningful input by users on the BP**, with working groups focused on capex efficiency, opex efficiencies, commercial revenue forecasts, service levels, and traffic forecast. This consultation must be meaningful, in that there is genuine opportunity to engage and challenge. There should be **clarity of optioneering, and airline scrutiny of those options**, with the regulated entity being incentivised to respond and demonstrate how user feedback is taken into account in subsequent plan revisions.

Indeed, Condition B3.2 of the H7 licence requires HAL to carry out appropriate consultation with users, airlines and other relevant stakeholders, which includes providing timely and accurate information, so that they can assist in identifying the reasonable demands for airport operation services.

CE should also cover items that HAL currently deals with outside the price control process but have an impact on charges during the price control period, such as the impact of master-planning and customer research. The WACC can be left to the CAA to decide outside of the CE process, with guidance given on the possible range to steer discussions in CE – see paragraph 6.17 below.

- ii. **Guaranteeing transparency of information** to address the asymmetry of information between HAL and the airlines. The method statement should mandate comprehensive transparency and information sharing between HAL and the airlines. Stakeholders should have access to detailed information and methodologies used by HAL in formulating its BP to facilitate informed feedback and discussions.

This should involve the provision of detailed financial models, the RAB make-up, capex and opex efficiencies, commercial revenue forecasts and passenger forecasts (in the absence of an independent forecast commissioned by the CAA), and other relevant data to allow for informed scrutiny and meaningful input from airlines. As in the past, confidentiality rings could be used where there are concerns about commercially sensitive information.

- iii. **Clarifying the role of the CAA**, for instance, that it will oversee the development of forecasts to ensure they are based on robust and realistic assumptions. This oversight would help prevent discrepancies that could impact future investment and pricing decisions. We expand on this below.

The role of the CAA

- 6.13. Prior to the H7 process, the CAA had indicated a willingness to adopt a more proactive stance within the CE process.²⁷ In particular, the CAA had outlined that for H7 it could play a more active role, for example, by attending more of the meetings and providing guidance to the parties and that "*this may be particularly relevant where it is apparent early on that the parties are unlikely to reach meaningful agreements e.g., by having an option for HAL or airlines to apply to us to arbitrate in specific debates that have reached an impasse.*" However, the CAA did not ultimately apply those recommendations in H7. The CAA either did not attend CE meetings or, if it did, was not accompanied by its relevant experts and did not provide guidance when asked to do so.
- 6.14. To remedy this, the method statement should clarify the role and timing for the involvement of the CAA in the CE process. **We advocate for a targeted and tiered role for the CAA**, whereby it is involved up front in the working group discussions, potentially involving subject matter experts in the area being discussed to inform the discussion as and when needed.
- 6.15. In doing so, the CAA:
 - 1) May opt to establish formal written procedures and timelines to enhance its early engagement in the CE process, particularly in instances where an impasse arises or is likely between airlines and HAL. This would facilitate timely discussions and help prevent or resolve deadlocks, ensuring that all parties have ample opportunity to contribute to the decision-making process.
 - 2) **Should clarify that it will provide timely guidance for the working group discussions** (for instance, on the type of information to be shared and highlighting any areas where engagement is stalling) to avoid an impasse or where agreement is unlikely. The CAA should **administer a structured timeline for the CE process**, with clear milestones and deadlines to ensure that the process is completed efficiently and on time. Stakeholders ought to be closely consulted on what constitutes an appropriate timeline to balance the need for thorough scrutiny and

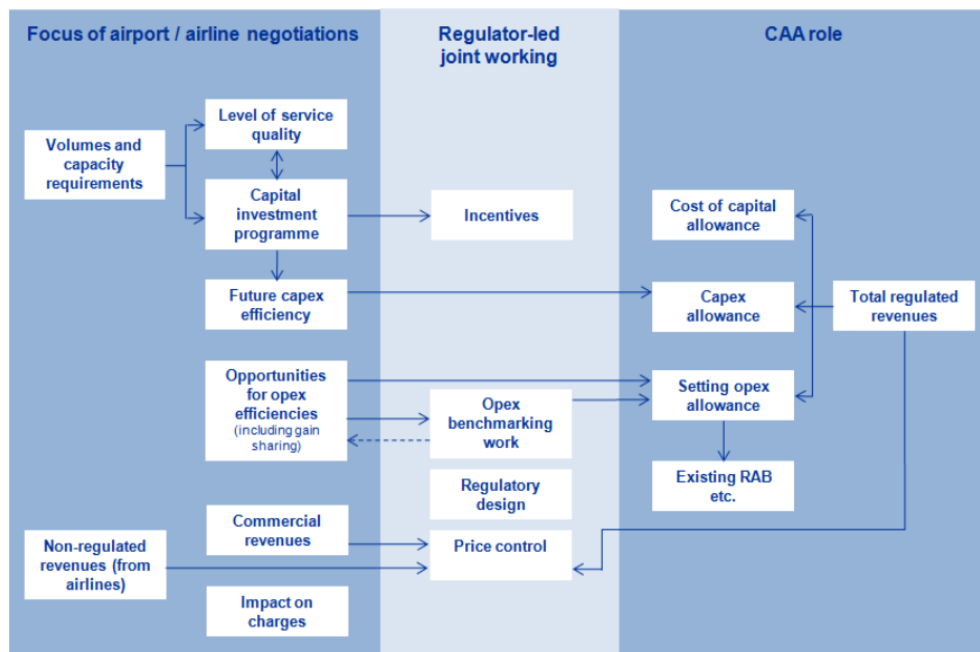
²⁷ See [CAP1383](#): Strategic themes for the review of Heathrow Airport Limited's charges: A discussion document.

the avoidance of unnecessary delays in decisions and airport operations planning. We elaborate further on timelines in paragraphs 9.4 *et seq.*

- 3) **Consider its resourcing currently allocated to economic regulation** to ensure the right level of staffing and identify any gaps. We elaborate on the CAA's resourcing this in paragraphs 9.6 *et seq.*
- 4) **Where agreement is not possible, the CAA should establish a clear dispute resolution mechanism that can be invoked quickly when an impasse occurs.** This mechanism should be designed to reach fair and balanced outcomes without causing undue delays in the CE process. **We support the CAA assuming the role of arbiter**, for instance through regulator-led joint working to iron out the areas of disagreement.

6.16. We note that the arrangement proposed above is not atypical and has previously been applied by the CAA, as shown by the CAA's Constructive Engagement Mandate for Q6 at Gatwick airport²⁸:

Fig 4.1 Illustrative CE process with a RAB³-based approach



Source CAA

6.17. Ahead of CE, we would propose that the CAA also presents early guidance of its orientations on the level of the cost of capital. This will allow for a more informed discussion on the impact of capital projects and depreciation. We refer to sections 12 of our response on the WACC on the need for streamlining the CAA's approach to the WACC.

²⁸ <https://www.caa.co.uk/media/tzvfbi/j/gatwickcemandate.pdf>

7. Timetable (Question 2.25): Changes are essential to deliver on the tight timelines

To deliver on a start for H8 in 2027, the CAA ought to strengthen the licensee's Business Plan transparency, overhaul Constructive Engagement and enhance its own role in the process. The CAA ought to recognise that the licensee should not benefit from delays to the price control due to its failure to provide timely and high-quality information. If there are unavoidable delays to the start of price control, the CAA should continue to ensure efficient charges during the interim period to protect consumers. These changes would also address the risk of having to delay NR28 to reduce parallel running.

- 7.1. We note the CAA's H8 timetable and the proposal to deliver an H8 price control beginning in 2027 after the end of H7, with the CE process beginning in early 2025 and the CAA's Initial Proposals, Final Proposals and Decisions scheduled for late 2025 and 2026. However, we consider that the likelihood of meeting these tight proposed timeframes will be dependent on:
- a. The CAA providing clear guidance to HAL on BP transparency and setting out its approach on information gathering and enforcement to secure timely and highly quality information needed to carry out its role (see section 8 of our response)
 - b. The implementation of our proposals to improve CE to avoid the failures of H7 and ensure meaningful user consultation, including the CAA assuming a more active role (see section 6 of our response).
 - c. The ability of airlines to feed into HAL's iBP ahead of CE (see paragraph 6.10).
 - d. Improvements to governance, including clearer timelines and a more expedient CAA decision-making, and the CAA's resourcing for the price control (see section 9 of our response)
 - e. The regulated entity should not benefit from its failure to provide timely and high-quality information – for instance, through a delay to the start of the price control. The regulator should ensure efficient costs and charges during a potential expansion period.
 - f. If there are unavoidable delays to the start of price control, the CAA should continue to use its powers to ensure efficient charges during the interim period to protect consumers.
- 7.2. Implementing those changes should moreover create efficiencies to both the H8 and NR28 processes which, in combination with the sequenced timeline presented by the CAA for the two price controls, should allow the regulator to carry out both price controls without the need for a delay to the start of NR28 in 2028, as suggested in the consultation.

GOVERNANCE AROUND PRICE CONTROLS

8. CAA guidance and information gathering (Question 2.33): Setting out minimum requirements on Business Plans and strengthening the CAA's enforcement against incomplete information

To avoid the failures of H7, we support the CAA's proposal to strengthen its guidance and use its powers to secure the provision of high-quality Business Plans by the licensees. The CAA should set clear timelines and the minimum information expected from the regulated entity as well as lay down stronger guidance on circumstances in which it will compel the provision of delayed or withheld information. This should include the use of the CAA's enforcement powers to gather information, impose penalties and disallow revenues. The CAA could consider adapting the Business Plan incentives used by other regulators into a penalty-only regime to incentivise high-quality submissions.

The CAA's lack of enforcement against incomplete information in H7

- 8.1. As noted in paragraphs 6.1 *et seq.*, one of the key failures of the H7 process was HAL's lack of transparency over its BP and a lack of early involvement by the CAA. The lack of transparency persisted throughout the process, and the CAA demonstrated a reluctance to intervene to ensure that HAL complied with its obligation to provide BP information in a comprehensive and timely manner. In particular, the CAA:
- a. Did not opine on how the conduct of CE or the suitability and the level of information shared when this lacked in detail and granularity (such as, HAL's "driver-based" BP, the opaque passenger forecast and the "top-down" model on opex).
 - b. Did not prescribe information sharing, or the format the information was to be shared in.
 - c. Failed to take action despite issues being brought to its attention in weekly meetings with the airline community.
 - d. Hired consultants at a late stage who eventually sided with airlines (for instance on opex and commercial revenues). In addition, the CAA's independent consultant reports, such as the one on opex, were given equal weight to the licensee's own studies, allowing HAL to benefit to lack from its lack of transparency (see paragraphs 14.10-14.11). In the case of NERL, the independent report was ignored with little justification in favour of a conflicting study by the licensee (see paragraph 14.17).
- 8.2. The lack of CAA action significantly limited its ability to examine the robustness of this information and, in turn, assess the BP.

Improving the CAA's guidance

- 8.3. We therefore strongly support the CAA's proposal to improve its guidance, using measures to secure the provision of high-quality BPs and other information in a timely way, and using its formal information gathering and related powers.²⁹
- 8.4. These improvements go hand in hand with our proposed changes to ensure transparency and meaningful user consultation, as well as a more proactive CAA involvement during CE described in section 6 of our response.
- 8.5. **The CAA ought to take a more active role in ensuring that HAL produces effective BPs.** Condition B3.1 of the H7 licence mandates that HAL conduct its business and related activities to ensure the economical and efficient operation, maintenance and development of Heathrow airport. This includes a commitment to meet the reasonable demands of users. It is not sufficient for HAL to merely produce BPs; these plans must be actionable, transparent, and aligned with the needs of the airport's users, including airlines and passengers.
- 8.6. **The CAA's method statement should set clear timelines and the minimum expectations of information delivery from the regulated entity to the regulator** (for instance, the elements of the business plan, the assumptions used and the options considered, alongside providing templates with the type of information required), the cut-off dates for providing that information, and the penalties for failure to comply. We have set out in paragraph 6.6 above how the CAA can outline the standards expected of the licensee's BPs, and the steps it can take to enable this.
- 8.7. Our proposed improvements will provide the CAA with the necessary transparency it requires early on, enabling it to carry out its own assessment of the BP and further the interests of users of air transport services as required by CAA12.

Information gathering powers

- 8.8. **In setting out the minimum information requirements for BPs on the regulated entity, the CAA should lay down a stronger guidance on circumstances in which it can and will compel the provision of information** where this information has been delayed or withheld. This should include use of the CAA's enforcement powers under CAA12 to gather information and impose penalties. Our proposals below should be seen in conjunction with our views on improving the CAA's monitoring and enforcement explained in Section 10 of our response.
- 8.9. Section 50 of CAA12 enables the CAA to obtain information from the regulated entity, especially in circumstances where there is reluctance to provide necessary information, the information is needed urgently, or confidentiality concerns.³⁰ In particular:

²⁹ See paragraph 2.33 of CAP2618.

³⁰ As outlined in [CAP1234](#) – Economic Licensing Enforcement Guidance (para 1.45).

- a. Section 50 of CAA12 provides that the CAA may by notice require a person to provide information or a document that is in the person's custody or under the person's control.
 - b. The CAA may only give a notice under that section for the purpose of carrying out its functions under Chapter 1 of the Act.
 - c. Given that the BPs feed into the CAA's process for determining whether to modify the licence under section 22 of CAA2012 (within Chapter 1), the CAA could exercise this power to compel information from HAL in respect of its BP.
- 8.10. Section 51 of the CAA2012 provides that, if the licensee refuses to comply with an information notice issued under section 50, the CAA may:
- d. Impose a penalty on the licensee; and/or
 - e. Enforce the duty to comply with the notice in civil proceedings for an injunction.
- 8.11. The CAA's Economic Licensing Enforcement Guidance outlines that, with respect to failure to provide information, the CAA "*would expect to use [its] legal powers to obtain information where businesses are unwilling to provide the information, where they have a history of being unwilling to provide information and the information is needed urgently, or where there may be an issue regarding the confidentiality of the information*"³¹.
- 8.12. Separately, where HAL has shared information with the CAA, it may object to the information being shared with airlines. This was the case with the passenger forecast model during the H7 process, where HAL claimed intellectual property and commercial confidentiality issues. In such circumstances, it may nevertheless be open to the CAA to make such a disclosure itself. This would not require the exercise of any of its specific statutory powers as:
- a. such a disclosure would be made in the course of fulfilling its general duty under section 1 of the CAA2012 (having regard to the need to carry out that duty transparently: s 1(4)(a)), and specifically for the purposes of section 22 of the Act.
 - b. paragraph 4(1)(a) of Schedule 6 to the CAA2012 permits disclosure of information obtained under or by virtue of Chapter 1 of Part 1 of the 2012 Act "for the purpose of facilitating the carrying out of functions" of the CAA under Part 1 of the Act (including those under section 22).
 - c. Where necessary, the CAA should establish confidentiality ring arrangements to share information – see paragraph 15.5.
- 8.13. A CAA monitoring and enforcement team on economic regulation could provide the resource needed to ensure this information gathering and monitor the regulated

³¹ CAP1234, para 1.55.

entity's compliance with its economic licence during the price control period as explained in section 10 of our response.

Consider introducing a Business Plan Incentive framework

- 8.14. To incentivise HAL to produce robust and ambitious BPs, in our view, the CAA could consider implementing a business plan incentive framework. The CAA may want to consider and adapt the BP incentives used by Ofwat and Ofgem.
- 8.15. In the water sector, Ofwat has implemented a framework that rewards high-quality, ambitious business plans and penalises companies which produce BPs that fail to meet minimum expectations outlined in its price review methodology. Similarly, Ofgem's RIIO framework for electricity distribution network operators includes a multi-stage assessment process with clear minimum requirements for BPs.
- 8.16. While we do not agree with having a reward element to a BP incentive for HAL, given the pronounced lack of transparency in H7 and that no comparable BPs exist to enable yardstick competition as in water and energy, we believe that there are key lessons to be drawn regarding the penalty elements to incentivise quality submissions.
- 8.17. By way of example, Ofwat's BP review process involves:
- 1) Framework and Methodology Setting: Before water companies submit their BPs, Ofwat sets out its methodology. This document outlines what Ofwat expects from the companies and the criteria it will use to assess the plans. It includes guidance on outcomes, performance commitments, risk and reward, and cost assessment.
 - 2) Ofwat workshops to discuss methodology and expectations of BPs.³²
 - 3) BP submission: Water companies develop and submit their BPs to Ofwat. These plans must detail how they intend to meet the needs of their customers, including the delivery of services and infrastructure investment, while providing value for money. The plans should align with the expectations and requirements set out by Ofwat in its methodology.
 - 4) Initial Assessment of Plans (IAP): Ofwat conducts an initial assessment of the BPs to determine their quality. The assessment focuses on the level of ambition and innovation in delivering outcomes for customers, the environment, and wider society. Based on this assessment, Ofwat categorises companies' plans, which can influence the level of scrutiny each company faces.³³
- 8.18. Following its assessment, Ofwat will rate plans on their quality, which will have different financial, process and reputational consequences. Where quality or

³² See Ofwat [PR24 draft methodology webinar – business plan incentives](#), July 2022.

³³ Ofwat's BP assessment is carried out in two stages. The first stage considers whether submissions are of sufficient quality, and the second stage considers the 'ambition' demonstrated – see [Appendix-12-Business-plan-incentives-1.pdf \(ofwat.gov.uk\)](#).

ambition are insufficiently demonstrated, the company will be penalised.³⁴ Potential penalties include a negative financial adjustment on the return on regulated equity (up to -30 bps for a business plan that 'lacks ambition' and equivalent to -30bps for a business plan that is 'inadequate').

- 8.19. Ofgem's business plan incentive framework for electricity distribution network operators (DNOs) is outlined in its RIIO ED-2 Business Plan Guidance.³⁵ The framework is also structured around the following multi-stage assessment process:
- a. Stage 1 - Minimum Requirements: Ofgem evaluates whether the submitted BP includes all material identified in the minimum requirements outlined in page 60-61 of the Guidance. Ofgem also assesses whether the BP plan is clearly presented, complies with Ofgem's Data Assurance Guidance, and demonstrates how they have been developed through enhanced stakeholder engagement.
 - b. Stage 2 - Consumer Value Proposition (CVP): Ofgem assesses the additional value that the BP offers beyond the minimum requirements and typical business-as-usual functions. DNOs must clearly outline how their plans deliver benefits to consumers, with proposals falling into specific categories such as services for vulnerable consumers, major connection customers, and Distribution System Operator (DSO) activities. Each CVP proposal must be supported by evidence of additional consumer value, including a monetised value of at least £3m per proposal, with a maximum of ten proposals per plan.
 - c. Stage 3 and 4: Cost Assessment: These stages involve a separate assessment of the costs included within the DNOs' business plans, however the Ofgem guidance document does not detail its approach to cost assessment.
- 8.20. Throughout the assessment process, Ofgem will consider the views of the RIIO-2 Challenge Group and Customer Engagement Groups, focusing on whether the minimum requirements have been met, the justification of costs, and the quantification of consumer benefits. Ofgem will also evaluate the robustness of the methodologies used to calculate the monetised consumer benefits and the distributional impacts on different consumer groups.
- 8.21. DNOs that fail to meet the minimum requirements at Stage 1 may face a financial penalty of 0.5% of allowed totex.
- 8.22. Further, for the Stage 3 process, where the costs included in a DNOs' business plan are deemed to be poorly justified, such costs are removed by Ofgem from the companies' forecasts and are also subject to a penalty. The size of the penalty would be 10% of the value of those poorly justified lower-confidence baseline costs removed by Ofgem from the companies' forecasts.³⁶

³⁴ See [Final Methodology for PR24](#), page 151.

³⁵ See <https://www.ofgem.gov.uk/publications/riio-ed2-business-plan-guidance>.

³⁶ https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/riio_ed2_ssmd_annex_2_keeping_bills_low.pdf, see page 94.



8.23. We propose that the CAA considers adopting an adapted Business Plan incentive framework for HAL, which would:

- i. **set clear and enforceable expectations for the quality and ambition of HAL's BP,** in line with the strategic objectives and duties of the CAA.
- ii. include a multi-stage assessment process to evaluate the plan against these expectations.
- iii. **impose financial penalties for plans that fail to meet the minimum standards or lack ambition, such as negative adjustments to returns or disallowing costs.**

8.24. Such a framework would incentivise HAL to develop business plans that are not only compliant, but also forward-thinking and consumer centric. It would also provide a mechanism for the CAA to hold HAL accountable for the quality of its BPs, ensuring that it is fully aligned with regulatory objectives and that it furthers the interests of consumers.

9. Management of process (Questions 2.28, 2.32 and 2.34): Streamlining the CAA's governance, increasing resourcing, improving stakeholder engagement and clarity of timelines

We agree that the CAA should have a focused decision-making process and we support improvements to its governance, regular stakeholder engagement and clarity of timelines for its economic regulation work. To deliver against its timelines, discharge its statutory duties and enhance its role throughout the price control, it is critical that the CAA strengthens its resourcing for H8, NR28 and beyond. The CAA should consider early consultant involvement where resourcing gaps cannot be filled during the price control cycle.

- 9.1. We agree with the CAA's proposal to have a focused decision-making process and stronger expectations around the timely information by the regulated entities.³⁷ We support improvements to the efficiency of the CAA's governance, improved stakeholder engagement and clarity of timelines.
- 9.2. It is critical that the CAA ensures it is resourced adequately and appropriately to ensure earlier and its more targeted involvement starting from the formation of the iBP, during CE, and subsequently the implementation of the price control.
- 9.3. These improvements are necessary to deliver on the tight timeline for H8 set out in the consultation in accordance with the CAA's primary duty to protect consumers.

Timelines

- 9.4. The CAA ought to provide clear timelines for its price control work, as well as a programme for delivering the various strands across its economic regulatory activity including Heathrow, NATS, Gatwick airport, potential competition work and market power determinations. This will enable both appropriate business planning by the CAA, the licensees and users.
- 9.5. Timelines for H8 and NR28 should take into account the CAA's internal governance but also reflect the need for efficient delivery and afford enough time for stakeholders to respond to the relevant material. Planning should factor in contingencies in case there are significant delays which could impact on the duration of the consultation or the start of the price control period. In particular:
 - a. The CAA should publish indicative timelines for the price controls in its relevant publications, explaining any dependencies.
 - b. Timelines should take into account the CAA's planned work across all workstreams in the price control and/or its implementation (e.g. remittals work and outstanding consultations for H7, capex reviews for NR23).

³⁷ Point 2.28 of CAP2618.

- c. Timelines should factor in the work needed to implement the required improvements culminating from the current lessons learned process.
- d. Any delays should be signalled early on and not result in truncating key elements of the process, including the (already tight) windows for CE and the consultation windows for the Initial and Final Proposals.
- e. Any delays by the licensees in delivering information (including lack of transparency and incompleteness) should be efficiently dealt with under the CAA's enforcement policy, as explained in section 8 of our response. Such delays should not in principle lead to knock-on delays to the next price control but rather in penalties and disallowed revenues as explained in paragraph 8.23. Due to its early involvement from the iBP stage, the CAA should be in a position to address any gaps in information through its own bottom-up assessment.

Adequate and appropriate resourcing

- 9.6. **It is critical that the CAA strengthens its resourcing for the H8 price control** to guarantee it is involved in the process in a targeted and proportionate way. Our proposals for the CAA are as follows:
- a. Carry out a review of the resources currently allocated to economic regulation to ensure the right level and experience of staff and identify any gaps in staffing.
 - b. Consider the recruitment of additional personnel with the necessary expertise in economic regulation, airport operations and financial analysis. The CAA should consider timely consultant involvement where these gaps cannot be filled during the price control cycle.
 - c. Ensure the CAA's ongoing involvement in the formation of the licensee's iBP and the CE between licensees and stakeholders. The CAA should ensure that its resourcing in respect of CE extends beyond the initial setup and modification of the licence to include active and continuous participation. This means not only facilitating the process but also committing to regular attendance by staff at the appropriate level to maintain a consistent and informed dialogue (for instance through the involvement of subject matter experts).
 - d. To further support this, the CAA should set out a structured framework for its engagement, which would include scheduled meetings, clear agendas, and documented action items to ensure that all parties are aligned, and that the CAA's oversight remains robust and effective.
 - e. Noting that the CAA is funded through licence fees, consider specifically ring-fencing funding for monitoring and enforcement and licence compliance activities
 - f. Establish a formal mechanism for regular engagement with stakeholders, including airlines, to gather feedback on the licensees' performance and compliance.

- g. Develop clear performance metrics to measure the CAA's effectiveness in monitoring and enforcement. These metrics should be made public to ensure transparency and accountability.
- h. Benchmarking the CAA's resource levels and capabilities against those of other leading economic regulators in the UK, and in the aviation sector globally, to ensure that it is in line with UK and international best practices.

Consultant engagement

- 9.7. As stated above, the CAA should consider consultant involvement where resourcing gaps cannot be filled during the price control cycle. The CAA should consider the timing and early integration of consultants or contractors in the regulatory process to extract the benefit of specialist involvement throughout the price control period.
- 9.8. Engaging these external experts earlier will allow for a more comprehensive understanding of the issues at hand. This proactive approach can prevent the pitfalls of last-minute engagements, which often lead to rushed work and unreasonable deadlines that may compromise the quality and thoroughness of the regulatory oversight. It also means that the CAA is able to operate independently, with less reliance on regulated entities (for example HAL in relation to the preparation of the traffic forecast model or opex plan in H7).

Governance

- 9.9. We agree with the CAA's proposal that, while the CAA Board retains overall responsibility for key decisions, there should be scope to make better use of board sub-committees and external advisors for decision-making.³⁸
- 9.10. To expedite the decision-making process, the CAA should consider implementing a robust delegation framework which delegates the power to make decisions to the appropriate level, so that such decisions can be made efficiently and bottlenecks are not created.

Stakeholder engagement

- 9.11. In respect of senior level stakeholder interactions, we appreciated the access to the CAA Board during the H7 process and consider this to be a positive aspect of the CAA's current approach that should continue to the subsequent price control periods.
- 9.12. However, as stated above, we do see value in the CAA having frequent structured engagement with stakeholders, both at senior and working level, including scheduled meetings, clear agendas, and documented action items to ensure that all parties are aligned.

³⁸ Point 2.28 of CAP2618.

10. Management of process (Question 2.28): Enhance the CAA's monitoring and enforcement

We ask for improved monitoring and enforcement by the CAA of the regulated entity's ongoing compliance with its licence. The CAA ought to be prepared to use its enforcement powers. A CAA monitoring and enforcement team on economic regulation would provide the resource needed to carry out these tasks, which are in line with the CAA's Regulatory Enforcement Policy, the Better Regulation Framework and international practice.

- 10.1. Throughout our response we have raised the need for improved enforcement by the CAA, both during the process leading up to the price determination and during the price control implementation. The lack of such enforcement to date results in a disproportionate cost of regulation being placed on airlines, which have de facto been monitoring the licensees (albeit with limited information), an increased likelihood of disputes, reduce regulatory uncertainty, as well as an increased likelihood of regulatory capture.
- 10.2. We have addressed in sections 6 and 8 above our proposed enhancements to the CAA's role in the process leading up to the price control, including in the iBP, during CE and for the purposes of information gathering.
- 10.3. Nevertheless, the CAA's primary duty to further the interests of users of air transport services also extends to **ensuring that the regulated entity complies with its licence during the entirety of the price control period**. For HAL, compliance notably covers Condition B3.1 of the licence which mandates that HAL conduct its business and related activities to ensure the economical and efficient operation, maintenance and development of Heathrow Airport.
- 10.4. There should be robust monitoring mechanisms that regularly assess the regulated entity's compliance, both with regards to the licence, but also the BP approved by the regulator. A **CAA monitoring and enforcement team on economic regulation** would provide the resource needed to carry out these tasks and use the CAA's suite of enforcement tools explained in paragraphs 8.8 *et seq.* of our response.
- 10.5. In light of the CAA Regulatory and Enforcement Policy³⁹, which emphasises the CAA's commitment to protecting consumers and the public by encouraging compliance and deterring non-compliance, the CAA ought to:
 - a. Increase its monitoring activities to ensure HAL's ongoing compliance with its licence conditions. This includes use of performance indicators and regular reporting to keep stakeholders informed and to promptly identify areas of concern.
 - b. Be prepared to use its legal powers, for example, under section 50 of the CAA12, to obtain information from the regulated entity, especially in circumstances where

³⁹ [CAP1326: CAA Regulatory Enforcement Policy | Civil Aviation Authority](#)

there is reluctance to provide the necessary information, the information is needed urgently, or confidentiality concerns.⁴⁰

- c. Clarify the consequences of HAL's failure to comply, including with Licence Condition B3.1. It is essential to understand the enforcement actions that the CAA will undertake if HAL does not meet its obligations.

10.6. The CAA's approach to regulation should adhere to the duties in section 1(4) of CAA2012, which require regulatory activities to be consistent with the principles of proportionality, accountability, consistency, transparency. These duties incorporate the Better Regulation Framework and Regulator Code which, among other things, require remedies to be appropriate to the risk posed, targeted to the problem posed and regulators to be subject to public scrutiny.⁴¹ In line with its response to the 2023 inquiry on UK Regulators by the House of Lords Industry and Regulators Committee⁴², the CAA stated that it will begin to publish a dashboard on service performance in 2024 so all interested stakeholders are better sighted on its performance.

10.7. Similarly, the CAA should consider international best practice in regulatory performance (and noted by the CAA in its response to the House of Lords Industry and Regulators Committee).⁴³ This could include adopting similar KPI and self-assessment processes, validated by an external panel to drive continuous improvement in the regulatory framework.

⁴⁰ As outlined in [CAP1234](#) – Economic Licensing Enforcement Guidance (para 1.45).

⁴¹ [Better regulation | Civil Aviation Authority \(caa.co.uk\)](#).

⁴² [Response by the CAA to the inquiry on UK regulators by the House of Lords Industry and Regulators Committee](#).

⁴³ See [Regulator Performance Framework | Treasury.gov.au](#). The framework applies to all Australian regulators that administer, monitor or enforce regulation. The Framework articulates the Government's overarching expectations of regulator performance and comprises 6 outcomes based key performance indicators (KPIs): (1) Regulators do not unnecessarily impede the efficient operation of regulated entities; (2) Communication with regulated entities is clear, targeted and effective; (3) Actions undertaken by regulators are proportionate to the regulatory risk being managed; (4) Compliance and monitoring approaches are streamlined and coordinated; (5) Regulators are open and transparent in their dealings with regulated entities; and (6) Regulators actively contribute to the continuous improvement of regulatory frameworks.

APPROACH TO KEY PRICE CONTROL ISSUES AND BUILDING BLOCKS

11. Regulated Asset Base and Inflation Indexation (Questions 2.46 and 2.51): addressing the size and growth of the largest driver of Heathrow's high charges

The CAA **should address as a priority the size of HAL's £20 billion RAB** which is driving 90% of the charges at Heathrow. Indeed, HAL's RAB is significantly larger than major European hubs. The CAA should look at addressing the inflation indexation applied to the RAB, which has driven a £6.9 billion growth and windfall profits in the past decade and seek to review the continued ownership of potentially underperforming assets of up to £2.2 billion. We also ask for an examination of the appropriateness of a blanket 15% addition to capex projects under 'Leadership and Logistics.' This exercise would ensure that the RAB reflects efficient costs and drives efficient charges in the consumer interest.

11.1. We advocate for changes in H8 to the estimation of the key building blocks driving the high level of charges at Heathrow. In particular, **the large size of HAL's RAB drives over 90% of the charge** in regulatory depreciation and the cost of capital (£8 billion out of £8.7 billion in aeronautical revenue for H7). It should therefore be examined by the CAA as a priority to ensure it reflects efficient costs in the consumer interest.

The size of the RAB

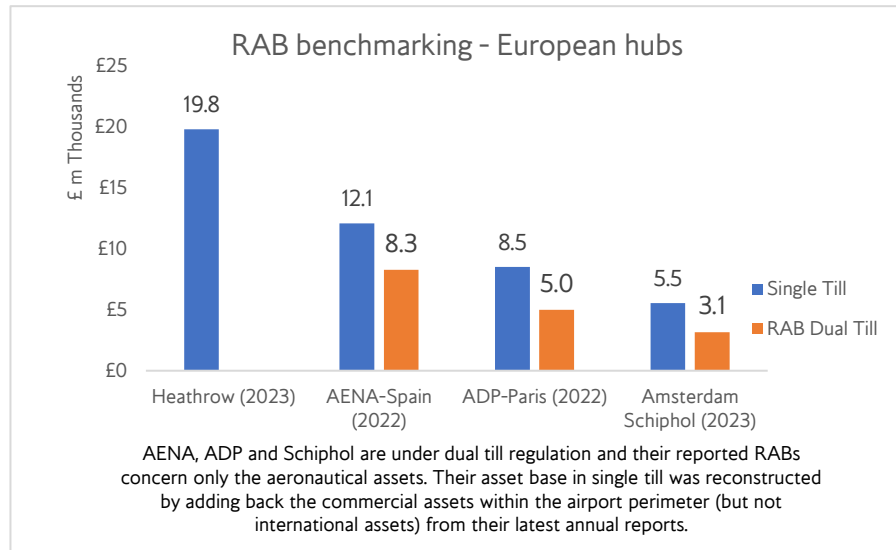
11.2. The CAA acknowledges that HAL has a relatively large RAB and therefore the allowances for regulatory depreciation and the cost of capital make significant contributions to the overall level of HAL's charges.⁴⁴

11.3. In fact, a comparison of the size of HAL's RAB to other major European airports, including airports that the CAA employs as comparators to set HAL's allowed return through the WACC, demonstrates that HAL's RAB is by far the largest. We note that some of the other operators:

- i. run several airports, including large airports, compared to the one airport run by HAL (46 airports in Spain for AENA, 3 airports in Paris for ADP).
- ii. operate hubs with more or a similar number of terminals to Heathrow's 4 terminals (9 terminals for Paris Charles de Gaulle, 4 terminals for Madrid Barajas), with some of those terminals having been as recently delivered as HAL's Terminals 2 and 5.⁴⁵

⁴⁴ Point 2.50 in CAP2618.

⁴⁵ Terminals 2E and 2G in Paris CDG were delivered in 2003 and 2008 respectively. Terminal 3 in Paris Orly was delivered in 2019. Terminal 4 in Madrid Barajas was delivered in 2006. Terminal 1 in Barcelona El Prat was delivered in 2009.

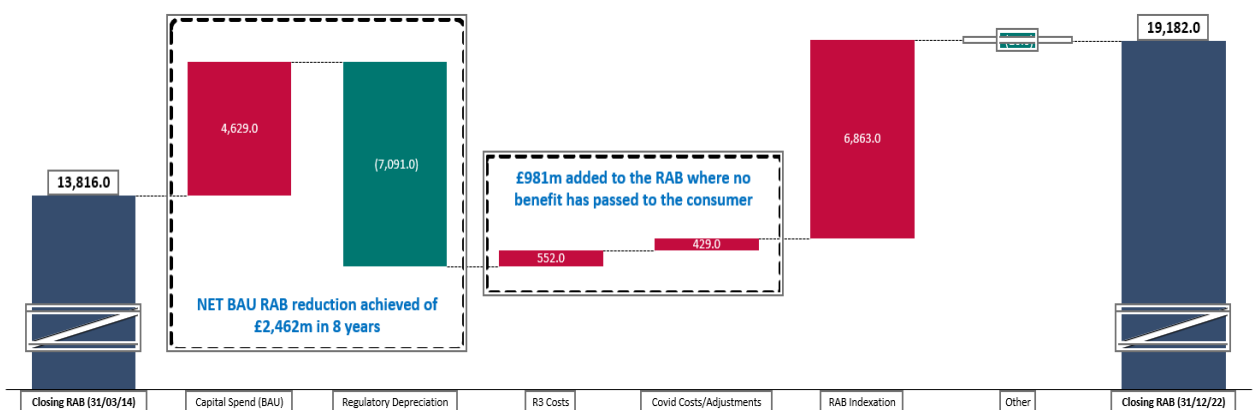


Source: BA analysis⁴⁶

11.4. The CAA should examine the reasons for the size and growth of the RAB in recent years. We set out below what we view as the main driver for the large size and growth of HAL’s RAB over the past decade.

The growth of HAL’s RAB: inflation indexation and windfall profits

11.5. HAL’s RAB has grown significantly over the past decade despite no single major investment since the delivery of Terminal 2. Between 2014-2023, **the RAB increased by around 50%** (£5.4 billion) despite depreciation being over 1.5 times higher than capital expenditure.⁴⁷ **This significant growth can largely be explained by the inflation indexation of the RAB (applied through RPI inflation in previous price controls) which drove an increase of £6.9 billion.**⁴⁸



Source: BA analysis using Heathrow regulatory accounts

⁴⁶ HAL RAB includes inflation indexation. Absent that inflation indexation between 2014-2023, HAL’s RAB is at ca.£14 billion. Annual average ECB rate used for EUR to GBP conversion.

⁴⁷ Excluding third runway costs.

⁴⁸ See Appendix A for underlying calculations. For instance, during the high inflationary year of 2022 alone, the inflation indexation drove a £2.3 billion growth in the RAB.

- 11.6. For the Q6 price control, the CAA's decision assumed an annual RPI inflation of 2.8%.⁴⁹ However, outturn RPI inflation was 150bps higher over the past decade. This differential is indicatively equal to an additional growth in the RAB of at least £2.2 billion, or £3.50 per passenger, and a windfall gain for HAL at the expense of consumers. Inflation indexation of the RAB is one of the key drivers of the excess profits discussed above in paragraphs 2.7 *et seq.*⁵⁰
- 11.7. While the intention of the CAA at the start of the pricing period was that the inflation indexation would provide a fair bet, outturn RPI inflation has driven significantly higher returns for HAL.

Addressing the growth of the RAB: inflation indexation

Use of CPIH to replace RPI

- 11.8. We strongly agree with the CAA's suggestion to consider how it treats inflation in price controls, notably with respect to the indexation of the RAB, and that there are advantages in using CPI or CPIH indexation for prices.⁵¹ RPI was removed as an Official National Statistic in March 2013, due to not meeting international standards of representative inflation series. This is prior to the Q6 and H7 price controls. Other regulators have moved to CPI or CPIH linked controls, with Ofwat discussing the change from RPI in 2015.⁵²
- 11.9. The use of a more market-reflective inflation assumption would have contained the growth in the RAB, reduced the cost of capital and removed some of the windfall gains. As the inflated RAB rolls over into subsequent price controls, these excess returns are further exacerbated at the consumers' expense.
- 11.10. Indeed, the use of CPIH (with a 2% assumption) over 2014-2023 would have led to half of the outturn variance (77bps higher) compared to the use of RPI (150bps higher). This would still have represented a windfall gain to HAL, but at a lower level than materialised, meaning that the use of RPI allowed HAL to effectively double its windfall gain and earn an additional £1.1 billion from customers, or £1.75 per passenger.
- 11.11. **We consider that the CAA should follow the example of other regulators in moving to a CPIH (or CPI) indexation from RPI inflation,** assuming RAB indexation will continue to be used.
- 11.12. The CAA should present to stakeholders how it plans to estimate the real CPIH cost of capital, using regulatory precedent and UKRN guidance.

⁴⁹ Paragraph 6.60 of [CAP1115](#).

⁵⁰ This does not capture the net effect – for example, index-linked debt would have increased, to increase overall debt costs.

⁵¹ Point 2.46 of CAP2618.

⁵² We note that Ofgem signalled their intention to change to a CPIH-linked control in December 2018 and the NI Utility Regulator has moved to a CPIH linked regime from GD23.

- 11.13. RPI will be aligned with CPIH inflation in 2030 through a period of reform. This means that any RPI-CPIH wedge and underlying RPI indexed linked returns for medium/long dated instruments will be undergoing structural change in a way that does not impact CPIH inflation. Any challenges from transitioning from RPI to CPIH will be time-limited and not represent a strong reason not to change approach.

Addressing inflation

- 11.14. Given the significant increases in the RAB and HAL's profits driven by the recent high inflationary shocks, **the CAA could also consider a mechanism to address the scope for inflation-driven returns.** This could be through a cap and collar approach, or through incorporation of inflation returns in broader return sharing mechanisms. Indeed, cap and collar approaches on returns have been used for interconnectors in energy and through Return Adjustment Mechanisms for energy networks.

Consider the pros and cons of removing inflation indexation from the RAB

- 11.15. The CAA may want to consider whether to move to setting a nominal allowance for nominal debt costs. This option could be consistent with how the CAA considered deflating nominal debt in the H7 controls. This has the potential to reduce the ever-increasing RAB and avoid windfall gains/losses from differences between expected and outturn inflation. There could also be improvements in financeability from such a change. A further advantage would be in greater stability and predictability of charges in nominal terms. We note that Ofcom generally applies the WACC in nominal terms, though we note the different regulatory framework relative to other sectors.
- 11.16. However, we would want to understand and be consulted on the impact on HAL's charges, which are the highest in the world, the transitional arrangements to phase in the revised approach, and whether the CAA would reduce the cost of capital to reflect the risk removed from HAL. A potential drawback of this approach is the near-term impact on consumer bills which would be expected to increase over the short run, but the CAA could consider mitigations for smoothing the impact over regulatory periods (such as through the profile of depreciation).
- 11.17. It may be that on balance a nominal (non-indexed) component is not preferable to a full CPIH indexed regime, but the CAA should continue to ensure that the price control is set up optimally and demonstrate it has considered such an approach.

Approaches by other regulators

- 11.18. Other UK economic regulators are also examining ways to address inflation variations from long-run assumptions to avoid excessive remuneration for licensees and ensure a fair mechanism for consumers. For example, Ofgem's RIIO-3 Sector Specific Methodology Consultation presented options to address inflation in the GB energy sector. One option suggested was to index the regulatory asset value, which would be aligned to the notional fixed rate debt assumption, by the long run inflation

assumption used to deflate the cost of debt allowance, instead of outturn inflation.⁵³ This would remove the scope for windfall gains and would keep charges lower.

Addressing the size of the RAB: reviewing the continued ownership of potentially underperforming assets

- 11.19. **We estimate that HAL could have underperformed with investments worth up to £2.2 billion that it could sell off as liquid assets.** These assets – which we do not believe are operationally critical as they have been labelled as “Investment Property” by HAL⁵⁴ – carry a significant amount for the airlines to service. At the same time, there is no detail of the revenues that each of those assets bring in, the level of savings or opportunity costs linked to each asset, and, most importantly, the extent to which those projects yield positive outputs for consumers.
- 11.20. For instance, it could be that if HAL divested those assets, the RAB could reduce, and charges would be lowered. The absence of an incentive on HAL to sell off those assets, instead earning the full cost of capital on them, comes at an excess cost to customers who are unable to take a decision to sell off these assets.
- 11.21. We strongly support the CAA examining how these perverse incentives can be corrected, notably the extent to which HAL is better served by retaining unprofitable investments on the RAB rather than selling those assets. The CAA should equally assess the option of removing assets from the RAB which should have otherwise been divested to ensure that it reflects efficient costs for consumers. We are aware from HAL’s accounts that an asset valuation is taking place annually, which would offer an opportunity to examine how to approach the inclusion of those assets in the RAB.

Leadership and Logistics expenditure

- 11.22. We note **the use by HAL of a blanket 15% addition to capex projects to cover portfolio costs for ‘Leadership and Logistics.’** We are concerned that these material costs are not scrutinised by airlines or the CAA and, as such
- i. It is not clear why a 15% rate is required for all capex projects.
 - ii. There is no regular and continued clarity on the type of costs being included under this heading (such as consultant costs) and we are concerned that there is a potential for double counting within business cases.
 - iii. There is no clarity or transparency on the distinction between fixed and variable costs within Leadership and Logistics.

⁵³ Paragraph 2.36 of [RIIO-3 SSMC Consultation – Finance Annex](#).

⁵⁴ Indeed, HAL’s 2022 accounts demonstrate that it is holding around £2.2 billion of Investment Property assets on its balance sheets (which can effectively mean that those assets are also on the RAB when reading across from HAL’s statutory to regulatory accounts). See Appendix C for details.

- iv. There is no clarity on the level of Leadership and Logistics costs that enters the RAB on an annual basis, and there is no reconciliation to the amount included in Core projects.
 - v. There could be distortions to the true cost of projects, in turn leading to poor decision-making for capital approvals.
- 11.23. We would propose a detailed assessment by the CAA of the type and quantum Leadership and Logistics costs, how to make it more relevant to all projects, the approval process and a regular assessment of the quantum of costs being capitalised onto the RAB. There should be improved and regular airline scrutiny of those costs.
- 11.24. This is a significant figure added to the RAB each price control and this goes largely unchallenged. There is scope that this has implications for opex allowances and generated returns for HAL, and therefore its transparency and governance must be improved.

Capex vs opex

- 11.25. The CAA should also consider how to address the incentive on HAL to develop capex solutions, which in turn increase the size of the RAB even further, compared to opex solutions. We note that the airlines are not part of the initial solution design meetings where the decision of opex vs capex is first discussed. For instance, we could be supportive of lease options where appropriate.

Future RAB adjustments

- 11.26. We would welcome guidance on whether the CAA would expect to make any adjustments to the RAB in future years, similarly to the H7 RAB adjustment. As such, we expect that the CAA would maintain a consistent approach, reserving such adjustments for truly exceptional circumstances, and not as part of ordinary regulatory practice. This is supported by the CAA's Final Decision, its Response filed in the H7 CMA appeal and also the CMA's Final Determinations.⁵⁵ Each of these documents reflects that the impact of the Covid-19 pandemic had created 'exceptional circumstances' and that the CAA had recognised the "*need to consider how the regulatory framework should change in response to these challenges*" and "*made and retained the £300 million RAB adjustment as a result of those considerations*".⁵⁶
- 11.27. We also note the CAA's inclusion in H7 of an asymmetric risk allowance, a shock factor in traffic forecasts and increases in the beta with subsequent empirical evidence to the contrary (see paragraph 12.7 *et seq.*). The regulator should avoid the risk of any double counting in compensating the licensee and maintain the incentives surrounding ex-ante economic regulation. Insulating a regulated firm from all

⁵⁵ See, for example, paragraph 5.275, CMA H7 Final Determinations; paragraph 107, CAA response to H7 appeals.

⁵⁶ See paragraph 10.78, CMA Final Determinations.

eventualities is inconsistent with the cost of capital and therefore the cost paid by consumers.

Framework for competition from new infrastructure (Question 3.9)

11.28. The CAA has invited comments on whether a largely reactive approach to dealing with plans to provide and operate infrastructure at Heathrow continues to be suitable. In the absence of a framework for how this will be assessed, potential providers are likely to be deterred from coming forward. Developing a more proactive approach could better support the development of such plans.

12. Cost of Capital (Question 2.47): Adapt the approach to reflect emerging precedent and updated market evidence to avoid over-compensating

The CAA's approach to estimating the WACC in H7/NR23 will need to be adapted for subsequent price controls to reflect emerging regulatory precedent and updated market evidence. This is consistent with a stable and predictable regulatory approach. Empirical betas show a return to pre-pandemic levels of risk, suggesting that the return allowed for H7 is inconsistent with the level of risk faced by HAL. The CAA ought to properly consider arguments, such as the differing level of risk borne by the airport comparators. The CAA should only adapt its approach where there is robust evidence, and we disagree with the suggestion that the approach to total market return should be revised given detailed precedent, empirical data, and long-term expectations on inflation.

12.1. While we understand that the CAA will want to build on the CMA's H7 decision supporting its broad assessment of the Weighted Average Cost of Capital (WACC), we note that this assessment was carried out in the particular context of the H7 price control which was heavily impacted by the Covid-19 pandemic.

12.2. We therefore agree with the CAA's statement that its approach will need to be adapted for subsequent price controls to keep pace with emerging precedent and emerging market conditions.⁵⁷ We suggest that the CAA carries a targeted review of its approach to the WACC, using robust evidence, by:

- i. Using precedent by economic regulators of other UK regulated sectors and the UK Regulators' Network (UKRN).
- ii. Using precedent by other European airport charges regulators, notably the airports the CAA may decide to use as comparators in the relevant WACC parameters, and taking into account the guidelines from the Thessaloniki Forum of Airport Charges Regulators on estimating the WACC.⁵⁸

⁵⁷ Point 2.48 of CAP2618.

⁵⁸ <https://ec.europa.eu/transparency/expert-groups-register/core/api/front/expertGroupAdditionalInfo/29019/download>

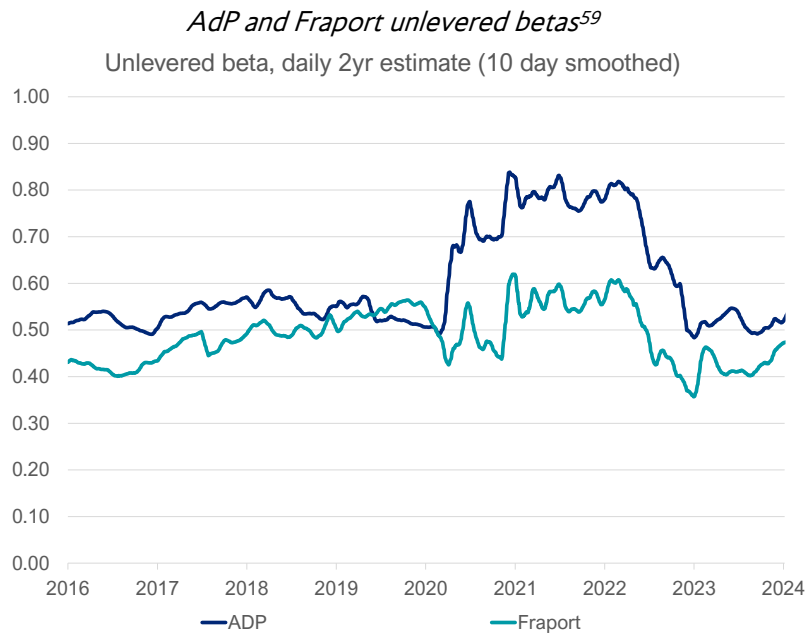
- iii. Looking empirically at the development of the WACC parameters retained for H7/NR23 to examine whether the return allowed for HAL was appropriate (i.e. too high) and whether the approach can be fine-tuned for H8/NR28.
 - iv. Conducting a thorough examination of any relevant views by stakeholders to examine whether these are substantiated or not.
- 12.3. Indeed, regulating based on updated evidence and best practice is entirely consistent with a stable and predictable regulatory approach.
- 12.4. This adapted approach will allow the CAA to establish whether or not the allowed return for H7 is inconsistent with the level of risk faced by HAL. For instance, the Covid pandemic led to the CAA revisiting the regulatory framework, simultaneously de-risking HAL (including Traffic Risk Sharing), whilst adding new revenue allowances for Heathrow and increasing the beta.
- 12.5. **We therefore advocate for the CAA to streamline its approach** on the cost of capital for the next price control periods to achieve consistency with the level of risk borne by the regulated monopoly. Our proposals below should be read in conjunction with our positions on tightening the regulatory incentives and risk allocation in section 16. As mentioned in paragraph 6.17, ahead of CE, the CAA should present early guidance of its orientations on the level of the cost of capital. This will allow for a more informed discussion on the impact of capital projects and depreciation.

Asset beta

- 12.6. We consider that an early and comprehensive review of beta estimation is a necessary step in the H8 process. This should include a proper relative risk assessment and an adaptation of some of the policy decisions made at H7 to reflect precedent and evolving market evidence, which will demonstrate that the return allowed by the CAA for H7 is inconsistent with the level of risk faced by HAL.

Empirical betas are inconsistent with the CAA's approach

- 12.7. Recent market evidence has corroborated our views from the H7 process. We had submitted evidence to the CAA that the spikes to the asset beta as a result of the pandemic were transitory and were not representative of a fundamental re-assessment from investors. While this analysis was rejected by the CAA, which applied a pandemic uplift of 0.10, the updated unlevered asset betas from Aéroports de Paris (AdP) and Fraport from mid-November 2022 to end 2023 demonstrate a return to pre-pandemic levels. Unavoidably the CAA's approach will lead to higher charges for consumers for H7.



- 12.8. Empirical betas therefore now demonstrate that the pandemic-related uplift was not required, and that the CAA would be justified in reconsidering its approach.
- 12.9. In addition, the level of risk implied by the asset beta exceeds the level of risk facing Heathrow after application of the Traffic Risk Sharing mechanism – see paragraphs 16.6 *et seq.*

Taking precedent into account

- 12.10. Furthermore, despite our submission to the NR23 Provisional Decision, the CAA dismissed without appropriate examination precedent from the French Transport Regulatory Authority (ART) which, in contrast to the CAA, had found that potential adjustments to the asset beta may appear arbitrary if they are based on assumptions about the length of the Covid-19 pandemic and frequency of future similar events.⁶⁰
- 12.11. Given the important value of regulatory precedent, the CAA ought to duly take into account other regulatory practice and appropriately examine the scope for alignment.

Peer group

- 12.12. The CAA rejected with little explanation the arguments in our response to the NR23 Provisional Decision that the regulator ought to factor in the different risk profile of comparators retained for the peer group. This is all the more relevant as all these airports are subject to different regulatory regimes and have significant non-

⁵⁹ AENA shows a similar relationship, but we consider this less representative as a comparator.

⁶⁰ See ART report, paragraphs 131-132, available at [2023-04-17-cmpc-aeroportuaire-consultation-publique_v-post-college_clean.pdf \(autorite-transports.fr\)](https://www.autorite-transports.fr/2023-04-17-cmpc-aeroportuaire-consultation-publique_v-post-college_clean.pdf).

regulated activities exposed to a higher systematic risk than HAL and NERL, necessitating downward adjustments to the betas.⁶¹

12.13. For instance, some comparators in the peer group (ADP, Fraport) operate airports in jurisdictions outside Europe, such as Asia, South America, the USA and Africa, while another comparator (AENA) operates a network of 47 airports in Spain – including small regional airports with higher exposure to traffic risk. These factors demonstrate different risk profiles to HAL and NERL.

12.14. We were clear in our response that our views concerned an adjustment required to the beta and not necessarily a reconsideration of the peer group as the CAA suggested in its NR23 Final Decision.⁶² The CAA ought to have examined those arguments duly, especially considering our involvement in the regulatory processes for the airports chosen for the peer group, rather than providing a cursory view that the ownership of international airports could potentially lead to lower risk exposure.

12.15. For the subsequent price controls, we therefore advocate that the CAA involves interested parties early in its analysis of those arguments which should examine and seek to substantiate their relevance.

12.16. In our view, Heathrow should be considered materially less risky than other comparators, the pandemic uplift of 0.10 was arbitrary at the time and is not justified today.

Total Market Return and Equity Risk Premium

12.17. In its consultation, the CAA alludes to the possibility of adapting its approach to the Total Market Return and the Equity Risk Premium “in light of persistently high interest rates”.⁶³

12.18. We disagree with the CAA’s statement. There is detailed precedent and we do not expect materially new arguments to arise on the total market return and the risk-free rate. It is crucial that the CAA considers a symmetric approach to regulation and only adapts its approach where there is robust evidence. We do not think these conditions are met here in light of:

- i. The long-term view on which bases the Capital Asset Pricing Model.
- ii. Observed market data and the limited duration of volatile events.
- iii. The Bank of England’s 2% inflation target by Q4 2025.⁶⁴

⁶¹ See point 7.10.6 of our [response](#) to the NR23 Provisional Determination.

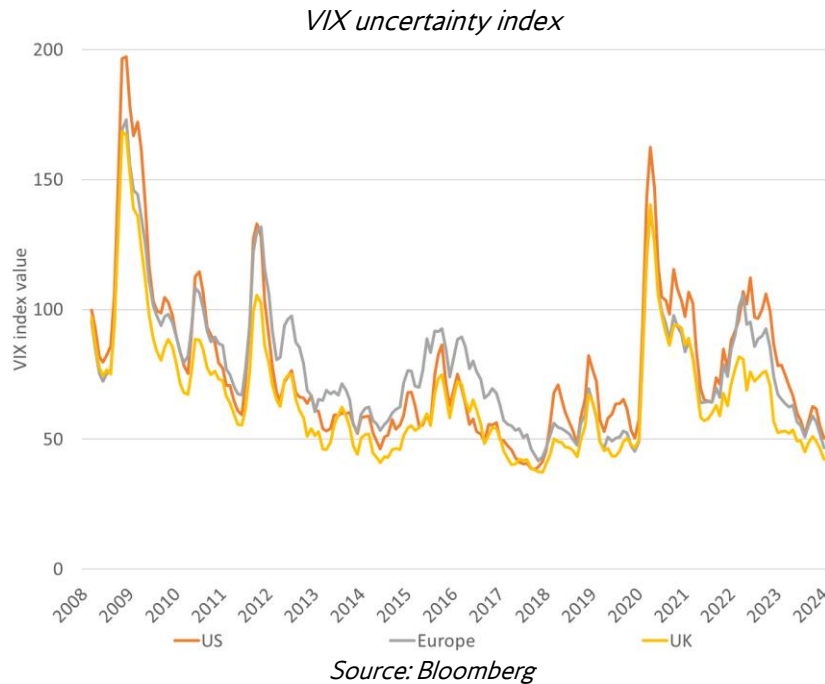
⁶² See paragraph 5.114 of [CAP2597](#).

⁶³ Paragraph 2.48 of the CAP2618.

⁶⁴ See [BoE’s Monetary Policy Report of February 2024](#).

- iv. Regulatory precedent excluding atypical observations due to exceptional events.⁶⁵
- v. The overestimation of the WACC in H7 and the excess returns earned by HAL in the past decade, as explained in paragraphs 12.6 *et seq.* and paragraphs 2.7-2.10 respectively.

12.19. We first look at the VIX uncertainty index, showing volatility (higher numbers = more volatile). The levels currently are as low as any level over the past 15 years.

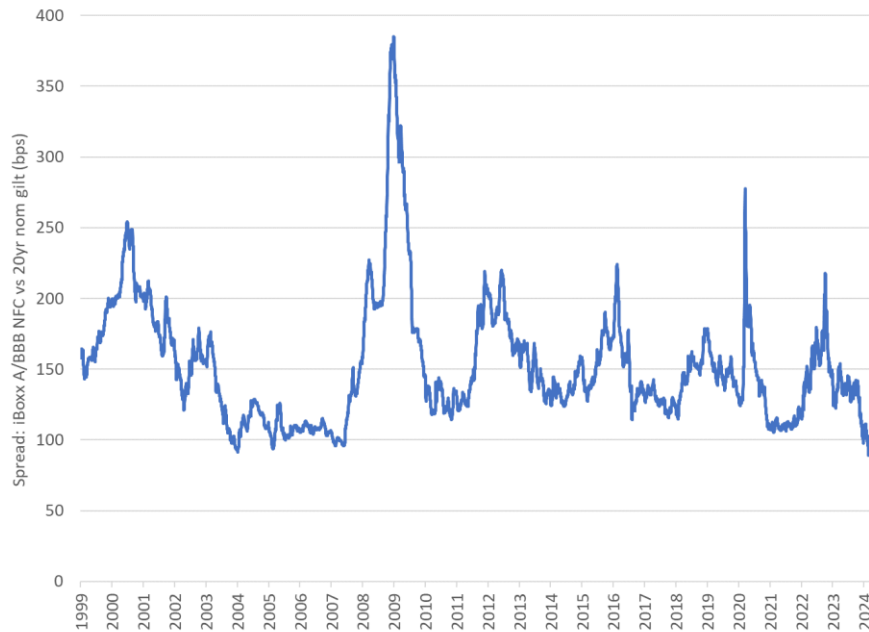


12.20. In addition, whilst nominal interest rates are higher than previous years, debt spreads are also at historical lows. This context is important in precluding aiming up, either implicitly or explicitly. If volatility did arise, the evidence suggests that it typically does not last the five years of a price control and so should have a limited impact.

12.21. We show these debt spreads for A/BBB non-financial corporates 10yr+, compared to 20yr UK nominal gilts. The figures are indicative and should not be interpreted as being recommended for use in the cost of debt.

⁶⁵ See paragraph 12 of the Thessaloniki Forum Guidelines on estimating the WACC.

Debt spreads on iBoxx GBP A/BBB non-financial corporates (NFCs) 10yr+ index vs UK 20yr nominal gilts



Source: Markit iBoxx

Cost of debt

12.22. We would expect a review of embedded and new debt, including an assessment of the appropriate inflation assumption.

12.23. We consider that HAL should be required to present more complete information to the CAA on its debt costs and how to translate these into a nominal rate. This evidence should be available to key stakeholders in the process.

RAB indexation changes

12.24. If the CAA moves to a CPIH/CPI/nominal regime, the CAA should give early sighting on how it proposes to update their cost of capital approach.

13. Financeability (Question 2.54): Looking at market evidence and the trade-off with consumer protection

Financeability should not come at a higher cost than necessary. The CAA should be looking at market evidence, such as HAL's excess profits despite the Covid-19 period and the ongoing sale of Ferrovial's stake for a premium. The CAA should be recognising that, as a secondary duty for HAL, financeability should not override its primary duty on consumers. Similarly, insulating a regulated firm from all eventualities is inconsistent with the cost of capital and, ultimately, the cost paid by consumers.

- 13.1. We are concerned by the CAA's question on considering its approach to equity financeability, to the extent that this increases further the focus on "investability".
- 13.2. The presence of a financeable regime is an important part of economic regulation. The regulatory framework should ensure that necessary investment is not constrained by an absence of capital, but equally that this finance comes at a significantly higher cost than is necessary.
- 13.3. However, as noted above, the CAA's price controls for HAL have led to imbalanced price controls in favour of HAL, with excess returns in the past decade despite the pandemic representing a third of this period. In addition, the ongoing sale by Ferrovial of its stake in HAL represents a 23% premium on HAL's enterprise value relative to its RAB suggesting a continuation of these excess returns. Financeability should therefore be looked through the prism of recent market evidence and take into account the risk of overly generous settlements to the licensees.
- 13.4. Similarly, the price control assumes a given credit rating for setting the cost of debt and financeability. This is a cross-check that can be thought about in relation to risk.
- 13.5. As part of its ED2 Draft Determinations, Ofgem quoted credit rating migration and how five-year average migration rate for Baa (i.e. BBB) rated issuers to sub-investment grade ratings are around 6%, stating that:

"They [migration rates] indicate that our financeability assessment should not be determined by the extreme tail of the probability distribution of potential outcomes. We note that a 1-in-16 probability is closely comparable (in a sector with 14 licensees) to the most severe outcome that might be expected for an individual licensee in a typical price control.⁶⁶"
- 13.6. Insulating a regulated firm from all eventualities will be inconsistent with the cost of capital and therefore the cost paid by consumers.
- 13.7. Furthermore, we consider that the CAA should look at broader possibilities to support financial resilience without passengers needing to pay over the odds. In fact, recognising that excessive dividend payouts threaten financial viability, Ofwat introduced a licence condition in March 2023 to restrict the ability for regulated

⁶⁶ See paragraph 5.56 of [Ofgem \(2022\) RIIO-ED2 Draft Determinations – Finance Annex](#).

companies to pay out dividends that were not driven by efficiencies or improved performance.⁶⁷

- 13.8. As a secondary CAA duty, financeability should not override the regulator's primary duty is to further the interest of airport users, as explained in paragraph 4.9.

14. Cost assessment (Question 2.41): addressing HAL's inefficiency, increasing information sharing and using a regulatory toolkit for cost efficiency

HAL is lagging on cost efficiency internationally. The failed Constructive Engagement in H7 did not allow airlines to challenge opex and capex budgets, or the pessimistic commercial revenues. **The CAA should not be using the licensee's estimates as a starting point in its efficiency assessment to avoid perverse incentives**, but adopt a view based on early involvement in the process and the use of a range of approaches, such as bottom-up assessments and productivity analyses. The CAA should consider how to track efficiencies and commercial revenues accruing from capital projects.

The impact of the failed H7 CE process

- 14.1. As a general rule, an economic regulator such as the CAA should deliver outcomes where valued outputs are delivered at efficient cost. In doing so, the CAA does have a strong countervailing consumer representative to support this decision, in the form of airlines. The CE process is therefore key.
- 14.2. However, we noted in section 6 above that the failed CE process for H7 meant a lack of transparency and meaningful consultation of users over HAL's BP. HAL's "driver-based" BP provided little insight and lack of detail as to the constituent elements, including capital projects and opex, and the assumptions and options considered.
- 14.3. We explained in paragraphs 8.1 *et seq.* how the CAA's reluctance to enforce against the lack of transparency, including on the lack of granularity on HAL's "top-down" plan, limited the regulator's ability to examine the robustness of this information and assess the BP. This limited efficiency and resulted in inflated capex and opex budgets and led to pessimistic commercial revenues, at the expense of consumers.

HAL's inefficiency

- 14.4. HAL appears to be lagging on cost efficiency internationally, with its operating costs per passenger (excluding depreciation) being the highest among European airports [...] This is further exacerbated by the fact that Heathrow is close to capacity and should benefit from economies of scale. This is inconsistent with condition B3.1 of HAL's Licence, which requires HAL to conduct its business and activities that relate

⁶⁷ <https://www.ofwat.gov.uk/ofwat-announces-new-regulatory-controls-on-water-company-dividends/>

to the provision of airport operation services to secure the economical and efficient operation and maintenance and timely and appropriate enhancement of the airport.

[...] ⁶⁸

14.5. [...]

14.6. Conversely, despite having by far the highest aeronautical revenues per passenger among large European airports [...], HAL is lagging on non-aeronautical revenues. This has ramifications for efficiency, as an entity subject to competitive forces would have sought to maximise its commercial revenues.

[...]

Revisiting the CAA's approach

14.7. We agree with the CAA's position that it should consider how to best improve its approach to cost assessment for the subsequent price controls.⁶⁹

14.8. While the CAA is limited, relative to the UK energy and water regulators, in not having comparators in the same country that can be used for yardstick regulation, its early engagement in the inception of BPs should enable it to consider how to best deploy a range of tools, such as independently commissioned studies, comparing top-down and bottom-up assessments, using precedent from other regulated airports, detailed assessments of productivity, and conducting a proper assessment of policies impacting on expenditure and revenues⁷⁰.

14.9. As noted in paragraphs 6.8-6.10 and 8.6, the CAA should consider setting clear expectations to the licensees on the content and level of detail to be provided on the key drivers of their iBP. This will allow the regulator to thoroughly question and challenge the assumptions used, obtain feedback from airlines where needed, and have sufficient time to commission its own studies.

14.10. We believe that **the CAA should not be using the regulated entity's estimates as a starting point for its assessment** but rather adopt a view on what the correct answer is based on the use of the most appropriate approach in its toolkit. A key error during H7 was affording equal weight to the CAA's own independently commissioned report and a study commissioned by HAL. This was an unbalanced approach and did not factor in HAL's incentive to set unduly high expenditure estimates if the regulator is likely to seek to compromise somewhere between parties. The regulated entity also has an incentive to disclose items that will lead to higher allowed costs, but no incentive to disclose those factors that are likely to lead to efficiencies. To partly address this incentive, we are also proposing the introduction of a mechanism on HAL to share opex efficiency gains – see paragraphs 16.18-16.22.

⁶⁸ [...]

⁶⁹ Point 2.41 of CAP2618.

⁷⁰ Such as the impact of the UK government policy to abolish tax free shopping.

- 14.11. In fact, given the lack of basic transparency by HAL during H7, we do not think a regulated entity should be allowed to benefit through higher allowances from its failure to provide its regulator and users with the required information.
- 14.12. It is equally important for the CAA to recognise that, while the CE process is a sufficient complement to its approach, airlines are themselves relying on the regulator for the necessary expertise and to address information gaps.
- 14.13. Moreover, the CAA ought to consider how to best place mechanisms for tracking opex benefits and commercial revenues against capex projects and business cases and integrating them into the regulatory settlement. Projects approved at G3 gateway through H7 have committed to deliver incremental commercial revenues and these should be confirmed as being baked in.
- 14.14. The CAA should also consider how to address the incentive on HAL to develop capex solutions, which in turn increase the size of the RAB even further, compared to opex solutions.
- 14.15. As noted in section 8 of our response, the CAA should be using the full suite of its enforcement powers to gather the necessary information, as well as imposing penalties and disallowing any costs that have not been properly evidenced, justified or consulted on (see paragraph 8.23).
- 14.16. The CAA may also want to put in place deeper periodic reviews of costs to ensure that there has been no gold-plating. Such reviews should involve looking at similar infrastructure projects and resorting to experts in capex planning.

NR28

- 14.17. Most issues in relation to H7 are also valid for NR23, particularly the adoption by the CAA of positions presented by NERL with little justification, including findings from a study commissioned by NERL that conflicted the CAA's own independent commissioned report.⁷¹
- 14.18. On NR23, we consider that the approach adopted by the CAA was light-touch. This included the lack of a proper assessment of staff costs. Failure to challenge increases to costs risks these becoming embedded, with the correction of inefficiency more difficult once the regulated business has gotten used to spending more money.
- 14.19. The regulator is also reputationally disadvantaged after imposing cuts at a subsequent phase, with reductions in opex typically associated with claims that any cuts to opex threatens safety.

⁷¹ CAA CAP2597, para 4.33

15. Passenger forecasts (Question 2.36): A defined process for sharing the model and appointing independent consultants

The disputed H7 passenger forecast, and the unavoidable significant discrepancies it has already resulted in during the first year of its application, demonstrate the need for a clearly defined process for HAL to share its unredacted model during Constructive Engagement. The CAA should commit to early intervention to resolve disagreements and consider appointing an independent consultant to produce its own model (or in conjunction with airlines and the licensee).

15.1. We agree with the CAA that, despite the introduction of traffic risk sharing mechanism, the passenger forecast is a crucial part of the price reviews as it has a significant impact on the allowances for costs.⁷²

HAL traffic forecast

15.2. As explained in paragraph 6.1, HAL’s passenger forecast was high-level and opaque throughout the H7 process, depriving users the opportunity to cross-examine robustly the drivers, assumptions and any differences to the airlines’ forecast. HAL also invoked confidentiality and intellectual property over the model. This led to the use by the CAA of a disputed passenger forecast model that defied commercial reality, leaving airlines no option but to raise it as a ground in the CMA appeal.

15.3. This unavoidably led to significant discrepancies between the CAA’s forecast and outturn passengers for 2023/the revised forecast for 2024:

	2023	2024
HAL latest pax forecast (m) – December 2023⁷³	79.1	81.4
Delta Vs Airlines’ proposal	-2% (80.4)	-1% (82.0)
Delta Vs HAL mid-scenario	+19% (66.6)	+17% (69.8)
Delta Vs CAA H7 Final Decision	+8% (73.0)	+3% (78.9)

15.4. In particular, HAL’s systematic underestimation of the passenger forecast until the very end of the H7 process, and **the subsequent significant revision shortly after the conclusion of the H7 process**, created concerns over regulatory gaming with both the airlines and the CAA.

15.5. **A truly collaborative approach** is therefore required for H8 to enhance trust and transparency in the modelling process. This will ensure that the model reflects a

⁷² Point 2.35 of CAP2618.

⁷³ <https://www.reuters.com/business/aerospace-defense/uks-heathrow-expects-over-80-mln-passengers-2024-2023-12-15/>

consensus view of future passenger demand which in turn impacts key building blocks such as investments, opex and commercial revenues.

- a. A defined process for the sharing of the unredacted HAL/CAA passenger forecast model, including all inputs and assumptions. This process must allow sufficient time for airlines to conduct a thorough analysis and scrutiny of the model.
- b. The sharing of the model should be scheduled early in the CE process to facilitate informed discussions and feedback from the airlines. The CAA may also opt to engage with HAL on the traffic forecast from the inception of the iBP as it forms part of the key cost drivers.
- c. The CAA should commit to early intervention to arbitrate or resolve disagreements between HAL and the airlines regarding the sharing of inputs and assumptions used in the passenger forecast model. This proactive approach by the CAA will help prevent delays and ensure that all parties have a clear understanding of the data underpinning the forecasts.
- d. Where necessary, the CAA should establish confidentiality ring arrangements, requiring the signing of NDAs by all parties, to protect commercially sensitive material shared during the CE process. This approach was implemented during the Q6 regulatory period and should be replicated to maintain the integrity of sensitive information. These arrangements will allow airlines to access detailed and commercially sensitive information without compromising HAL's legitimate commercial interests.

15.6. In relation to the production of the model, consideration should equally be given to:

- 1) The CAA funding and appointing a consultant to produce its own passenger forecasting model.
- 2) The joint commissioning of the passenger forecast model by the CAA, HAL, and the airlines.

15.7. Our proposals on the passenger forecast should be viewed in combination with the changes proposed to the traffic risk sharing mechanism in section 16 below to incentivise proper forecasting.

NR28

15.8. We supported the use of the STATFOR traffic forecasts for NR23 as it provides an independent source for NERL's price control. It would be appropriate that the accuracy of these forecasts, including of their different scenarios, is assessed as part of setting the NR28 price control. Without prejudicing the outcome of such assessment or future developments and alternative forecasts emerging, it would appear appropriate at this current point in time to continue the use of STATFOR.

15.9. Producing an independent Oceanic traffic forecast would be a beneficial development for NR28. The NR23 Oceanic traffic forecast was derived by NERL using STATFOR datasets and as such runs the risk of regulatory gaming. The CAA should consider the same steps proposed for addressing the Heathrow traffic forecast.

16. Strengthening the package of regulatory incentives (Questions 2.39, 2.43 and 2.52)

We advocate for a change in risk allocation through a tighter and more balanced incentive package, in order to achieve consistency between the CAA's price control and the level of risk borne by HAL, and therefore a 'fair bet'. We support the continuation and tighter implementation of the CAA's ex ante capex efficiency incentives imposed in H7, which we consider critical in delivering capital projects with positive outputs for users and consumers. We also advocate for the tightening of the incentives on service quality, changes to the Traffic Risk Sharing mechanism and the introduction of an opex gain sharing mechanism to ensure HAL behaves efficiently.

On NERL, we support the CAA in developing incentives that reflect NERL's 2+5 capex approach to incentivise improvements to efficiency. We support the continuation of the capex engagement incentive aimed at improving NERL's engagement of users on its Service and Investment Plan. Any emerging lessons on the effectiveness of service performance incentives from the Independent Review of the NATS August 2023 outage should be considered in the round for NR28.

16.1. We noted in section 12 above how empirical evidence has shown that the allowed return by the CAA for H7 is inconsistent (and higher) than the level of risk faced by HAL. We also highlighted in paragraphs 2.8-2.10 and 11.5-11.7 the excess returns and windfall profits generated by HAL over the past decade. Changes in risk allocation and the cost of capital would be needed to achieve this consistency, a balanced regulatory settlement and to ensure a 'fair bet'.

16.2. The Covid-19 pandemic led to the CAA revisiting the regulatory framework, simultaneously de-risking HAL (including Traffic Risk Sharing), whilst adding new revenue allowances for Heathrow and increasing the beta. The CAA ought to take a step back to assess risk allocation and the level of return ahead of H8, whilst strengthening the incentives on HAL to deliver high levels of service.

16.3. **We advocate for a redesign, regearing and the introduction of incentives** to reflect the asymmetry of information, ensure continued economy and efficiency by the licensees, and avoid regulatory gaming. The combined effect of those incentives should result in a system that recreates competitive pressures on the licensees' monopoly and best protects the interests of consumer.

16.4. Ahead of CE, we would propose that the CAA presents a menu of choices, indicating its view on cost of capital impacts from different risk allocation. We recommend that the CAA looks to provide WACC impacts from different risk allocations to give a

better view on the expected trade-offs from risk allocations. Presenting such options could help achieve a more optimal risk allocation.

Volume risk and Traffic Risk Sharing (Question 2.39)

16.5. The H7 and NR23 settlements included Traffic Risk Sharing (TRS) mechanisms. These are designed to protect the regulated entities from undue risk and prevent unnecessary increases to the cost of capital resulting in higher charges. These arrangements share the risk between the licensee and its customers for unexpected variations in traffic volumes.

Recalibrating the H7 TRS

16.6. We consider that HAL is likely to receive positive net returns from the TRS mechanism, both due to the way it is structured and the significant divergence between actual passengers and the traffic forecast retained for H7. Indeed outturn traffic for 2023 is close to the breaching the inner +10% bound. This is in addition to the level of risk implied by the asset beta in the WACC, which exceeds the level of risk facing Heathrow as demonstrated in section 12 of our response.

16.7. The TRS mechanism introduced for H7 included risk-sharing across all levels of outturn passenger volumes:

- a. A central band covered variations on +/- 10% of the CAA's passenger forecast. 50% of airport charges risk is passed onto users, which the CAA estimates would protect HAL from 43-45% of traffic risk on an EBITDA basis.
- b. Outside of this band, 105% of airport charges risk would be passed onto users, which the CAA estimates would protect HAL from 91-94% of traffic risk on an EBITDA basis.
- c. Adjustments to HAL's charges would be spread over 10 years (from year t+2 to year t+11), reflecting through adjustments to charges and Heathrow's RAB.

16.8. The cost of capital was reduced to reflect the TRS mechanism. The TRS was assumed to reduce traffic risk by 50%, with 50-90% of the difference between a post-pandemic HAL asset beta and a network utility asset beta (0.18-0.37) assumed to be related to traffic risk.

16.9. However, the TRS calibration leads to undue positive financial outcomes for HAL from the expected traffic. This is because of the profile of traffic.

16.10. We present an illustrative example to make this point, using the following assumptions:

- i. Let us assume that EBITDA per passenger is £1.00 and the CAA's traffic shock adjusted forecast is for 100 passengers per annum (or 500 passengers over a five-year price control).
- ii. EBITDA sharing is 44% within bounds and 94% outside of these bounds.

- iii. We assume that HAL has 105 passengers per annum for the first four years of the price control, and 80 passengers per year in one year only (total passengers are 500).
- 16.11. Under the TRS mechanism, the first four years would be within the inner bounds. Heathrow would keep 56% of the upside; equivalent to $5 \times £0.56$ each year (i.e. £2.80 annually, or £11.20 gained over four years). Conversely, HAL would only bear 6% of the downside in the final year outside the bands and 56% within it (on average, 31%). The cost borne by Heathrow is equivalent to $20 \times £0.31 = £6.20$. HAL has therefore earned £5.00 (£11.20 less £6.20) from the TRS mechanism. This is despite the fact that outturn passengers over the price control being equivalent to forecast.
- 16.12. Firstly, we would highlight that the capacity constraint facing Heathrow airport is beta reducing, in that it narrows the distribution of outcomes and profitability. The CAA has previously stated that it agrees with this position.
- 16.13. Secondly, the TRS is also beta reducing (as recognised by the CAA), yet it creates expected rewards for HAL.
- 16.14. Thirdly, there are already significant upsides in traffic for H7 due to HAL's unrealistic traffic forecast tabled during the H7 process, with the 2023 traffic already exceeding the CAA forecast by more than 8%. Under the TRS, HAL will benefit from its regulatory gaming by benefitting from 50% of this divergence. At the same time, the remainder will be returned to airlines over 10 years, with the benefit not necessarily accruing to the airlines that were subject to the over-recovery as their passenger numbers may vary over such a long period of time.
- 16.15. Options to reduce this asymmetry of outcome would be to:
- 1) Recalibrate the TRS mechanism to lead to expected revenues closer to zero, thereby producing symmetric outcomes and ensuring a fair bet. This could be through having the outer bound on upside sharing at +5% with the lower bound unchanged at -10%.⁷⁴
 - 2) Remove the asymmetric risk allowance, which creates a further positive net expected value for HAL.
 - 3) Recalibrate the TRS so that a higher proportion of upside is shared compared to the proportion shared for downsides to reflect the asymmetry of information and avoid regulatory gaming.
 - 4) Apply any positive adjustments in their totality to the charges applicable for the subsequent year, rather than over 10 years, to ensure an incentive on the regulated entity not to game the traffic forecast and accrual of the benefit to the airlines that were subject to the over-recovery.

⁷⁴ Even with our proposed change, Heathrow would still achieve the same positive net rewards in our example.

16.16. We do not propose one option as a recommendation at this stage, but these options could be worthy of consideration by the CAA and follow up with stakeholders.

NR28 TRS

16.17. On TRS, we consider that many of the above points are relevant to NERL. This includes calibration to ensure symmetry of outcomes, reductions to beta to reflect risk and the value in presenting different policy options alongside estimated cost of capital impacts.

Opex incentives (Question 2.43)

16.18. We recognise that a 100% opex cost efficiency incentive is common in utility regulation. The principle behind this is that any savings during a price control is kept by HAL, with the 'base' element of cost assessment for the subsequent period being correspondingly lower (e.g. £100 per annum savings in H7 are expected to reduce opex allowance by £100 per annum in H8).

16.19. In the case of HAL, there are four key impediments to this working as intended:

- i. Firstly, the customer base differs over time and therefore the excess allowances paid by customers in a given price control may accrue to different passengers in the next price control period. The policy therefore has more notable distributive effects than in other sectors.
- ii. Secondly, the extent to which savings get reflected in next period allowances for HAL in a single regulated company system is more limited. HAL is able to suggest that 'one-off' cost savings were made in the previous control that should not be reflected as lower allowances in the next period.
- iii. Thirdly, HAL may demonstrate regulatory gaming by proceeding to cost 'reclassifications' midway during the regulatory period, resulting in opex savings for the licensee but 'double charging' for the airlines. This is demonstrated by ongoing 2024 reclassification of Fast Track security into a revenue, with an additional cost generated through commercial revenues without a corresponding decrease in opex.
- iv. Fourthly, savings in the final year of the price control are likely to be too late to be reflected in a lower baseline in the following period.
- v. Fifthly, financeability is potentially impacted by inaccurate opex forecasts, with excess profitability or greater financial pressures from setting the wrong level of allowance.

16.20. We would therefore **propose some form of sharing factor on opex efficiencies for the next control**, with a certain percentage of the outperformance retained by HAL, whilst HAL faces 100% of any overspend. Such a calibration is more likely to obtain

symmetric outcomes, even though it uses asymmetric mechanism calibration. It is the former that matters most with respect of the cost of capital.⁷⁵

16.21. The asymmetric calibration is suitable given the weight placed on HAL's BP and the ability to influence the CAA through 'one-off' factors. For example, if HAL underspends, we consider that some of these factors would be put forward as exceptional events and the new opex baseline would not be reduced to the full extent that it should be.

16.22. The approach would allow consumers to enjoy the benefits of underspend and be fairer from an intertemporal equity basis. It also reduces the incentive for HAL to inflate cost forecasts during their BP submissions. As explained in paragraph 14.10, the licensee's estimates act as an inaccurate anchoring point for the CAA's cost assessment.

Capex incentives (Question 2.43)

H7 ex ante capital incentives

16.23. As highlighted in our responses to the CAA during the H7 process, and our positions during the H7 appeals, **we strongly support the CAA's ex ante capex efficiency incentives imposed on HAL**. These incentives were confirmed by the CMA in its H7 Final Determination and we consider them to be critical in promoting efficiency in capital spending and delivering projects.

16.24. We take note of the CAA's H7 Guidance on capital expenditure governance published in November 2023 and agree with the CAA that there continue to be opportunities to enhance the existing regime and improve how HAL engages with stakeholders on its capital expenditure to deliver more efficiently.⁷⁶ It is critical that HAL is incentivised to develop projects that have clear ambitions and delivery objectives from inception (G0/G1 gateways) and firm and measurable objectives, outcomes and benefits for users and consumers by G3.

16.25. We agree with setting delivery obligations (DOs) for each capex project agreed at G3 gateway, which HAL is held to account against, and assessing its capex delivery against evolving baselines. We continue to think that the need for agreed DOs between airlines and HAL will help address the information asymmetry and late information disclosures by HAL under the previous ex post system. This is because users will, in principle, be given sufficient detail and can meaningfully engage on the scope and benefits of a given project. Given the size and growth of HAL's RAB, it is important that only efficient capex spend can be added to the asset base and any delays or shortcomings in delivery are appropriately penalised.

16.26. Furthermore, we think that the adjustments to the RAB permitted under those incentives – where HAL bears a set share of any overspend (and benefits from a

⁷⁵ Ofwat and Ofgem have moved to totex regimes, where sharing factors apply.

⁷⁶ See [CAP2605](#).

share of any underspend) – can produce a balanced and proportionate incentive effect on HAL given the size of the RAB.

16.27. We therefore strongly support the continuation of those incentives into H8.

16.28. However, in line with our recommendations on a stronger and more proactive role by the CAA, we advocate for speedier CAA guidance, as well as intervention where needed, on issues pertaining to the implementation of the regime. While the airline community has regularly engaged HAL since the CAA's H7 Initial Proposals to deliver the roll out and implementation of the regime, including the relevant Protocol on capex incentives, we have been faced with consistent delays in the regime's implementation, including the timing of its introduction and the roll out of specific elements of the system. These have included questions such as the weightings afforded to each individual DO, the application of the regime to pre-G3 spend, the application of knife-edge assessment, requests by HAL to introduce a change control for delays in delivery, the level of risk included in the baseline schedule date, how risk should be managed post-G3, questions over "reasonable" timeframes and which sliding scale should apply. We are also concerned about potential attempts to circumvent the incentive regime by HAL passing on the risk to their supply chain for the non-achievement of the DOs, which will in turn increase the cost of projects for the consumer.

16.29. In addition, while the CAA's H7 Final Decision was published in March 2023, and the CMA did not suspend the application of the Final Decision while examining the H7 appeals, we did not receive the CAA's Final Guidance on capital expenditure governance until November 2023.⁷⁷ This Guidance set an expected entry into force for the system on 1 March 2024, a whole year after the decision.

16.30. It is therefore pivotal that the CAA monitors and intervenes against any attempts to circumvent or deviate from its policy intent on those incentives, in order to guarantee the effectiveness of the system and ensure compliance with Condition B3.1 of the Licence requiring to the licensee to secure the economical and efficient operation, maintenance and appropriate enhancement and development of the airport.

16.31. In doing so, the CAA should conduct a review of how DOs have been rolled out across projects to assess their effectiveness in guaranteeing capital efficiency and draw any improvements. For instance, we consider that benefit proof and realisation should be included in the DOs (rather than just outputs focusing on the project being delivered) and that experts should be given the ability to validate the base costs for projects.

NERL capital incentives

16.32. For NERL, the CAA has discussed moving from an ex post incentive regime to a settlement that more strongly incentivises efficiency, delivery and maximising

⁷⁷ See [CAP2605](#).

benefits accruing from capital investment. We support the objective and consider that further work should be developed in this area.

16.33. The Egis report for the CAA highlights issues with the NR23 capex plan, both for the original submission and the replan contained in the 2023 Service and Investment Plan (SIP23). The conclusions of the report highlight that the regulatory approach is not delivering on high quality information:

“The options for replanning the DP En Route programme, which contributed to the revised plan set out in SIP23, were not fully developed, costed, or evaluated. The primary method of selection was subject matter expertise and managerial judgement. NERL only developed a business case for the selected option, and only evaluated the costs, benefits, timescales, and risks of NERL’s selected option at a high-level.”⁷⁸

16.34. The CAA needs to ensure that, as a minimum, there is sufficient information to set a suitable price control settlement. During NR23, we supported the CAA’s strengthening of the capex engagement incentive for NR23 and supported the CAA’s position during NR23 for greater capex monitoring and strengthened capex delivery incentives.

16.35. During NR23, we had also argued to the CAA that the price control should appropriately reflect NERL’s newly introduced 2+5 approach to capex planning, as well as setting appropriate incentives. For NR28, the CAA ought to further consider how its assessment of NERL’s BP, including the information required of the licensee, and the incentive design factor in NERL’s approach.

16.36. Whilst the capex engagement incentive is relatively new, having been introduced in 2021, the CAA and the RP3 Independent Reviewer were able to draw key lessons and suggest improvements on its practical operation and NERL’s engagement. The incentive allows an Independent Reviewer to score NERL’s engagement on a number of areas of its annual SIP, including on user focus, optioneering, responsiveness to user feedback and corrective actions, with the possibility of a penalty in case the engagement falls below a certain score.

16.37. Trusting in the practical experience that has been gained, as well as considering the 2+5 capex planning approach adopted by NERL that heighten the requirement for quality engagement, we support the incentive’s continuation into NR28.

Service quality incentives (Question 2.39)

H7 OBR and service level bonus

16.38. Regulators use service quality incentives to ensure that companies do not forfeit the quality of consumer’s service in the search of lower costs. H7 saw a move towards Outcome Based Regulation (OBR). This conceptually has strengths, including a

⁷⁸ See [Egis report](#) for the CAA, Review of Key Capital Programmes Proposed by NERL for the NR23 period, page 3.



greater focus on those objectives that are valued by consumers, monitoring and continuous improvement.

16.39. For H7, the CAA included 36 specific measures, 20 of which would be subject to financial incentives, and 16 that would be subject to reputational incentives. Four of the most relevant measures offer a financial bonus for Heathrow.

16.40. We are nevertheless concerned that, while some targeted measures were introduced (e.g. baggage belts), the outcomes measured and the measurement techniques are currently insufficient to incentivise performance improvements.

16.41. We would expect that performance targets are tightened before service rebates would apply. We continue to support the setting of outcomes that are measurable and measurement techniques which disincentivise service quality failures (such as daily targets).

16.42. We also disagree with the principle of HAL awarding itself a bonus for maintaining service levels that are to be expected from an airport infrastructure provider, and the perverse effects this is generating. For the 2024 charges, HAL awarded itself a service level bonus of £0.11 per passenger for year 2022 (totalling almost £9 million) despite significant disruption at Heathrow after the pandemic owing to HAL's lack of resourcing of critical functions. We ask for this bonus to be removed for H8.

16.43. Moreover, we have a concern that there will be double counting of measures in H8, namely that HAL will receive opex or capex allowances to deliver improvements, which then lead to financial rewards. Targets should be weighted to improvements and have step-ups for productivity improvements in the broader economy.

16.44. As with opex, this was an area where the CAA went against the view of its technical advisers and decided to sit somewhere between those independent views of the advisers and HAL's own estimates. The CAA should rather adopt a view on what the correct answer is based on the use of the most appropriate approach in its toolkit.

16.45. Similarly, service performance measures should be linked to the delivery of capital projects and therefore change mid-period as projects are delivered to reflect the expected improvements in service. For instance, as capital is spent on facilities for customer comfort, the targets for the respective OBR measure should be adjusted. This is not currently the case for the Security Programme, Terminal 2 Baggage, any of the customer facility improvements or the airfield improvements. While much of the H7 spend has been labelled as "maintain", improvements in service levels should be reflected in the OBR targets in the mid-term review and in H8.

16.46. We invite the CAA to consider these questions in its upcoming mid-term review of the OBR framework.

NR23 performance incentives

16.47. We await the results of final report of the Independent Review into the technical issues faced by NATS in August 2023. As such, we do not go into depth on the implications for what should change. It is important to note that the adjustment of incentives in isolation can result in unintended consequences for the ongoing price control. As a result, we would advocate that any adjustments are considered in the round for NR28.

16.48. We also note that the CAA intends to conduct a wider review into how environmental performance is measured in future price controls, which we welcome as an approach. We support incentives around efficiency of flight paths, as long as these are properly calibrated. We further elaborate on our views in section 18 of our response, such as our view that the CAA should be conducting a review of the 3Di metric ahead of NR28.

17. Other Regulated Charges (Question 2.55)

We ask for the CAA to intervene in the lack of agreement with HAL on the ORC Protocol to ensure appropriate consultation, transparency and dispute resolution. The CAA should also ensure that ORC pricing respects the user pays principle and does not result in users paying twice or paying for services they do not receive.

17.1. We disagree with the CAA's proposal to wait and see the impact of changes to governance arrangements and the results of the independent review before considering further changes to the regulatory framework for Other Regulated Charges (ORCs). There have already been several issues arising in relation to ORC governance and consumer detriment being generated due to HAL's ORC pricing decisions that the regulator should be seeking to address.

ORC governance

17.2. As at March 2024, there has been no agreement on the ORC Protocol setting out the governance arrangements for these charges, which was due to be agreed between HAL and the airlines by end December 2023 under HAL's Licence. This is because of disagreements between airlines and HAL, amongst others, on affording airlines a role in future changes to the Protocol, the need for airline agreement to effect changes to airline-only ORC costs, and the need for transparency and agreement on contracts impacting the cost of the service.

ORC pricing

17.3. With regards to ORC pricing, we disagree with HAL's decision to maintain 'matched' pricing for 2024 which recovers non-airline fixed costs from both airline and non-airline at an even rate. This is to the detriment of airline users, which, in addition to their own fixed costs paid through the regulated airport charges, will have to subsidise a significant proportion of the £90 million in non-airline costs over H7. We

note the CAA's position in the H7 Final Decision that it is not appropriate for all passengers to effectively bear the costs of providing non-airline services that they do not use.⁷⁹

- 17.4. Indeed, the CAA found that there would be significant advantages in distinguishing between airlines and non-airlines in determining ORCs and that there has been "no convincing evidence" that HAL is not capable of establishing charging arrangements consistent with the principles of transparency, cost pass through and user pays.⁸⁰ We are therefore concerned that HAL's decision leads to users (and consumers) paying twice or for services they do not use, and could be running counter to the ORC pricing principles.
- 17.5. We would therefore advocate for the CAA's intervention to ensure governance arrangements that guarantee appropriate consultation, transparency and dispute resolution. The CAA should also ensure that pricing respects the user pays principle.

18. Contributing to the UK aviation sector reaching net zero (Question 2.45)

Both BA and IAG have ambitious commitments to net zero emissions by 2050.

Airport charges should be used to address environmental objectives that are related to the provision to airport infrastructure. Sustainability investments still need to demonstrate firm objectives and positive consumer outcomes, in line with the CAA's primary duty on consumers. The CAA needs to be cautious in its assessment to ensure that competing initiatives and innovation are not discouraged.

NERL has a key role to play in improving airlines' environmental performance. We have always been supportive of airspace modernisation and incentives on NERL to improve its contribution to environmental performance. We suggest several improvements, including reviewing the 3Di metric, that can further these goals and enable reduced environmental impacts generated from aviation.

- 18.1. We agree with the CAA that the existing price control frameworks provide a reasonable basis for allowing licensees to contribute towards the UK's legally binding target to reduce all greenhouse gas emissions to net zero.
- 18.2. Our parent company, International Airlines Group (IAG), is committed to improving environmental performance and was the first European airline group to commit to powering 10% of its flights with sustainable aviation fuel (SAF) by 2030. IAG was the first airline group worldwide to commit to net zero carbon emissions by, or before, 2050 and is one of the 10 global companies recognised by the UN for their ambitious carbon targets.⁸¹ We are committed to delivering best practices in sustainability

⁷⁹ See [CAP2524C](#), point 8.18.

⁸⁰ See [CAP2524C](#), points 8.18-8.19.

⁸¹ For more details about our plans in this regard, see:

<https://www.britishairways.com/content/information/about-ba/ba-better-world/planet>

programmes, processes and impacts. Creating a truly sustainable business is fundamental to our long-term growth.

- 18.3. We support ICAO's Policies on Charges for Airports and Air Navigation Services and specifically the four key charging principles of non-discrimination, cost-relatedness, transparency and consultation with users.⁸²
- 18.4. In assessing environmental projects by the licensees, the CAA ought to consider the impact that these may have on airline initiatives and whether they are in line with industry roadmaps. Any sustainability investments continue to constitute spend by the licensee recoverable from the consumer, and as such the CAA should assess its outputs on consumers, the natural incentive on the monopolist to inflate its cost base and consider the risk of greenwashing investments.

HAL

- 18.5. CAA12 provides for a secondary duty on the CAA to have regard to ensuring that the licensee can take reasonable measures to reduce, control or mitigate the adverse environmental effects of the airport, its facilities and aircraft using that airport. We understand that this objective may at times be at tension with the regulator's duty to protect consumers and ensure value for money. As noted in paragraphs 4.9-4.10, the CAA ought to balance this duty against its primary duty to protect consumers, and the other secondary duties, in a way that the primary duty is not overridden.
- 18.6. Airport charges should not be used to address broader policy objectives or environmental challenges that do not affect the local environment or that are not related to the provision of airport infrastructure.
- 18.7. HAL should therefore focus on any environmental improvements that contribute to Net Zero that can be delivered within their role as an infrastructure provider. When it comes to carbon emissions, airlines are already strongly motivated to invest in SAF, by virtue of emission trading systems, CORSIA, RefuelEU and future governmental mandates.
- 18.8. Given the developing nature of different sustainability initiatives, the CAA should be cautious in its assessment of projects proposed as part of HAL's BP to ensure they do not result in the imposition of solutions where alternative initiatives exist, and in turn, the stifling of innovation. Similarly, those investments need to demonstrate firm and measurable objectives, as well as positive outputs for users and consumers.

NERL and Airspace Modernisation (also covers Question 3.11)

- 18.9. Air Navigation Service Providers (ANSPs) play a crucial role in improving airlines' environmental performance and reducing carbon emissions. We have been highly supportive and desirous of airspace modernisation throughout the last few regulatory periods and continue to strongly advocate for its delivery. Various issues

⁸² See https://www.icao.int/publications/Documents/9082_9ed_en.pdf.

have resulted in delays and the postponement of previous plans and there is significant pent-up demand for airspace modernisation now.

- 18.10. The CAA's Airspace Modernisation Strategy (AMS), which has been recently refreshed, is intended to be complementary to other initiatives ongoing in the sector, including the independent activities of the Airspace Change Organising Group (ACOG) and enabling activities at both NERL and airports across the UK. Nevertheless, progress towards delivery of airspace modernisation has been slow and there are significant risks⁸³ to the progress that can be achieved in 2024.⁸⁴
- 18.11. There is currently a disjointed model of funding to deliver the various elements in the airspace modernisation chain, some of which appear insufficient and are generating significant risks to the delivery of airspace changes.⁸⁵ The potential introduction of an additional function, in the form of a Single Design Entity (SDE), could add further complication to the funding structure.
- 18.12. NERL's price control does not appear to currently present barriers to the delivery of the AMS or the function of ACOG directly, with NERL being afforded costs for the provision of the ACOG function⁸⁶ in satisfaction of Condition 10a of its licence.⁸⁷ However, the CAA and DfT should consider if the current model represents an efficient and proportionate system and ultimately delivers the outputs required without placing undue burden on a subsection of current or future airspace users. Given the emergence and anticipated growth of new users and unmanned services, for which an appropriate charging mechanism needs to be developed, it is important to consider the further complexity in funding arrangements that this could generate.
- 18.13. The CAA and DfT should ensure any funding structure appropriately provides sufficient resource for all elements of airspace modernisation from design, co-ordination through to implementation. We consider rather that the government has a role in funding the delivery of modernised airspace, in what is essentially a public good akin to National Highways⁸⁸.
- 18.14. TA00 places secondary duties on the CAA to promote efficiency and economy from the licensees and to take account of any guidance on environmental objectives given to it by the Secretary of State. These duties ought to be balanced against the other secondary duties, including furthering the interests of users and the licensee's financeability, in a way that the primary duty on safety is not overridden.
- 18.15. Airlines are acutely aware that current airspace design and processes do not deliver the most efficient environmental outcome and have been supportive, over many

⁸³ https://s3-eu-west-1.amazonaws.com/assets.acog.aero/wp-content/uploads/2023/05/ACOG-Annual-Report-2022_23.pdf

⁸⁴ <https://www.acog.aero/blog/2024/02/22/blog-whats-ahead-for-acog-in-2024/>

⁸⁵ Cardiff airport withdrawal, page 5, CAP 2312A Addendum
<https://www.caa.co.uk/publication/download/19890>

⁸⁶ [Para 7.34 CAP2597](#)

⁸⁷ See NERL's NR23 [licence](#)

⁸⁸ <https://nationalhighways.co.uk/about-us/how-we-work/#:~:text=We%20receive%20funding%20from%20the,the%20taxpayer%20and%20the%20country.>

years, of proposed multi-million-pound investments by NERL that should have delivered significant improvements in its technical capabilities to deliver beyond what has been achieved to date.

- 18.16. With elements of NERL's capex plan forming a critical enabler in the realisation of greater airspace modernisation, especially in lower airspace where significant environmental benefits can be achieved, the CAA should strive to incentivise the delivery of the required investment in a manner that is efficient and economical.
- 18.17. NERL's incentives should therefore be geared to reflect the potential reductions in emissions that NERL can achieve from investment. Incentives and price control allowances should take into account the impact on NERL's scope 1 and 2 emissions and the airline emissions in the UK airspace it manages.⁸⁹
- 18.18. In considering how its NERL price control contributes to the achievement of the net zero goal, the CAA should ensure that the current 3Di metric is developed from its current form in time for NR28. The metric is a positive development from the European metric for environmental performance, but its computation may require a revision for subsequent price controls to ensure it captures the latest practices in airline flight planning, airspace structure changes (including issues arising from the introduction of free route airspace). It should also reflect, among other things, airframe developments, flight control systems and weather. Maintaining the strength of incentive on 3Di for NR23 appeared appropriate given the concerns raised. However, a review of the metric and the strength of the incentive ahead of NR28 should remove these concerns.
- 18.19. We present below several operational improvements that NERL can make to achieve the goal of improved environmental performance. These can also play a role in the CAA's assessment of how to best support airspace modernisation in subsequent price controls, as mentioned in Question 3.11:
- i. **Efficient Routing:** ANSPs can optimise flight routes to minimise fuel consumption and emissions. This involves utilising advanced air traffic management technologies to plan more direct routes, taking advantage of favourable winds and altitudes, and avoiding congested airspace.
 - ii. **Continuous Descent Approaches (CDA):** Implementing CDA procedures allows aircraft to descend gradually and smoothly from cruising altitude to the runway, reducing fuel burn and emissions compared to traditional step-down approaches.
 - iii. **Continuous Climb Operations (CCO):** Similarly, CCO procedures enable aircraft to climb continuously after take-off, optimizing fuel efficiency and minimising emissions during the ascent phase.
 - iv. **Dynamic Airspace Management:** ANSPs can dynamically adjust airspace configurations and traffic flow to accommodate changing demand and optimise

⁸⁹ See NATS [GHG report](#) 2022-23.



efficiency. This may involve opening additional routes or sectors during peak traffic periods to reduce congestion and fuel burn.

- v. Collaborative Decision Making (CDM): By fostering collaboration among airlines, airports, and ANSPs, CDM initiatives enable stakeholders to share real-time information and coordinate operations more effectively, leading to reduced delays, fuel burn, and emissions.
- vi. Implementation of Performance-Based Navigation (PBN): PBN allows for more precise navigation based on satellite signals, enabling more direct flight paths and reducing fuel consumption and emissions compared to traditional ground-based navigation systems.
- vii. Air Traffic Flow Management (ATFM): ANSPs can implement ATFM measures to balance air traffic demand with available capacity, minimising delays, holding patterns, and unnecessary fuel burn caused by airborne congestion.
- viii. Investment in Next-Generation Technologies: ANSPs can invest in advanced technologies such as automation, artificial intelligence, and data analytics to optimize airspace utilisation, enhance traffic flow management, and reduce fuel consumption and emissions.

BROADER STRATEGIC ISSUES

19. Longer-term reforms to price controls

- 19.1. With respect to the broader and strategic issues raised by the CAA's consultation, we agree that these constitute longer-term questions requiring an extensive assessment by both the CAA and the DfT and **should be addressed outside the current lessons learned exercise.**
- 19.2. We have already noted our positions on sustainability, transitioning to Net Zero and airspace modernisation (Questions 3.6 and 3.11, see paragraph 18.9 *et seq.*) and on the framework for competition from new infrastructure (Question 3.9, see paragraph 11.28).
- 19.3. On the form of controls (Question 3.4), **we strongly support the CAA in continuing to use single till regulation for subsequent price controls**, where commercial revenues contribute to offset the airport's costs recoverable from users, as this closely replicates the way in which a regulated monopoly would behave had it been in competition. We note that HAL's charges, which are already the highest in the world, would rise even further absent single till, further harming consumers.
- 19.4. On expansion at Heathrow airport (Question 3.8), our long-standing position has been that any expansion in the London airport area must meet the following conditions:
 - i. **Affordability:** Expansion must be affordable for consumers, and we need to be confident in the cost of delivery.
 - ii. **Cost Transparency:** We must be able to scrutinise costs of development in an open book and transparent way.
 - iii. **Incentivised Development:** We need the right incentives for the developer to deliver expansion for the primary benefit of consumers.
 - iv. **Competition:** Expansion must result in a multi-operator environment (e.g. competition on the airport for aviation infrastructure; breaking down HAL's monopoly).
 - v. **Environment:** The programme must have the strongest of environmental credentials.
- 19.5. We believe that the issue of alleged scarcity rents (Question 3.10) is unrelated to economic regulation and any assessment should be done independently under the relevant framework(s).
- 19.6. **We advocate for longer-term reforms to ensure increased protection of airport users**, and consumers, in the future and we look forward to engaging with the CAA and the DfT further on them:



- 1) **Shifting from a capital-focused model to an operational one.**
- 2) **A regulatory framework that could extend beyond the economic regulation of airports, potentially to the economic regulation of transport.**
- 3) **Fundamentally addressing the size of the RAB at Heathrow.**
- 4) **Ensuring that the CAA is fulfilling its duty to protect consumers.**
- 5) **Enabling users to legally trigger the regulator's intervention.**



Appendix A: Historic profitability estimation

We present below the information we have used to estimate profitability. This is from Heathrow Airport Limited's regulated accounts.

The two highlighted values are those where we have made an assumption over the regulated operating profit. For the first data point, we have used an estimate consistent with the following year, as this pre-dates regulated accounts. For the final data point, we have used as estimate where approximately two-thirds of overall Heathrow profitability accrues to the regulated entity.

	Opening RAB	Closing RAB	Indexation	RAB adjustments	Reg Operating Profit	Nominal return (inc RAB adjust)	Nominal return (exc RAB adjust)	RPI inflation	CAA Real RPI WACC
31/03/2014	13816	14816	1016		710	12.49%	12.49%	7.35%	4.65%
31/12/2014	14816	14860	159		710	5.87%	5.87%	1.08%	4.65%
31/12/2015	14860	14921	178		881	7.13%	7.13%	1.21%	4.65%
31/12/2016	14921	15237	371		925	8.69%	8.69%	2.50%	4.65%
31/12/2017	15237	15786	626		964	10.44%	10.44%	4.13%	4.65%
31/12/2018	15786	16202	425		1020	9.15%	9.15%	2.69%	4.65%
31/12/2019	16202	16598	358		1073	8.83%	8.83%	2.20%	4.65%
31/12/2020	16598	16492	197	91	-582	-1.77%	-2.32%	1.22%	4.65%
31/12/2021	16492	17474	1220	338	-500	6.42%	4.37%	7.67%	4.65%
31/12/2022	17474	19182	2313		642	16.91%	16.91%	13.71%	4.65%
31/12/2023	19182	19182	997		1000	10.41%	10.41%	5.20%	3.26%
	15944	16432	715	215	622	8.60%	8.36%		4.52%

Appendix B: Expected profitability – 2023 Ferrovial transaction

The expected future profitability of Heathrow Airport can be inferred from a recent equity sale agreement under which Ferrovial agreed to sell its 25 percent stake in the airport to the Saudi Public Investment Fund and French private equity company Ardian for £2.4 billion.

The 2023 Ferrovial transaction implies that the market values Heathrow's equity at £9.48bn. This, together with Heathrow's published net debt for the year ending in December 2023,⁹⁰ implies a market-to-asset ratio (MAR) of 1.23 (put another way, Heathrow's enterprise value is at a 23% premium to its Regulated Asset Base).

Assuming 60% notional gearing, we find that the airport's equity trades at a 56% premium to its regulated equity.

We can infer the extent of Heathrow's future outperformance using a twenty-year discounted cash flow (DCF) model⁹¹. We present potential explanations for this valuation through combinations of i) cost of equity outperformance, and ii) non-cost of equity performance (e.g. traffic risk).

The 56% premium on the value of the equity necessarily implies outperformance in at least one of these measures.

- **Mixed outperformance:** if we assume a 250bps non-Cost of Equity (non-CoE) outperformance is expected, there is a 201bps outperformance on the cost of equity⁹².
- **Cost of equity outperformance only:** no non-CoE outperformance implies c.390bps outperformance on the cost of equity.
- **Non-cost of equity outperformance only:** c.520bps non-CoE outperformance is consistent with the CAA setting the appropriate WACC.

Heathrow's allowed cost of equity under H7 is 6.96% (in real RPI terms⁹³). 201bps of cost of equity outperformance would reduce the cost of equity to 4.95% in RPI terms, or likely >5.50% in real CPIH terms. We do not consider that it is credible that the H7 allowed cost of equity is insufficient. The allowed cost of equity is very likely to be set at a level in excess of the risk-adjusted return for the airport.

Figure below presents sensitivities around the asset MAR from the 2023 equity sale. The transaction clearly suggests the need for tightening of the regulatory regime to dampen windfall gains and ensure the regulatory regime is not imbalanced in the favour of Heathrow. This is needed for both for the cost of equity and other factors.

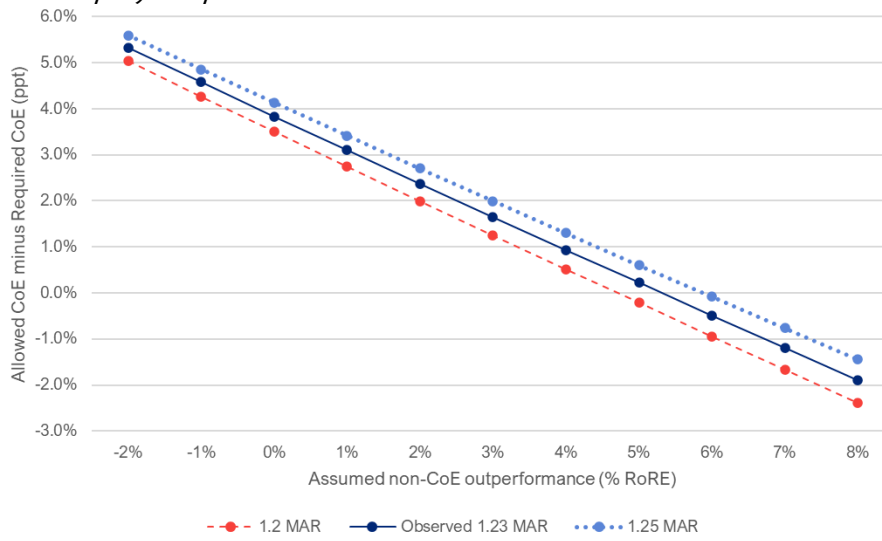
⁹⁰ [Heathrow \(SP\) Ltd, Results for the Year Ended 31 December 2023.](#)

⁹¹ With a MAR of 1.00 after 20yrs and zero real RAB growth.

⁹² Assuming a MAR close to that implied by the 2023 equity sale and a reasonable non-CoE outperformance band of 50bp around the central case (non-CoE outperformance of two to three percent RoRE), Heathrow could be expected to outperform its allowed cost of equity by between 1.3-2.7% over the next twenty years.

⁹³ [Economic regulation of Heathrow Airport Ltd: H7 Final Decision, Table 9.6](#), CAA, March 2023.

Figure 1: Cost of equity outperformance sensitivities



Appendix C: Heathrow Investment Properties – Heathrow Airport Limited Annual Report 2022

Investment properties

Investment properties are fair valued by CBRE Limited, Chartered Surveyors. The valuations are prepared in consideration of FRS 102 and in accordance with the appraisal and valuation manual issued by the Royal Institution of Chartered Surveyors. Valuations are carried out having regard to comparable market evidence relevant to each specific property or class of properties. In assessing fair value, current and potential future income (after deduction of non-recoverable outgoings) is capitalised using yields derived from market evidence. This market evidence also considers planned transactions and use of the property (for example the future expansion of Heathrow). Independent valuations are obtained for all investment properties.

Judgement is exercised in adjusting cash flows to reflect what a 'Reasonably Efficient Operator' would be able to achieve outside of the economies of scale achieved by Heathrow when operating a portfolio of car parks. These judgements are needed so that each car park can be valued on an individual basis and include judgements on the "Fair Maintainable Turnover" that would be achievable and a determination on the allocation of business rates and operating cost inefficiencies.

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Heathrow Airport Limited

Significant accounting judgements and estimates for the year ended 31 December 2022 *continued*

Car parks classified as investment property

Management have exercised judgement in order to determine the appropriate classification of the car parks as investment properties rather than property, plant and equipment. Heathrow provides insignificant ancillary services as the day-to-day operation of the car parks is outsourced to a third-party provider. The third-party provider receives a portion of fixed fee and variable fee for the use of the car parks and Heathrow does not bear the associated risks and rewards of supplying the car park services to the passengers. The revenue received by the Company in respect to the car park revenue, represents rental income for the use of the space and service provided.

Investment properties

Investment properties have been estimated to be worth £2,230 million as at 31 December 2022. To assist in assessing the valuation of our investment properties Heathrow engages a professional valuation firm, CBRE Limited, Chartered Surveyors, that is regulated by the Royal Institution of Chartered Surveyors (RICS). Valuations are carried out having regard to comparable market evidence relevant to each specific property or class of properties. In assessing fair value, current and potential future income (after deduction of non-recoverable outgoings) is capitalised using yields derived from market evidence. Independent valuations are obtained for all investment properties

Management have reviewed the main assumptions underlying the valuation of Investment properties and provide sensitivity analysis based on reasonable possible changes to relevant assumptions. The main estimations made that have a significant risk of resulting in a material adjustment to the carrying amounts of investment properties within the next financial year have been assessed as those related to Car Parks. Car parks are valued individually based on actual data on revenue in the current year and expectations of future growth rates. Sensitivities have been run to analyse the impact of a reasonable change in growth rates and a reasonable change in base year revenue informed by discussions with CBRE and internal Heathrow car park experts. Estimations are also made concerning expectations of future growth rates of operating costs including business rates. The results of the sensitivities are shown in Note 9 to the accounts.



Classification: Internal

Heathrow Airport Limited

Statement of financial position as at 31 December 2022

	Note	Year ended 31 December 2022 £m	Year ended 31 December 2021 £m
Assets			
Non-current assets			
Property, plant and equipment	6	10,380	10,654
Investment properties	7	2,230	2,297
Intangible assets	8	193	155
Retirement benefit surplus	16	-	343
Investment in subsidiary	9	42	42
Derivative financial instruments	14	777	113
Trade and other receivables	11	3,653	2,282
		17,275	15,886
Current assets			
Inventories	10	16	13
Derivative financial instruments	14	1	1
Trade and other receivables	11	598	455
Term deposits	12	1,548	2,410
Cash and cash equivalents	12	272	204
		2,435	3,083
Total assets		19,710	18,969
Liabilities			
Non-current liabilities			
Borrowings	13	(14,800)	(14,811)
Derivative financial instruments	14	(2,075)	(1,964)
Deferred income tax liabilities	15	(301)	(305)
Retirement benefit obligations	16	(126)	(30)
Provisions	17	(1)	(1)
Trade and other payables	18	(3)	(27)

Heathrow Airport Limited

Notes to the Company financial statements for the year ended 31 December 2022 *continued*

7 Investment properties

	Car park £m	Airport operations £m	Land and other £m	Total £m
Valuation				
1 January 2021	1,017	520	581	2,118
Additions	-	-	4	4
Transfers to property, plant and equipment	-	-	1	1
Fair value movements	115	9	50	174
31 December 2021	1,132	529	636	2,297
Additions	-	-	2	2
Fair value movements	(42)	(20)	(7)	(69)
31 December 2022	1,090	509	631	2,230

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Valuation				
1 January 2021	-	1,243	875	2,118
Additions	-	4	-	4
Transfers to property, plant and equipment	-	1	-	1
Fair value movements	-	110	64	174
31 December 2021	-	1,358	939	2,297
Additions	-	2	-	2
Fair value movements	-	(36)	(33)	(69)
31 December 2022	-	1,324	906	2,230

Investment property valuations are prepared in accordance with the valuation manual issued by the Royal Institution of