

Economic regulation of Heathrow Airport Limited: H7 Initial Proposals - Summary

CAP2265A



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The latest version of this document is available in electronic format at www.caa.co.uk/CAP2265A

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About this document

This consultation sets out our Initial Proposals for Heathrow Airport Limited's ("HAL") H7 price control review. It includes:

- this summary document which discusses our overall approach and the impact of the particularly challenging circumstances created by covid-19 on Heathrow airport, the price control review and these Initial Proposals.
- Section 1 which discusses¹:
 - our proposed approach to the form of regulation for HAL, including our intention to introduce traffic risk sharing arrangements and to set a 5-year price control; and
 - our projections for each of the key price control "building blocks" (including numbers of passengers, costs and commercial revenues) that have informed our Initial Proposals.
- Section 2 which sets out²:
 - our views on HAL's request for a covid-19 related RAB adjustment, the treatment of asymmetric risk, the WACC, financeability and our provisional range for the H7 price control on airport charges; and
- Section 3 which describes³:
 - our proposals for developing stronger capital efficiency incentives and implementing outcome based regulation ("OBR"); and
 - our approach to dealing with airport charges in 2022 noting the particularly difficult and challenging circumstances that have been created by the pandemic and its impact on the CAA's H7 price control timetable.
- The appendices provide further information on the main issues set out in this consultation⁴.
- We are also publishing, alongside these Initial Proposals, a number of supporting consultancy studies⁵.

¹ www.caa.co.uk/CAP2265B

² www.caa.co.uk/CAP2265C

³ www.caa.co.uk/CAP2265D

⁴ www.caa.co.uk/CAP2265E

⁵ www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Reports-by-external-consultants/

Views invited

We welcome views on all the issues raised in this document. Please e-mail responses to economicregulation@caa.co.uk by no later than:

- **Wednesday 17 November 2021** for any matters relating to airport charges for 2022 and the introduction of the holding cap discussed above; and
- **Friday 17 December 2021** for the wider issues in this consultation relating to our Initial Proposals for HAL's H7 price control and the associated incentive arrangements.

We cannot commit to take into account representations received after these dates.

We expect to publish the responses we receive on our website as soon as practicable after the period for representations expire. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

If you would like to discuss any aspect of this document, please contact Rob Toal (robert.toal@caa.co.uk).

Summary

Introduction

1. This document sets out the CAA's Initial Proposals for the price control and associated regulatory framework that should be applied to Heathrow Airport Limited ("HAL") after the present arrangements expire at the end of December 2021.
2. This price control review is being conducted in particularly challenging circumstances:
 - HAL, and the aviation sector more widely, are recovering from the extremely severe impact of the covid-19 pandemic, and the associated travel restrictions, on passenger numbers;
 - significant uncertainty remains about the future path of this recovery;
 - there are new and difficult issues to deal with such as HAL's request for a covid-19 related adjustment to its Regulated Asset Base ("RAB"); and
 - these issues have created significant pressure on the price control review timetable, which in turn has created uncertainty about the appropriate level of airport charges for 2022.
3. Setting price controls for HAL is one of the CAA's core functions under the Civil Aviation Act 2012 (CAA12). Our primary duty under CAA12 is to further the interests of users⁶ of air transport service regarding the range, availability, continuity, cost and quality of airport operation services ("AOS"). We are now consulting stakeholders on our Initial Proposals for HAL's H7 price control. This is a crucial step in our H7 price control review programme and the views of respondents will be important in helping us shape Final Proposals (due in early 2022).
4. This summary sets out our broad approach to these Initial Proposals including:
 - key considerations, context and the supporting process;
 - how we intend to deal with the high degree of uncertainty created by the impact of the covid-19 pandemic;
 - HAL's request for a further covid-19 related RAB adjustment;
 - our approach to incentivising efficient capital expenditure and service quality;

⁶ Under CAA12, our primary duty is owed to "users" of air transport services. These users are present and future passengers and cargo owners. As in previous consultations, we refer to these users as a whole using the term "consumers".

- the projections of costs, revenues, allowed returns and passenger numbers and how we have used these to identify a range of price controlled airport charges;
- our views on the way forward for dealing with airport charges in 2022 noting the very difficult and unusual circumstances that have been created by the covid-19 pandemic and the impact of these circumstances on the timetable for setting the price control; and
- the next steps for this price review programme.

Key considerations and context

5. The present circumstances create a significant challenge for the appropriate discharge of our statutory duties as the lower level of passenger numbers puts upward pressure on airport charges per passenger, even if the overall costs of operating and investment in the airport may not be higher than before or expected to increase materially in the medium term. In developing these Initial Proposals we have critically evaluated the passenger forecasts that HAL produced in its business plan and have assumed a level of passenger traffic about 7% higher than that assumed by HAL. Nonetheless, these forecasts were produced some time ago and before the recent government announcements on the lessening of travel restrictions. Therefore, the indicative range of airport charges in these Initial Proposals should be regarded as provisional.
6. We have built on the advantages of the existing regulatory framework where it is appropriate to do so, including basing these Initial Proposals around a Regulatory Asset based, five-year price control. This has twin advantages in terms of furthering the interests of consumers: it allows for a degree of smoothing of any increases in airport charges and also provides investors with a degree of certainty about the medium term and so this should support the cost effective and efficient funding of new investment.
7. As noted above there are also regulatory levers available that can help reduce volatility in airport charges and provide a degree of smoothing or mitigation of upward pressure on prices in the short-term, but it is also important that HAL can finance new investment, which requires sufficient revenues and returns to support reasonable access to debt and/or equity markets. In practice, this limits the scope we have to mitigate short-term price increases and our assessment suggests that given the assumptions we have made on forecasts of passenger numbers then it is likely that there will need to be significant increases in airport charges per passenger to support the necessary further investment to maintain a safe, secure and resilient operation of the airport.
8. Nonetheless, significant uncertainty remains about the path of the recovery and we will consider further the likely evolution of passenger numbers in the run up to our Final Proposals. This, and dealing with the other uncertainties that the pandemic has created, means that it is appropriate to base these initial proposals on a range of estimates that leads to a relatively wide and provisional range of airport charges in these Initial Proposals for the period 2022 to 2026. We will work with stakeholders over the coming months to narrow this range and establish a firm basis for Final Proposals.

9. The top of our provisional range in these Initial Proposals is airport charges of about £34.40 per passenger, which would involve a real increase in airport charges of around 60%. Increases towards the upper end of our range could cause material consumer detriment. Nonetheless, it is important to note that airport charges typically represent a relatively modest proportion of the air fares at Heathrow and so they would create a very significantly smaller percentage increase in the overall cost of travel. It is also vital for consumers that airport charges raise sufficient revenue to allow HAL to provide an appropriate level of service and finance new investment, including the capital spending necessary to keep the airport safe and secure. Given the difficulties that have been created by the impact of the covid-19 pandemic, we cannot rule out the need for such increases and, so, are consulting stakeholders on these matters.
10. The bottom of our provisional range for airport charges of about £24.50 would represent a real increase of about 15%. Increases towards the lower end of our range would create less risk of detriment for consumers through the level of charges, but would require HAL to meet stretch efficiency targets and would put greater pressure on the financeability of new investment. We also welcome further representations from stakeholders on HAL's financeability challenges and whether it is practicable to establish charging arrangements that allow for efficient financing at a lower level of airport charges.
11. We hope that recent developments with respect to international travel arrangements will allow us to revise upwards our passenger traffic forecasts for Final Proposals and reduce pressure on both the affordability of HAL's charges and its financeability. Nonetheless, this is not certain and in the event that the pandemic were to lead to significant new restrictions on air travel, we would need to consider how best to respond, including in relation to whether a five year price control settlement would represent the best way forward.
12. We also note that when we look forward to the end of the H7 period and beyond we hope that the number of passengers will have bounced back to at least the level seen historically and this will provide the opportunity to reduce airport charges to more normal levels. This should be possible because the upward pressure on prices in this period is driven primarily by lower forecast passenger numbers rather than a material and sustained increase in operating and capital costs.

Summary of our process

13. The process for setting HAL's next ("H7") price control began in 2017. Initially the focus was on how best to adapt the regulatory framework to support the expansion of Heathrow airport. This led to an interim price cap ("iH7") being put in place for the two years (2020 and 2021) following the end of the Q6 price control period (2014 to 2019), while work continued on the detail of capacity expansion.
14. HAL's Initial Business Plan ("IBP") for the H7 price control period was issued in December 2019. Shortly afterwards, HAL paused its plans for expansion in the light of the Court of Appeal's decision to set aside the Airports National Policy Statement ("NPS") and the onset of the covid-19 pandemic. As a consequence, we confirmed in April 2020 that the H7 review would focus on the "two runway"

airport, with the intention of having a new price control in place from 1 January 2022.

15. As noted below in the section on HAL's request for a covid-19 related RAB adjustment, we also considered HAL's representations that its RAB should be increased to compensate for its covid-19 related losses and we made a targeted adjustment of £300 million. We considered this adjustment appropriate to further the interests of consumers, particularly to support timely re-opening of airport capacity during this year.
16. In the light of the impact of the covid-19 pandemic, HAL also issued a revised financial forecast and accompanying narrative in July 2020 which it referred to as a building block update ("BBU"). This was intended to update the baseline set out in its IBP to reflect the pausing of expansion and its initial assessment of the impact of the covid-19 pandemic. After HAL issued the BBU, a period of Constructive Engagement ("CE") with airlines started, which ran between August 2020 and October 2020. CE is a process for engagement between HAL and its airline customers to enable them to discuss and review HAL's plans and to provide a forum for airlines to set out their preferences on issues such as charges, costs, investment and service quality.
17. Following CE, HAL issued a revised business plan ("RBP") in December 2020. HAL's RBP "base case" implied a very significant increase in airport charges compared to the iH7 price control period. HAL's base case for H7 assumed an average charge of £30 per passenger (2018 prices) compared to an average of around £22 (nominal prices) for 2020.
18. The April 2021 Way Forward Document provided an update on our overall approach to the price control review, our initial assessment of HAL's RBP, our latest thinking in key policy areas and our proposed approach to developing projections for each of the key price control building blocks.
19. HAL then provided an updated business plan ("updated RBP") at the end of June 2021. The updated RBP noted that lower levels of passenger numbers expected over the H7 period meant that airport charges would need to rise beyond the level identified in the RBP. The updated RBP included two scenarios, one implying average charges over H7 of £32 per passenger, and the other implying charges of £43 per passenger (in 2018 prices).
20. These Initial Proposals include our assessment of both the responses to the Way Forward consultation and of HAL's updated RBP.

Uncertainty and demand risk

21. We are preparing these Initial Proposals against the backdrop of an unprecedented reduction in the number of passengers travelling to both domestic and international destinations. In August 2021, passenger numbers at Heathrow airport remained 71% lower than the equivalent month in 2019. Uncertainty about the pace and strength of the recovery of passenger demand in the wake of the covid-19 pandemic remains high and this creates significant challenges for this price control review.