

Economic regulation of Heathrow Airport Limited: H7 Initial Proposals

Appendices

CAP2265E

Published by the Civil Aviation Authority, 2021

Civil Aviation Authority
Aviation House
Beehive Ring Road
Crawley
West Sussex
RH6 0YR

You can copy and use this text but please ensure you always use the most up to date version and use it in context so as not to be misleading, and credit the CAA.

First published October 2021

Enquiries regarding the content of this publication should be addressed to: robert.toal@caa.co.uk

The latest version of this document is available in electronic format at: www.caa.co.uk/CAP2265E

Contents

Contents	3
Appendix A	6
Our duties	6
Appendix B	7
Glossary	7
Appendix C	15
Notice of Proposed Licence modification to insert a new price cap from 1 January 2022 to 31 December 2022	15
Introduction	15
Representations invited	15
Reasons for the proposed modifications to the price control condition	16
Background	16
Setting an interim price control	16
The structure of the price control condition	17
The level of the maximum allowable yield	18
Requiring a new consultation on the airport charges.	19
Arrangements for capital investment	19
Reasons for, and effect of, other modifications	20
Condition A3 (Definitions): changing the definition of “Regulatory Year” and removing the definition of “Regulatory Period”	20
Condition C2 (Charges for other services) – inclusion of 2022 within the reporting requirements	21
Schedule 1 (Statement of Standards, Rebates and Bonuses) – consequential changes	21
Next Steps	21
Table C.1 –The proposed modifications, with a summary of the reasons and effects	22
New condition -	24
C1 Price Control	24
Appendix D	32

Capex efficiency incentives	32
Introduction	32
Our overall approach	32
Setting capex categories	35
Setting delivery objectives	37
Incentive rate	38
Timing incentives	39
An updated trigger mechanism for H7	39
Penalty for delayed delivery of capex categories	41
Enhanced governance arrangements	42
Appendix E	44
Q6 Capex Review	44
Introduction	44
Summary of earlier consultations	44
Update on the main projects and other related issues	46
Summary of Initial proposals	50
Next steps and implementation	50
Appendix F	51
Early expansion costs	51
Introduction	51
Background	51
Stakeholders' views	53
Our views	54
Policy on early costs and the efficiency assessment for 2018	54
Expansion costs incurred in 2018	55
Policy in relation to the recovery of early expansion costs	55
Efficiency assessment of costs incurred from 2019 to February 2020	57
Background	57
Approach to quantifying inefficiency ranges – initial proposals	61
Next steps and implementation	69
Appendix G	70
Financial resilience and ring fencing	70

Introduction	70
Background: the need for change	70
The development of these Initial Proposals	72
Stakeholders' responses	73
Our views	74
Sufficiency of resources and certification	74
Supporting information for the certificates of sufficiency of resources	76
Provision of financial market information	77
Ultimate controller obligation	77
Our Initial Proposals on financial resilience and ring fencing	78
Views invited	81
Appendix H	82
Draft assessment of proposed H7 capex incentives framework against the CAA's duties	82
Introduction	82
Rationale for intervention	84
Assessment of the proposed capex incentives framework against our duties	86

Appendix A

Our duties

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

Appendix B

Glossary

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

- Legislation and regulatory processes
- Price controls
- Stakeholders
- CAA documents
- Stakeholder documents
- Financial
- Capex-related
- Recurring terms

Legislation and regulatory processes

Acronym / term	Description
ACR2011	Airport Charges Regulations 2011
AOS	Airport Operation Services
CAA12	Civil Aviation Act 2012
CE	Constructive Engagement – a CAA-mandated process that requires the airport operator to discuss its business plan with the airlines before we need to reach a decision on the appropriate price control. For H7, CE took place between August 2020 and October 2020
CMA	The Competition and Markets Authority
CMA Provisional Findings	CMA provisional findings report in relation to the NERL RP3 regulatory appeal
Companies Act 2006	Companies Act 2006
Consumers	As defined in CAA12, consumers are passengers and cargo owners, both now and in the future
DCO	Development Consent Order
NPS	The Airports National Policy Statement published on 5 June 2018 produced by the Government under the Planning Act 2008

S factor	The security factor in the price control formula that allows a partial pass-through of costs resulting from changes to security standards
----------	---

Price controls

Acronym / term	Description
Q5	Q5 is the price control for the period from 2008 to 2013, the approach to which was subsequently extended to cover January to March 2014.
Q6 / Q6 price control	Q6 is the price control for the period from 2014 to 2018, the approach to which has subsequently been successively extended to cover 2019-2021
H7	The next price control for Heathrow, assumed to be in place from 1 January 2022 until 31 December 2026
iH7	Heathrow Interim H7 price control, running from 1 January 2020 until 31 December 2021
H8	The price control for Heathrow following H7
PR19	The five-year price control settlement for water companies in England and Wales for 2020-2024. Ofwat's decision published in December 2019 can be found here: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Overview-of-final-determinations.pdf
RP3	The NATS En Route plc (NERL) Reference Period 3 price control that was originally expected to run from 1 January 2020 to 31 December 2024
RIIO2	Ofgem RIIO2 price control, for details please see Network price controls 2021-2028 (RIIO-2) Ofgem

Stakeholders

Acronym / term	Description
AOC	Airline Operators' Committee (for Heathrow)
BA/IAG	British Airways plc/International Airlines Group (owner of British Airways)
CAA ("us"/"we")	The Civil Aviation Authority

CAA Consumer Panel	A non-statutory body established to act as a “critical friend” to the CAA. It provides expert advice to make sure that the consumer interest remains central to CAA policy development
CCB	Consumer Challenge Board. The H7 Consumer Challenge Board (CCB) was established by the CAA in partnership with HAL and the airlines that currently use Heathrow to strengthen the link between consumer outcomes and priorities and the regulation of Heathrow
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport
IATA	International Air Transport Association, a global trade association representing airlines
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport
NERL	NATS En Route plc
VAA	Virgin Atlantic Airways

CAA documents

Acronym / term	Description
FPs / Final Proposals	The CAA’s final proposals for H7, due to be published in 2022
Initial Proposals	The CAA’s initial proposals for H7 published in October 2021
The December 2016 Consultation	CAP1486 “Future of service quality regulation for Heathrow Airport Limited: Consultation on the design principles for a more outcome-based regime”, www.caa.co.uk/cap1476
The April 2017 Guidance	CAP1549 “Guidance for Heathrow Airport Limited in preparing its business plans for the H7 price control”, www.caa.co.uk/CAP1540
The April 2018 Consultation	CAP1658 “Economic regulation of capacity expansion at Heathrow: policy update and consultation”, http://www.caa.co.uk/CAP1658
The July 2019 Consultation	CAP1819 “Economic regulation of capacity expansion at Heathrow: consultation on early costs and regulatory timetable”, www.caa.co.uk/CAP1819
The Updated Business Plan Guidance	Guidance included as an Appendix in CAA publication CAP1819 “Economic regulation of capacity expansion at

	Heathrow: consultation on early costs and regulatory timetable”, www.caa.co.uk/CAP1819
The August 2019 Working Paper	CAP1832 “Economic regulation of Heathrow Airport Limited: working paper on financial resilience and ring fencing”, www.caa.co.uk/CAP1832
The December 2019 Consultation	CAP1871 “Economic regulation of Heathrow Airport Limited: policy update and consultation on early costs of capacity expansion”, www.caa.co.uk/CAP1871
The January 2020 Consultation	CAP1876 “Economic regulation of Heathrow Airport Limited: further consultation on regulatory framework and financial issues”, www.caa.co.uk/CAP1876
The April 2020 Update	CAP1914 “Economic regulation of Heathrow: programme update”, www.caa.co.uk/CAP1914
The June 2020 Consultation	CAP1940 “Economic regulation of Heathrow: policy update and consultation”, www.caa.co.uk/CAP1940
The June 2020 Business Plan Guidance	Guidance included as an Appendix in CAA publication CAP1940 “Economic regulation of Heathrow: policy update and consultation”, www.caa.co.uk/CAP1940
The August 2020 Working Paper	CAP1951 “Economic regulation of Heathrow Airport Limited: working paper on capital expenditure efficiency incentives”, http://www.caa.co.uk/CAP1951
The September 2020 Working Paper	CAP1964 “Economic regulation of Heathrow: working paper on the efficiency of HAL’s capital expenditure during Q6, September 2020”, http://www.caa.co.uk/CAP1964
The October 2020 Consultation	CAP1966 “Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment”, http://www.caa.co.uk/CAP1966
The February 2021 Consultation	CAP2098 “Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment”, http://www.caa.co.uk/CAP2098
The April 2021 Way Forward Document	CAP2139 “Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward”, http://www.caa.co.uk/CAP2139
The April 2021 RAB Adjustment Decision	CAP2140 “Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment”, http://www.caa.co.uk/CAP2140
The April 2021 Working Paper	CAP1996 “Economic regulation of Heathrow Airport Limited: working paper on Q6 capital expenditure and early expansion costs”, http://www.caa.co.uk/CAP1996

Stakeholder documents

Acronym / term	Description
ABP	Airlines' publication, Alternative Business Plan submitted in February 2021
BBU	HAL's publication, Building blocks update with a revised financial forecast submitted in July 2020
IBP	HAL's publication, Initial Business Plan submitted in December 2019 in response to the Updated Business Plan Guidance, https://www.heathrow.com/company/about-heathrow/economic-regulation/h7-update
RBP	HAL's publication, Revised Business Plan submitted in December 2020
RBP update / Updated RBP	HAL's publication, Revised Business Plan updated to take the 2021 situation into account submitted in July 2021

Financial

Acronym / term	Description
CAPM	Capital Asset Pricing Model
CPI	Consumer price index
EBITDA	Earnings before interest, taxes, depreciation and amortisation
Equity beta	Company specific estimate of risk relative to the whole market
FFO	Funds From Operations
iBoxx indices	The Markit iBoxx Corporates Indices represent investment grade fixed-income bonds issued by public or private corporations and are produced by IHS Markit. For the purpose of calculating HAL's cost of debt, we have used two of these indices corresponding to A-rated and BBB-rated bonds respectively. Both of these comprise sterling-denominated bonds of 10-year or greater maturity
IRR	Internal Rate of Return
Notional financial structure	Financial structure of the regulated company that reflects our views on the efficient balance between debt and equity finance

NPV	Net Present Value
P0	The price per passenger at the beginning of a price control
PMICR	Post Maintenance Interest Cover Ratio
RORE	Return On Regulatory Equity
RPI	Retail Price Index
TMR	Total Market Return
WACC	Weighted Average Cost of Capital

Capex-related

Acronym / term	Description
AM	Asset Management
Capex	Capital Expenditure
Category A costs	Costs which are incurred by HAL during the Airports Commission process, or before Heathrow was named as the preferred location for new runway capacity on 25 October 2016. For more information please see Appendix C to the July 2019 Consultation
Category B costs	Costs associated solely with seeking planning permission for the delivery of new runway capacity at Heathrow. For more information please see Appendix C to the July 2019 Consultation
Category C costs	Costs incurred by HAL in connection with implementation and construction of new capacity, up to entry-into operation. For more information please see Appendix C to the July 2019 Consultation
Core and development framework	The core and development framework describes the transition of capex from development capex to core capex. Core capex is capex that has been through Gateway 3 (investment decision stage) of capex governance, in line with the approach for the Q6 price control. Development capex is capex at an earlier stage of development
DIWE	Demonstrably inefficient and wasteful expenditure
Early costs	Expansion-related costs that are incurred by HAL prior to obtaining planning consent
Gateway 3 (G3)	Capex projects follow an eight phase "Gateway" process which aligns with each project's level of maturity. Project business

	cases are reviewed at key points (Gateways) throughout their life. Gateway 3 is an investment decision stage of capex governance arrangements, in line with the approach for the Q6 price control.
IFS	The Independent Fund Surveyor for Heathrow, which is jointly appointed by HAL and the airlines, with a duty of care to the CAA. The scope of the IFS role is broadly to assure that capital funds are invested efficiently to meet agreed project objectives
IPCR	Independent Planning Costs Reviewer appointed by the CAA under the Planning Costs Recovery Policy Statement
Wind-down costs	Expansion-related costs that HAL has incurred since the Court of Appeal's judgement in February 2020

Recurring terms

Acronym / term	Description
Building blocks	Price control building blocks, including passenger numbers, operating costs, capital costs and commercial revenues
CdG	Charles de Gaulle Airport
Commercial revenues	Revenues HAL derives from services to passengers, such as retail, food and beverage, <i>bureaux de change</i> , advertising, car parking and car rental, or from services to airlines, check-in desks, office rental, airline lounges and warehousing
Expansion	HAL's programme to expand Heathrow airport by the construction of a new northwest runway and associated infrastructure in accordance with the Airports National Policy Statement NPS
HBS	Hold Baggage Screening
Lower Quartile scenario	This scenario uses the lower quartile of the input range used in financial modelling. One end of the input range is HAL's updated RBP projections scaled to CAA passenger forecasts. The other end of the input range is CEPA/Taylor Airey's mid case.
OBR	Outcomes Based Regulation, the proposed service quality regulation regime for H7
Opex	Operational Expenditure

ORCs	Other Regulated Charges, which are for specified services and facilities that are collected separately from the general regulated airport charges and are, in general, levied on a “user-pays” basis.
Price Control Model	The financial model developed by the CAA to compute the revenue requirements for H7
RAB	Regulatory Asset Base
Revenue risk sharing	A mechanism that allows Heathrow to share the impact to aeronautical and non-aeronautical revenues due to the difference between outturn and forecast passenger traffic
RNS	The London Stock Exchange Regulatory News Service
Shock factor	A downward adjustment to volume forecasts to address the asymmetry of risks
SQRB	Service Quality Rebates and Bonuses, the service quality regulation regime for Q6
TRS	Traffic Risk Sharing
TTS	Track Transit System
Upper Quartile scenario	This scenario uses the upper quartile of the input range used in financial modelling. One end of the input range is HAL’s updated RBP projections scaled to CAA passenger forecasts. The other end of the input range is CEPA/Taylor Airey’s mid case.

Appendix C

Notice of Proposed Licence modification to insert a new price cap from 1 January 2022 to 31 December 2022

Introduction

- C1 This Appendix gives notice under section 22(2) of the Civil Aviation Act 2012 (“CAA12”) that the CAA proposes to modify HAL’s licence¹ (“the licence”) to:
- remove the definition of “Regulatory Period” in Condition A3 (Definitions) at Condition A3.1(f) and all subsequent references to that term throughout the licence;
 - amend the definition of “Regulatory Year” in Condition A3 (Definitions) at Condition A3.1(g) to remove references to specific years so that it refers only to the twelve-month period from 1 January to 31 December in any year;
 - replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes a price cap for the Regulatory Year 2022;
 - include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6; and
 - modify paragraph 4 in Schedule 1 to the licence (Statement of Standards, Rebates and Bonuses) to ensure that rebates and bonuses can continue to be accrued in relation to performance against the targets set in Tables 1a to 10 in that Schedule.
- C2 A draft of the proposed modifications is set out in Table C1 below.

Representations invited

- C3 We welcome representations on any of the modifications proposed in this notice. Please e-mail responses to economicregulation@caa.co.uk by no later than 17 November 2021. We cannot commit to take into account representations received after this date.
- C4 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 CAA12 and the Freedom of Information Act 2000.

¹ The licence granted to Heathrow Airport Limited by the CAA under section 15 of the CAA12 on 13 February 2014.

- C5 If you would like to discuss any aspect of this document, please contact Rob Toal (robert.toal@caa.co.uk).

Reasons for the proposed modifications to the price control condition

Background

- C6 HAL's current price control ends on 31 December 2021. For the reasons set out in Chapter 15 of this Initial Proposals consultation, the final decision on licence modifications for a new five year control period for H7 will not be made until early in 2022. As a result, without further action by the CAA, no price control will apply to the airport charges levied by HAL from 1 January 2022 until the licence modifications to implement the H7 price control have effect. We currently expect that those modifications will not have effect until the summer of 2022.
- C7 The absence of a price cap in the intervening period would create very significant risks of consumers being exposed to charges that would be unduly high in 2022 and could also create or exacerbate a conflict between the interests of “present consumers” travelling during the first part of 2022 and “future consumers” travelling later in the H7 period. Present consumers could experience materially higher charges while future consumers somewhat lower charges because of the impact of any “truing up” arrangements.
- C8 Chapter 15 of this Initial Proposals consultation sets out the details of our engagement with HAL and the airlines on this issue since our April 2021 Way Forward Document and their views on it. We have been encouraging HAL and the airlines to see if they could agree the level of a “holding cap” which would be trued up with the CAA’s final decision. HAL and airlines have said that they support the approach of introducing a holding cap, but they have not been able to reach agreement on the level at which such a cap should be set and how it should be implemented.
- C9 At the end of August 2021, HAL issued its consultation on airport charges for 2022, which it considered was in accordance with the requirements of the ACR2011. HAL's consultation assumes a yield of £37.60 per passenger (nominal prices) which it derived from the assumptions included in its updated RBP.
- C10 The ACR2011 provides limited, largely procedural, protection to consumers. It does so indirectly through the requirements on airports to consult on the level of charges they intend to set in advance. In normal circumstances, the ACR2011 requires HAL to consult airlines at least four months before changing charge levels and to notify airlines of its decision on charges at least two months before the change takes effect. Nonetheless, there is some flexibility within the ACR2011 that allows for shorter periods of consultation and notice in exceptional circumstances.

Setting an interim price control

- C11 The reasons why action by the CAA is needed to set an interim price control are set out in detail in Chapter 15 of the Initial Proposals. Those reasons apply to, and form part of this notice. In summary, we:

- consider that the absence of a holding cap exposes consumers to the risks identified in paragraph C.7 above;
- do not consider that the provisions in the ACR2011 provide an adequate level of protection for consumers because the focus of the ACR2011 is on transparency and consultation processes rather than the level of airport charges;
- take the view that the competitive dynamics of the airline market suggest airlines will seek to pass increases in airport charges directly to consumers in the form of higher airfares;
- are concerned that higher airport charges in 2022 could artificially restrict airlines' ability to support the recovery in services, which would also disadvantage consumers and limit the demand for AOS; and
- consider that the interests of consumers will be served by having clarity on the level of airport charges at Heathrow in 2022 as soon as possible.

C12 Therefore, we consider that action by the CAA may be needed to put in place a licence condition to prevent HAL unduly increasing prices for 2022 to the detriment of consumers overall and to manage the conflict between the interests of present and future users of Heathrow airport. Given the importance of charges in 2022 to consumers discussed in Chapter 15, any such licence modification would need to

- set the holding cap; and
- be accompanied by a provision that compelled HAL to price to the level of the holding cap in 2022 and consult under the ACR2011 to that effect.

C13 If the modifications were not to do this, HAL might seek to leave in effect any charging arrangements it had put in place following its consultation on its charging proposals in August 2021 and rely on the operation of the truing up of charges and/or the correction factor mechanism with the price control licence condition to address the difference. If HAL took this approach, the benefits to consumers of addressing the issues set out in paragraph C7 and C11 above would not be realised.

The structure of the price control condition

C14 The licence modification proposed by this notice would remove the current price control condition in its entirety (save for relevant definitions in Condition C1.16, which shall be restated as Condition C1.4) and replace it with the new condition setting a single price cap.

C15 The proposed condition does not include any adjustment arrangements for corrections for any over recovery against the maximum yield in 2020, or bonuses under the SQRB scheme in Schedule 1 of the Licence. We will replace these adjustment factors into Condition C1 (Price Control) and will take these factors into account in the truing up of the holding cap against the price control we put in place following our Final Decision for H7.

C16 The proposed condition also does not include the adjustment factors for additional security measures, the transition of capital projects from

“development” to “core” status, capital project tiggers, business rate revaluations or expansion. These are generally adjustments to the price control in the year after the expenditure is incurred and, as we are intending to reinstate most of them in the H7 settlement,² it is not necessary to include them here.

- C17 Given our preference and that of stakeholders for a five year price control period for H7, the holding cap will be trued up against the price control we put in place following our Final Decision for H7, as discussed in Chapter 15. Our current view is that the Final Decision would simply remove the holding cap from HAL’s licence and the correction factor in the price control would automatically adjust revenue in the later years of the price control for any under or over recovery of revenue against the level specified for 2022 in our Final Decision.
- C18 We are proposing this approach to provide a simple price control for a short period until the modifications to implement the H7 price control come into effect. We consider that this approach will provide clarity for HAL and the airlines on airport charges in 2022 but, through the truing up of the holding cap against the price control we put in place following our Final Decision for H7, will allow for the current uncertainty over the level of the cap to be corrected through the H7 settlement. This will ensure that present consumers are protected in 2022 and future consumers through the operation of the H7 price control. As such, this approach will manage the conflict between the interests of present and future consumers in the manner we think furthers the interests of each of them best.

The level of the maximum allowable yield

- C19 As discussed in Chapter 15, there is a significant difference between HAL and airlines on what they consider the appropriate level of the cap in 2022 should be. HAL’s analysis, driven by its financeability concerns, implies a price of £37.6 (nominal prices). Airlines have said they want “flat or falling” charges and have suggested no increase in real terms from 2021 levels.
- C20 Our detailed analysis of the appropriate range for HAL’s H7 price control for the notional company, which should further the interests of consumers and has been developed having regard to our duties under CAA12 as a whole, is set out in Chapter 11. Chapter 15 discusses the uncertainty that remains about the appropriate level of charges for the H7 period and the overall range for charges set out in our Initial Proposals. On balance, for the reasons set out in Chapter 15, we consider that the middle of the range for the cap on airport charges of £24.50 - £34.40 per passenger would both further the interests of consumers and have appropriate regard to supporting the financeability of the notional company in 2022. On this basis, the holding price cap proposed by this notice is based on the mid-point of this range which we have rounded to £29.50 per passenger.
- C21 As Chapter 15 makes clear, this figure is based on analysis for our Initial Proposals, our calculation of the building blocks and the precise estimates that we select within them are all subject to further comments from stakeholders and analysis by us as we prepare our Final Proposals. Other variables and assumptions might also change. As a result, the proposal for the level of the

² As discussed in relevant Chapters in this Initial Proposals consultation.

holding cap cannot, and should not, be interpreted as indicating that the CAA would necessarily take the view that the mid-point of the range is the appropriate price cap for the full H7 period when we come to make the Final Decision on the H7 price control.

Requiring a new consultation on the airport charges.

- C22 Our expectation is that HAL's decision on its current ACR2011 consultation should account fully for the CAA's proposals for a price cap for 2022.
- C23 Nonetheless, we are also proposing to include an obligation on HAL to carry out a new consultation on its airport charges under the ACR2011 within one month of the modifications set out in this notice taking effect, if it has already made a decision under the ACR2011 based on a higher maximum yield per passenger. We consider that this condition is necessary to protect consumers from higher prices in 2022 as otherwise HAL may decide to continue with its original decision and rely on the correction factor, once it has been re-inserted into the price control in the H7 settlement, to repay any 2022 over recovery in later years. As discussed in paragraph C13 above, unless addressed, this could negate the effect of the modifications set out in this notice to manage the conflict between the interests of present and future consumers in the manner we think furthers the interests of each of them best. Furthermore, including this additional condition in the licence should provide airlines with greater clarity on the level of charges in the first part of 2022, which should allow them to plan how this is passed through ticket prices more consistently across the year.

Arrangements for capital investment

- C24 Although we are not proposing to include the adjustment factors for capital investment, we are proposing to retain the existing capital governance arrangements and triggers, so that discussions on these important elements can continue as normal. As compliance with these arrangements will not be an element of the formulae for the price control, to effect this, we are proposing to include a requirement on HAL to maintain the existing capital governance arrangements and capital investment triggers handbook. The proposed simple licence condition will achieve this.

Summary

- C25 For the reasons set out above and in Chapter 15, we consider that:
- action is needed in relation to the charges that HAL sets for 2022;
 - the proposals set out in this notice will further the interests of present and future consumers regarding the cost of AOS provided at Heathrow airport during 2022 by preventing HAL from unduly increasing prices for 2022;
 - these proposals will not make it unduly difficult for the notional company to finance its activities at Heathrow airport and will support it in meeting the demands of consumers at Heathrow in 2022; and
 - putting in place the modifications to HAL's licence set out in this notice is appropriate in the context of the principles set out in section 1(4) CAA12 because

- (i) it is more transparent than relying on commitments by HAL in relation to its charges;
- (ii) it is consistent with both the CAA's ongoing approach to the economic regulation of HAL and the Initial Proposals;
- (iii) setting prices at the mid-point of the range calculated for Initial Proposals, but with HAL's revenues to be trued up after the final H7 price control is set, represents a proportionate means of addressing these issues while still furthering the interests of consumers in the manner discussed above; and
- (iv) the use of a licence modification ensures that any decision we make to implement these modifications will be accountable through the appeal processes stipulated in CAA12.

Reasons for, and effect of, other modifications

Condition A3 (Definitions): changing the definition of “Regulatory Year” and removing the definition of “Regulatory Period”

- C26 We are proposing to change the definition of Regulatory Year in Condition A3 (Definitions) to remove the references to specific years, so the definition will simply specify the start and end dates of a Regulatory Year. This is because some of the licence conditions which use the term should not be time limited but should continue to have effect from one control period to the next, unless modified either under section 22 CAA12 or under provisions of the licence. Making this change will achieve this.³ Where a specific licence condition needs to be time limited, this will be made clear in the condition itself.
- C27 In addition to this change, we propose making some consequential changes throughout the licence to change references to “each” and/or “subsequent [number]” Regulatory Years to “any” Regulatory Year. In Condition C2 (Charges for other services) we are also proposing to change references to a “year” to refer to a “Regulatory Year”. These changes will provide clarity to the licence but will have no effect on the obligations themselves.
- C28 We are also proposing to remove the definition of “Regulatory Period” from Condition A3 (Definitions) and delete all uses of the term throughout the licence. This term was required for the unique period from 1 April 2014 to 31 December 2014 when HAL changed its financial and reporting year to mirror the calendar year. As this term is now redundant, it is good practice to remove it from the licence. This change will remove redundant terms from the Licence and have no effect on HAL's ongoing obligations in the licence.

³ Relevant conditions are (C2 Charges for other services, C4 Cargo, E1 Regulatory accounting requirements, E2 Financial Resilience and Schedule 1, Statement of Standards, Rebates and Bonuses)

Condition C2 (Charges for other services) – inclusion of 2022 within the reporting requirements

- C29 We are proposing to include the year 2022 with the reporting requirements for these “Other Regulated Charges” or (“ORCs”). In the Q6 settlement, we included a forecast for ORCs and required HAL to report on the reasons for any differences between actual revenues and those included in the forecast. We did not include forecasts for the extended years of the price control period (2019 to 2021), but instead required HAL to report on differences between actual revenues in each year with actual revenues in the previous year. HAL has committed to continue with this practice in 2022 but we propose to make this change for clarity and completeness. This effect of this modification will, therefore, be to ensure the current arrangements continue uninterrupted within the licence framework.

Schedule 1 (Statement of Standards, Rebates and Bonuses) – consequential changes

- C30 We are proposing to make some consequential changes to the Bonus term in paragraph 4 of the Schedule 1 to the licence (Statement of Standards, Rebates and Bonuses) to remove cross references to Condition C1 (Price Control) and to modify Table 9 to remove information relating to past years and insert information relating to 2022. This is because the new Condition C1 (Price Control) does not use the bonus factor. We intend to replace the relevant terms and tables in the H7 licence modifications later in 2022 so that the bonus arrangements will remain in place for the whole of H7.
- C31 We also propose to ensure that bonuses can be earned in 2022 under Schedule 1 for recovery in 2024, in line with the current arrangements. Bonuses accrued in years up to and including 2021 shall be dealt with in truing up the price control for 2022 in line with our Final Decision for H7.
- C32 Redundant terms relating to the early years of Q6 will also be deleted to avoid confusion.

Next Steps

- C33 Following the end of this consultation, we aim to make our final decision in late November or early December. Subject to any appeals and associated decision by the CMA to suspend the modification, the licence modification would take effect in the middle of January 2022 but be applicable to charges levied by HAL from 1 January 2022.

Table C.1 –The proposed modifications, with a summary of the reasons and effects

Relevant Condition	Summary of the Modification	Details of changes to the condition	Summary of the reasons and effects
A3.1(f) and C2.5, C4.1, E1.3, E1.5(a)&(b), E2.2, E3.5, Schedule 1: 2.1(e),(f) &(j), 2.28(a)&(b), 3.2, 3.4, 3.4(a)&(b), 3.5, 3.7, 3.11, 3.13, 3.15, 4.2, 4.4, 4.5, 5.2(b) 6.2, 6.3(c).	Delete the definition of Regulatory Period and replace with “NOT USED” and all delete all references to the term throughout the licence in text and formulae.	~~(the Regulatory Period means the period of nine months between 1 April 2014 and 31 December 2014 and this period shall also be considered to be the Licensee’s financial year for the purposes of this Licence~~ (f) NOT USED	This term was used for 2014 only, when HAL changed its reporting year from 1 April to 31 March to be from 1 January to 31 December and the term is now redundant. This modification has no effect other than removing a redundant term from the licence.
A3.1(g) and C2.1, C2.2, C2.3, C3.7, C4.1, E1.3, E3.1, Schedule 1: 2.4, 3.4(a), 3.5, 3.11, 6.6.	Modify the definition of Regulatory Year, Change references to “each” and/or “subsequent [number]” Regulatory Years to “any” Regulatory Year.	(g) the Regulatory Year means ~~for each of the seven years from 2015 to 2021,~~ the twelve month period beginning on 1 January and ending on 31 December. ~~These years shall also be considered to be the Licensee’s financial year for the purposes of this Licence.~~	The current definition means that all conditions using this term only have effect during the calendar years specified. However, only the Condition C1 (Price Control) should be time limited, while other conditions should continue to have effect unless changed under

			the modification process set out in section 22 CAA12. Where references to specific calendar years are needed, these should be included in the relevant condition. The reference to HAL's financial year is unnecessary as the Financial conditions (Part E) all refer to the Regulatory Years. <u>Effect</u> – Conditions that use the term "Regulatory Year" will no longer be time-limited, unless references to calendar years are specified within that condition.
--	--	--	--

C1	Delete the whole of the current Condition C1 Price Control and replace with new Conditions C1.1 and C1.2.	New condition - C1 Price Control C1.1 When the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022, it shall fix those charges at the levels best calculated to secure that, in that Regulatory Year, the total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the maximum revenue yield per passenger, which shall be £29.50 (2020 prices, CPI-real).	This condition is needed to implement a “holding” price control for 2022 and is being implemented for the reasons set out in the Notice above and in Chapter 15. Its effect will be to set the maximum yield per passenger that HAL can recover for 2022 at £29.50.
		C1.2 If the Licensee has fixed the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022 at levels that exceed the maximum yield per passenger set out in Condition C1.1, the Licensee shall, within 1 month of Condition C1 Price Control coming into effect in relation to the Regulatory Year 2022, consult airlines under the Airport Charges Regulations 2011 (2011 No. 2491) to reset its prices to a level calculated to secure compliance with Condition C1.1.	Given that, by the time this condition would be implemented, HAL has already undertaken a consultation on the level of its charges in 2022, this condition is being proposed in order to ensure that the charges that HAL applies in the year 2022 are designed to meet the maximum yield per passenger set out in the proposed modified Condition C1.1 so that consumers throughout 2022 can benefit from the price control set in that condition and to

			support the furthering of the interests of consumers in the manner described in Chapter 15 and in this notice above. Its effect will be to require HAL to undertake a fresh consultation on charges for 2022 to achieve this.
C1	Insert a new Condition C1.3 to require HAL to maintain the existing capex governance arrangements.	C1.3 The Licensee shall maintain the governance arrangements and the Q6 Capital Investments Triggers Handbook in relation it is core capex projects and development capex projects.	We propose to retain the existing capital governance arrangements and triggers for the early months of 2022, so that discussions on these important elements can continue as normal. We are, therefore, proposing to include a requirement on HAL to maintain the existing capital governance arrangements and capital investment triggers handbook. The proposed simple licence condition will achieve this.

C1	Retain relevant existing definitions from Condition C1.16 and restate them as Condition C1.4.	Definitions C.1.4 In this Condition C.1: (a) core capex project is any project that has passed Gateway 3, being taken forward for implementation in accordance with the governance arrangements; (b) development capex project is any project under development that has not passed Gateway 3 in accordance with the governance arrangements, but for which an allowance has been included in the development capex allowance; (c) Gateway 3 has the meaning set out in the governance arrangements; (d) the governance arrangements means the arrangements set out in the Q6 Capital Efficiency Handbook published by the Licensee by 1 October 2014 as agreed by the CAA, and updated in April 2015; (e) passenger using the Airport means a terminal passenger joining or leaving an aircraft at the Airport. A passenger who changes from one aircraft to another, carrying the same flight number is treated as a terminal passenger, as is an interlining passenger; (f) the Q6 Capital Investment Triggers Handbook means the handbook in existence when this Licence comes into force, having been agreed by the Licensee and the airlines. This handbook contains details of the triggers, milestone months and monthly trigger payments for core capex projects and details of how future changes to those elements can be made with the agreement of the Licensee and the airlines; and (g) relevant air transport services means air transport services carrying passengers that join or leave an aircraft at the Airport,	These definitions are required to support the operation of Conditions C1.1 to C1.3 above and are restated from condition C1.16 in the licence in the form it is in as at 1 October 2021. Insertion of this condition therefore supports the effective operation of those conditions.
----	---	--	---

		including air transport services operated for the purpose of business or general aviation.	
C2	In Condition C2.5 and C2.6, remove references to “2019, 2020 and 2021” and replace with “2022”	C2.5 Where in respect of any relevant ~~Regulatory Period or~~ Regulatory Year (apart from the ~~2019, 2020 and 2021~~ Regulatory Years ~~2022~~) actual revenue for any of the Specified Facilities differs from that forecast for the purposes of the price control review for the period 1 April 2014 to 31 December 2018 (as specified by the CAA), the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences. C2.6 Where in respect of the ~~2019, 2020 and 2021~~ Regulatory Year ~~2022~~s actual revenue from any of the Specified Facilities differs from actual revenue in the preceding Regulatory Year, the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences.	This change is needed so that these provisions can apply to 2022: the proposed changes will have this effect.
Schedule 1 Statement of Standards, Rebates and Bonuses.	modify paras 4.1, 4.2, 4.3, 4.4, 4.5 and 4.6. (Bonuses)	(a) Payment 4.1 The Licensee may recover bonuses from Relevant Parties. Bonus payments shall be included in the calculation of the ~~Airport Charges~~ maximum revenue yield per passenger in respect of relevant air transport services in ~~Condition C1~~ Relevant Year 2024. 4(b) Calculation 4.2 B~~2022~~, the bonus factor ~~as specified in Condition C1~~, is based on performance achieved in respect of specified elements ~~k~~ in the relevant ~~Regulatory Period or~~ Regulatory Year ~~2022~~ as set out in Table 8 of this Schedule.	Schedule 1 paragraph 4 has terms and formulae which link to the formulae in the deleted C1 price control and which are not relevant to the new C1 price control. These modifications remove the link to formulae in Condition C1 but retains ability for HAL to accrue bonuses in 2022

		4.3 ~~For the purposes of calculating M_t as specified in Condition C1, the corresponding periods for which bonuses are recoverable by the Licensee to be included in the calculation of M_t are set out in Table 9 of this Schedule.~~ 4.4 ~~Not used. For the purposes of calculating M_t for the Regulatory Period, $B_{t-2} = B_{2012/13}$ is set to zero; for the purposes of calculating M_t for the Regulatory Year t starting on 1 January 2015, $B_{t-2} = B_{2013/14}$ is set to zero. This is because bonuses earned in 2012/13 and 2013/14 should have been recovered through the K factor as specified in Condition C1.~~ 4.5 ~~Not used. B_t for the Regulatory Period, i.e. B_{2014}, shall be calculated as follows:~~ <del> $B_t = \sum_{j=\text{April}}^{j=\text{December}} \sum_k \text{Max} \left[0, \text{Min} \left[\text{BNS}(T2)_{kj}, \text{BNS}(T3)_{kj}, \text{BNS}(T4)_{kj}, \text{BNS}(T5)_{kj} \right] \right]$ </del> ~~For each month j and specified element k;~~ <del> $\text{BNS}(T2)_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(T2)_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$ $\text{BNS}(T3)_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(T3)_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$ $\text{BNS}(T4)_{kj} = \frac{1}{9} \times \text{MB}_k \frac{\text{Min}[\text{UPL}_k, \text{MP}(T4)_{kj}] - \text{LPL}_k}{\text{UPL}_k - \text{LPL}_k}$ </del>	to be recovered later in the H7 price control. Redundant terms relating to the early years of Q6 are also deleted to avoid confusion.
--	--	---	--

		$BNS(T5)_{kj} = \frac{1}{9} \times MB_k \frac{\text{Min}[UPL_k, MP(T5)_{kj}] - LPL_k}{UPL_k - LPL_k}$ where: ~~MB_k, LPL_k and UPL_k are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and~~ ~~$MP(T2)_{kj}$, $MP(T3)_{kj}$, $MP(T4)_{kj}$ and $MP(T5)_{kj}$ are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.~~ 4.6 $B_{\pounds 2022}$ for ~~any subsequent relevant the~~ Regulatory Year ~~2022~~ $\pounds$ shall be calculated as follows: $B_{\pounds 2022} = \sum_{j=\text{January}}^{j=\text{December}} \sum_k \text{Max} \left[0, \text{Min} [BNS(T2)_{kj}, BNS(T3)_{kj}, BNS(T4)_{kj}, BNS(T5)_{kj}] \right]$ For each month j and specified element k; $BNS(T2)_{kj} = \frac{1}{12} \times MB_k \frac{\text{Min}[UPL_k, MP(T1)_{kj}] - LPL_k}{UPL_k - LPL_k}$ $BNS(T3)_{kj} = \frac{1}{12} \times MB_k \frac{\text{Min}[UPL_k, MP(T1)_{kj}] - LPL_k}{UPL_k - LPL_k}$ $BNS(T4)_{kj} = \frac{1}{12} \times MB_k \frac{\text{Min}[UPL_k, MP(T4)_{kj}] - LPL_k}{UPL_k - LPL_k}$ $BNS(T5)_{kj} = \frac{1}{12} \times MB_k \frac{\text{Min}[UPL_k, MP(T4)_{kj}] - LPL_k}{UPL_k - LPL_k}$ where:	
--	--	---	--