

Economic regulation of Heathrow Airport Limited: Notice of licence modifications

CAP2305

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About this document

This document gives notice under section 22(6) of the Civil Aviation Act 2012 of the CAA's decision to modify the Licence granted to Heathrow Airport Limited under section 15 CAA12 on 13 February 2014. The modifications that the CAA has decided to make are to:

- replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes a "holding price cap" for the Regulatory Year 2022;
- 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;
- 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; and
- include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6.

The decision on these licence modifications follows on from the Notice issued by the CAA under section 22(2) of CAA12 in October 2021 as part of the October 2021 Initial Proposals for the H7 price control.¹

The licence modifications will take effect on 2 February 2022.

If you would like to discuss any aspect of this document, please contact Abigail Grenfell (abigail.grenfell@caa.co.uk).

¹ For references to where these materials can be found, see page 6.

Summary

Introduction

1. This document gives notice under section 22(6) of the Civil Aviation Act 2012 (“CAA12”) that the CAA has decided to modify the licence granted to Heathrow Airport Limited (“HAL”) under section 15 CAA12 (“the Licence”).² The modifications that the CAA has decided to make are to:
 - replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes the “holding price cap” for the Regulatory Year 2022;³
 - 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;
 - 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; and
 - include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6.
2. The modifications are specified in Appendix B. The licence modifications will take effect on 2 February 2022.
3. The CAA has made the decision to make these licence modifications after considering the responses we received from stakeholders to the notice issued by the CAA under section 22(2) of CAA12 in October 2021 (“the October 2021 Notice”).^{4, 5}

² Licence granted to HAL on 13 February 2014 under section 15(5) CAA12 at www.caa.co.uk/HAL_licence.

³ In this Notice, we refer to the “interim” or “holding” price control to apply to HAL in the first part of 2022 which will be replaced by the full price control for the “H7” period (2022 to 2026) as the “holding price cap”.

⁴ The October 2021 Notice was published alongside, and as part of, our Initial Proposals for the H7 price control to apply to HAL for the period 2022 to 2026. See: Economic regulation of Heathrow Airport Limited: H7 Initial Proposals October 2021 (CAP2265) www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Consultations-and-policy-documents. (“the October 2021 Initial Proposals”).

⁵ Appendix C of the October 2021 Initial Proposals set out the October 2021 Notice as a notice under section 22(2) CAA12 proposing licence modifications to set a holding price cap for HAL for 2022, see: www.caa.co.uk/CAP2265E. Reasons for the proposals contained in the October 2021 Notice were set out at chapter 15 of the October 2021 Initial Proposals, see: www.caa.co.uk/CAP2265D.

Background

4. HAL's current price control ends on 31 December 2021. In the October 2021 Initial Proposals, we noted that the final decision on the licence modifications to put in place a new five year control period for H7 will not be made until summer 2022. In this context, it is important for us to protect the interests of consumers by setting a holding price cap for 2022. This is needed even though we intend to true-up (or true-down) the charges in the early part of 2022 to the level of the price control for the full H7 period that we intend to put in place during 2022. If we were not to do this, prices might be too high in 2022 and this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period.
5. To deal with these issues, we consulted on a holding price cap of £29.50 (in 2020 prices) in the October 2021 Initial Proposals and received responses from a range of stakeholders including HAL, airlines, airline representatives and others. HAL and airlines made a wide range of comments, which included important representations on the overall level of the holding price cap:
 - HAL said that we had made errors in our approach (including that the allowances we had made for its operating costs were too low and estimates of its commercial revenues too high) and that the holding price cap should be significantly higher. It also said we had not properly considered its financeability; and
 - airlines and their representatives said that airport charges at Heathrow were already the highest in the world and that we had also made errors in our approach (including that we had under-estimated the number of passengers likely to use Heathrow airport over the period of the H7 price control and that the allowances we made for operating costs were too high and estimates of HAL's commercial revenues were too low). Airlines said that these issues meant that the holding price cap should be significantly lower.

Our assessment

6. We have reviewed the additional information provided by HAL and airlines and consider that:
 - in the light of the developments associated with the Omicron variant of covid-19,⁶ it would be premature at this time to adopt the significantly higher forecasts of passenger numbers put forward by airlines;

⁶ We refer to this as "Omicron" in the remainder of this Notice.

- in relation to the forecasts of operating costs and commercial revenues, we remain of the view that, at this stage of our process (when HAL has not had the opportunity to respond to the detail of our consultants' work),⁷ it is appropriate to take account of the evidence provided by both the information in HAL's business plan and the work of our consultants in making projections of operating costs and commercial revenues; and
- we note HAL's concerns about its financeability, but observe (i) that credit markets and credit rating agencies did not react adversely to our consultations in October 2021 on the Initial Proposals and holding price cap, and (ii) the increasingly strong outlook in our forecasts of HAL's key credit metrics over the H7 period.

7. We have also noted the likely pressures on the affordability of air travel for consumers in 2022, including in relation requirements for covid-19 testing and also reflected on airline suggestions that we should give more weight to the detriment to consumers caused by the relatively high level of airport charges at Heathrow.

8. There would undoubtedly be benefits to passengers in seeing lower airport charges as we expect that this would be reflected in lower fares and through airlines having an extra incentive to bring back additional services in 2022. Nonetheless:

- these benefits would be limited, as we have committed to a true-up (or true-down) of 2022 revenues against the main H7 price control, so a lower cap in the first part of 2022 would mean higher charges in the future;
- while we are confident that a £29.50 holding price cap for HAL would be consistent with efficient financing for HAL, we would have less confidence with respect to financeability if we were to set the holding price cap at a significantly lower level and, in particular, the £19.39 suggested by airlines;
- we also note that, in adopting our proposed holding price cap of £29.50 (in 2020 prices), we have already ensured that consumers already benefit from the profiling of charges in 2022. Had we not done this, taking 2022 in isolation, the unprofiled range for charges was £38.44 to £51.02 (CPI-real 2020 prices) with a mid-point of £44.73, compared to the holding price cap we proposed for 2022 that benefitted from smoothing of £29.50; and
- a substantial change to our proposals for the holding price cap would trigger the need for additional consultation to support the associated licence modifications and lead to a greater period of time at the start of 2022 when HAL would not have a price control condition in place restricting the amount it could charge airlines.

9. Bearing the above in mind as well as the advantages of retaining the assumptions in the October 2021 Initial Proposals on passenger forecasts, operating expenditure, commercial revenues and the cost of capital, at least

⁷ HAL's response to the October 2021 Initial Proposals was received on 17 December 2021 and, therefore, was not available to the CAA at the time it made its decision on the holding price cap. We will consider this evidence alongside that provided by other stakeholders in developing our Final Proposals.

during the current period of heightened uncertainty about the impact of the Omicron variant, the balance of evidence supports retaining £29.50 (in 2020 prices) as the holding price cap. Further details of our assessment are set out in chapter 1 of this Notice.

10. We need to translate the £29.50 from 2020 prices to 2022 prices so that we can include them in HAL's Licence and remove any ambiguity about adjustments for price indexation. Consistent with the method currently set out in HAL's Licence, we adopted price indices in April to calculate the applicable inflation uplift. The increase in the consumer price index was 0.8% in April 2020 and 1.5% in April 2021, giving a compound increase of 2.32%. Applying this to £29.50 gives a holding price cap of £30.19. We have used the CPI as it is now a properly recognised measure of inflation and is preferred to the RPI.
11. In formulating Final Proposals for the five year price control for H7 in early 2022, we will look to set suitably stretching targets for HAL, such that the path of its charges delivers value for money for consumers in the medium and longer-term. Given the present level of uncertainty, we will also need to reconsider the forecasts of passenger numbers, and there should be no presumption that the H7 price control will be at the same level as the holding price cap. We will formulate the Final Proposals for the five year H7 price control in a way consistent with our statutory duties, ensuring that consumers' interests are appropriately protected, while also having regard to the matters required by those duties, including HAL's financeability and the financing of essential new investment at Heathrow airport.

Next Steps

12. The modifications to the Licence set out in Appendix B will take effect on 2 February 2022, and subject to any appeals and subsequent decisions of the Competition and Markets Authority under the provisions of CAA12.⁸

Our duties

13. In taking this decision, the CAA had full regard to our statutory duties under CAA12. These are set out more fully in Appendix A.

Structure of this document

14. The structure of this document is as follows:
 - Chapter 1 explains our reasons for making the modifications to put in place price control arrangements for 2022, including:

⁸ The price control condition that the CAA has decided to put in place for 2022 to implement the holding price cap has the effect of requiring HAL to set its prices so as not to exceed the maximum revenue yield per passenger in respect of the Regulatory Year 2022. As noted in paragraph 2.3, on 17 December 2021 (pursuant to its obligations under the ACR2011), HAL issued its decision to set airport charges consistent with the holding cap of £30.19.

- how we have taken account of the representations made in response to the October 2021 Notice, and
 - the reasons for any differences between the modifications and those set out in the October 2021 Notice.
- Chapter 2 sets out our reasons for, and the effects of, the drafting of the modifications to put in place price control arrangements for 2022 and other modifications to remove redundant terms and update relevant dates, including:
 - how we have taken account of the representations made in response to the October 2021 Notice, and
 - the reasons for any differences between the modifications and those set out in the October 2021 Notice.
 - Appendix A summarises our statutory duties.
 - Appendix B sets out the modifications to existing licence conditions and the new licence conditions.

Chapter 1

The holding price cap for 2022

Introduction

1.1 This chapter:

- explains the background to our proposal to implement an holding price cap on HAL's airport charges for 2022;
- summarises the responses we received from stakeholders on this issue;
- discusses our views of the responses; and
- sets out and explains our decision.

The October 2021 Notice

1.2 The October 2021 Initial Proposals noted that:

- the impacts of the covid-19 pandemic had adversely affected the timetable for the H7 price control review. In particular, HAL's RBP and updated RBP were delayed to ensure they were based on more up-to-date information and traffic projections. In addition, we needed to take extra time and resources to consult stakeholders on the important issues raised by HAL's request for a covid-19 related RAB adjustment. These developments meant that the Initial Proposals were issued in October 2021 rather than summer 2021 as we had intended at the time of our April 2020 timetable update;
- HAL's current price control ends on 31 December 2021. This means that, without further action by the CAA, there would be no price cap applicable to HAL from 1 January 2022 until the summer of 2022, when we expect the licence modifications for the five year H7 price control to take effect;
- the absence of a price cap in the intervening period risks exposing consumers to charges that could 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 than necessary because of the absence of a price control in early 2022, while future consumers could experience somewhat lower charges than they otherwise would have done because of the impact of any truing-up arrangements;
- 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 assumed charges at a level that is designed to deliver a yield of £37.64 per passenger (nominal prices). It developed this approach from the assumptions included in its updated RBP; and

- we have been considering this issue with HAL and airlines since our April 2021 Way Forward Document.⁹ We have encouraged both sides to engage on the level of the charge for 2022 to see if they could agree a holding price cap which would be trued-up (or trued-down) with the CAA's final decision to ensure that each of HAL and consumers would be "held harmless" for any difference between the holding price cap and the eventual price cap that the CAA sets for H7. Unfortunately, agreement between HAL and airlines has not been forthcoming.

- 1.3 To address these difficulties (and as part of the publication that also contained our Initial Proposals) we issued the October 2021 Notice as a formal consultation on, and notice of, licence modifications which proposed to put in place a licence condition to regulate HAL's prices in 2022 based on an holding price cap of £29.50 per passenger (2020 prices).¹⁰ We also said we would use a correction factor in the price control licence condition that we intend to include in our final decision for H7 to provide an automatic mechanism that will true-up (or true-down) any under- or over recovery of revenue between the holding price cap and the final level of the H7 price control.
- 1.4 On 27 October 2021, HAL wrote to the airlines to delay the publication of its final 2022 airport tariff list and associated Conditions of Use to better understand the implications of the October 2021 Initial Proposals and the impact of them on the 2022 airport charges. On 16 December 2021, we wrote to HAL, British Airways, Virgin Atlantic Airways and the Heathrow AOC (and put the letter on our website)¹¹ stating that we had decided to make the modifications as proposed in the October 2021 Notice, and that we would be confirming our decision in this Notice before Christmas. In response to the 16 December 2021 letter, HAL published its final decision on its charges for 2022 under the ACR2011 on 17 December 2021, based on a holding price cap of £30.19.

Stakeholder views

- 1.5 We received 19 responses to our consultation on the holding price cap set out at chapter 15 of the October 2021 Initial Proposals and in the October 2021 Notice. These were from HAL, airlines, airline representative bodies, one consulting firm and one member of the public. The key issues are summarised below.

HAL

- 1.6 HAL said that the holding price cap proposed by the CAA is too low and would significantly undermine its financial resilience. HAL also stated that airport charges represent a modest proportion of airfares. It argued that the interests of consumers would be furthered by the CAA prioritising a charge that allows for and incentivises investment and resilience, including protecting HAL's access to capital markets. It said that this would enable it to obtain sufficient liquidity and efficient financing to remain financially resilient. In HAL's view, the CAA's

⁹ See www.caa.co.uk/CAP2139.

¹⁰ As noted above, the October 2021 Notice of the proposed modifications to the Licence to implement this holding price cap under section 22(2) CAA12 was given at Appendix C of the October 2021 Initial Proposals See footnotes 5 and 6 above.

¹¹ See <https://www.caa.co.uk/CAP2307>

proposed charge failed to do this and creates risk of a credit rating “downgrade” that would restrict its access to finance and increase its costs. It said this would not be in the interests of consumers.

1.7 HAL also:

- disputed the CAA’s method for calculating the WACC on the grounds that it assumes the covid-19 pandemic has had no impact, ignores evidence from other airports and the method followed by the CAA’s consultants is flawed;
- identified an error in the CAA’s financeability analysis relating to HAL’s opening gearing and another error in respect of opex that reduces the projections of the funds from operations (“FFO”) financing metrics; and
- stated that the CMA had set clear thresholds for what FFO should be to support an investment grade credit rating, and the CAA’s approach put this at risk.

1.8 Noting the need for caution over passenger forecasts, HAL said that its existing forecasts for 2022 remained reasonable central forecasts, especially given the uncertainty from rising covid-19 cases in Europe. HAL also argued that the CAA’s passenger forecast for later years of H7 was wrong as it did not take account of the annual cap of 480,000 aircraft movements at Heathrow.

1.9 It also said there were serious errors in the estimates made by the CAA’s consultants (CEPA/Taylor Airey) for opex and commercial revenues in 2021/22 such that these projections are neither realistic nor credible.

1.10 In HAL’s view, the CAA had erred in its judgement in relation to financeability, opex, commercial revenues, passenger numbers and the WACC so that the estimates for these were below what is required to operate a safe and resilient airport. HAL stated that the CAA’s range for charges set out in the October 2021 Initial Proposals is too low and fundamentally compromised.

1.11 HAL argued that the consequence of the CAA’s price cap being set at the level it proposed would be a loss for HAL before tax of over £300 million based on a notionally financed company. HAL considered that it is unprecedented for a regulator to set a price cap that would lead to such a degree of loss. It also said the CAA’s process had led to a timeline that is inconsistent with the requirements on HAL to consult on its charges for 2022 under ACR2011.

1.12 HAL’s proposed solution was for the CAA to set the cap at the top of its range and at the level that HAL had consulted on under the ACR2011 (£37.64 in 2022 prices).

1.13 It also said that it was provisionally accepting the notion of a holding price cap for 2022 provided that, if the final H7 determination were to be for a higher level of revenue for 2022, it could recover any shortfall. It reserved its rights to make further representations (including in relation to opex and financeability) and to fully evaluate the CAA’s H7 final decision.

Airlines and other stakeholders

1.14 Airlines’ positions were broadly aligned in suggesting that the October 2021 Initial Proposals were not in line with the CAA’s duties because they did not