

Economic regulation of Heathrow Airport: H7 Final Proposals – Summary

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Summary

Introduction and overview

Introduction

1. This document sets out the CAA's Final Proposals ("Final Proposals") for the price control and associated regulatory framework that will apply to Heathrow Airport Limited ("HAL") for the five-year ("H7") period starting in January 2022 and ending in December 2026. These arrangements will replace the holding price cap that came into effect on 1 January 2022 and which will run until 31 December 2022.
2. This summary has four main parts:
 - this introduction and overview;
 - the context and the process we have followed to reach our Final Proposals;
 - a summary of the main components of our Final Proposals and approach to developing the key elements of the regulatory framework for HAL; and
 - an overview of our statutory duties that are key to our work on this price control review and the remaining steps of the process necessary to finalise the arrangements for the new price control, quality of service arrangements and regulatory framework for the H7 period.
3. Setting price controls for HAL is how the CAA fulfils one of its core functions under the Civil Aviation Act 2012 ("CAA12"). Our primary duty is to further the interest of users¹ (collectively referred to as "consumers") of air transport services regarding the range, availability, continuity, cost, and quality of airport operation services ("AOS").²
4. We have formulated these Final Proposals on the basis of a "single till" whereby we make projections of (i) HAL's total efficient costs and (ii) projections of its "single till" revenues (commercial revenues such as from car parking and retail outlets, other regulated charges and revenue from cargo flights). We net these off against one another as described below to help ensure that airport charges are no higher than is necessary.

¹ "Users" include present and future users and are defined in CAA12 as passengers and those with "a right in property" (cargo) carried by air transport services.

² Airport operation services ("AOS") are defined in section 68 CAA12.

5. These projections of efficient costs are based on estimates of operating expenditure, regulatory depreciation of and return on the Regulated Asset Base ("RAB").³ The RAB changes as new investment is added and regulatory depreciation is removed (allowing investment to be financed over its expected life, rather than in the year it is incurred). The price control is then calculated by dividing the overall projections of costs less the projections of single till revenues by our forecast of passenger numbers (over the period of the price control) to give an allowed level of price control revenue per passenger that HAL can collect from airport charges.
6. HAL and airline stakeholders have put forward diametrically opposed positions on the key issues discussed in our Initial Proposals, such as passenger forecasts and the cost of capital. These positions are consistent with their commercial interests, with HAL suggesting airport charges should increase significantly and airlines saying they should be significantly lower. We have given all stakeholders extensive opportunities to make their views and concerns known to the CAA and have responded to these challenges with a consistent focus on developing an appropriate and evidence-based view of the various elements of the price control in the interests of consumers as required by CAA12.
7. We are also setting out alongside this document our Final Proposals for incentives, continuous improvements in service levels and improved governance arrangements that encourage HAL and airlines to work together to further the interest of consumers. These Final Proposals will be implemented by modifying HAL's licence: a Notice under section 22 CAA12 specifying the necessary modifications accompanies this document.⁴

Overview

8. These Final Proposals follow on from the Initial Proposals we published in October 2021. Noting the uncertainties and difficulties that the covid-19 pandemic had created, those Initial Proposals were based on a range of estimates of airport charges. Since then, we have assessed the responses to that consultation, updated the evidence base, and updated our own analysis to support the Final Proposals set out here.
9. The impact of the covid-19 pandemic on the aviation sector has been severe, with passenger numbers at Heathrow airport in 2020 and 2021 around 75% lower than their pre-pandemic levels in 2019. The beginning of 2022 was also

³ The RAB is a regulatory construct used for setting the price control and is a notional sum representing the value of the investments made by HAL. Broadly, additions to the RAB are determined by reference to HAL's capital spend, after the application of any capital incentives under the licence.

⁴ See Appendix C.

affected by travel restrictions introduced following the emergence of the Omicron variant, but the Spring has seen sharp increases in demand.

10. To help deal with the passenger forecast uncertainty over H7, we have developed further the Traffic Risk Sharing (“TRS”) mechanism set out in the Initial Proposals. This mechanism will mean that, if passenger numbers are lower than expected, then HAL will have some protection against lower revenues. This should help secure that HAL can finance investment in a cost effective way and avoid any undue upward pressure on airport charges. Consumers will also benefit through lower prices if volumes are higher than expected. We explain how this mechanism works in more detail below and in chapter 2 (Regulatory framework).
11. Where appropriate, we are building on the advantages of the existing regulatory framework, including by retaining the approach based on the Regulatory Asset Base (“RAB”) described above and setting a five-year price control. This should provide airlines and consumers with significant certainty about the level of airport charges and HAL with a stable framework that will allow it to continue to finance the investment necessary to provide a safe, secure and resilient airport.
12. Over the last two years, Heathrow and many businesses across the aviation sector supply chain have seen many staff leaving the industry. It is important that, through the recovery from the pandemic, HAL can bring new staff on board to provide a good service to passengers. The operational challenges across the aviation sector in recent months have further emphasised the importance of all parts of the sector having the people and other resources to provide an appropriate quality of service to consumers.
13. Since the Initial Proposals, we have increased our estimate of HAL’s operating expenditure to £5.9 billion (2020 CPI prices) over the five years. While this is about £330 million less than HAL’s proposals (consistent with promoting economy and efficiency), it should support the recruitment of new staff and allow HAL to provide a good quality service. We have also updated our projections of commercial revenues, which are closer to HAL’s proposals, but which will nonetheless provide HAL with the challenge of driving real increases in the level of its commercial revenues across the H7 period.
14. There are some very important investments that HAL intends to make in the coming years that should further improve not only the passenger experience, but also the safety, security and resilience of the airport. Our Final Proposals are based on investment of £3.6 billion over the five years of H7 compared to HAL’s estimate of £4.5 billion. Our estimate of the investment HAL will make includes next generation security scanners and a new baggage system in Terminal 2, which are collectively expected to cost about £1.3 billion. “Net Zero” and making aviation more environmentally sustainable is a strategic challenge and priority for the sector (all 2020 CPI prices). HAL has proposed expenditure to help address

these issues and, while further work is required on the detail of these projects, including with airlines, we welcome the focus that HAL is placing on these issues.

15. Inevitably, there is always uncertainty about the most appropriate investments over a five-year period and, particularly, in the later years of the period where detailed planning for projects has not yet commenced. Where we have not included specific projects in our estimate, it will be for HAL to work with airlines under the governance framework that will be strengthened and made more flexible by these Final Proposals. HAL can bring forward proposals for higher levels of spending, but will need to show that such spending would be efficient and improve consumer outcomes. Therefore, our estimate of capital spending is not an absolute cap.
16. We have also developed new incentives for HAL to deliver capital spending efficiently and in the interests of consumers, with the intention that these will lead to a more efficient airport and better value for money from airport charges in the future.
17. The return that HAL earns on its asset base (its “cost of capital”) forms a very significant component of the price cap calculation. Since the Initial Proposals, we have considered the extensive evidence presented by stakeholders, but also taken account of wider developments. As a result, we have made two main changes since the Initial Proposals to our estimate of HAL’s cost of capital:
 - the increase in inflation and expected inflation reduces the real cost of much of HAL’s existing debt, which feeds through to a lower real cost of capital; and
 - we have reduced our assessment of the cost of equity to account for the material reduction in risk as a result of introducing TRS arrangements.
18. HAL has continued to request that the CAA make an adjustment to its RAB that would have the effect of allowing HAL to recover a significant proportion of the losses it experienced during the covid-19 pandemic. In April 2021, we decided to make a targeted and focused adjustment to HAL’s RAB of £300 million (2018 RPI prices) to support it in maintaining a high quality of customer service and re-open terminal capacity in a timely manner in 2021. We have considered whether a further RAB adjustment is appropriate, including the £2.5 billion (2018 RPI prices) suggested by HAL and have concluded that such an adjustment would not further the interest of consumers or be necessary to support the efficient financing of HAL. Therefore, we have retained the £300 million adjustment made in Initial Proposals and not made any further RAB adjustment. This is consistent with the basis on which we set the previous “Q6” price control, which provided for HAL to manage the risks associated with changes in passenger volumes.

19. Our Final Proposals are based on retaining the “holding price cap” which we set in December 2021 to cover 2022. This is £27.39⁵ in 2020 prices and £30.19 in 2022 prices. Implementation of these Final Proposals will see the price cap reducing over the H7 period to £21.75 in 2026 in 2020 prices. The higher charges at the start of the H7 period support HAL’s financeability with lower airport charges in real terms as the period progresses, consistent with furthering the interests of consumers. Compared to the mid-point of the range that we used for the Initial Proposals of £29.50 in 2020 prices, our Final Proposals are an average price cap of £24.50 in 2020 prices over the H7 period. This is about £2 per passenger more than during Q6, which largely reflects the lower predicted passenger volumes we expect during the recovery period from the covid-19 pandemic, rather than an increase in HAL’s costs. The reduction compared to the mid-point of the Initial Proposals reflects a number of factors, in particular, the increase in the passenger forecast and the reduction in the cost of capital.
20. In setting airport charges, HAL will also be able to take account of the impacts of inflation up to 2023 and beyond. Given our current forecast of inflation we expect the allowed airport charge for 2023 will be £29.68 (nominal prices). Based on current forecasts of inflation this charge would fall to £26.31 in 2026.
21. Given the challenges of the covid-19 pandemic, it is particularly important that we consider whether our proposals are consistent with our statutory duty to have regard to the need to secure that HAL is able to finance its activities at Heathrow. We consider that this level and profile of airport charges reasonably supports the financeability of an efficiently financed regulated business carrying out the activities of HAL.
22. Since the Initial Proposals, we have introduced price profiling that means higher airport charges in the early years of H7 and lower charges later, and revised our approach to the TRS mechanism, which should support HAL’s financeability. Nonetheless, it will be for HAL’s shareholders and management to address any issues that arise as a result of its actual financial structure differing from the assumptions we make in setting price controls and, in particular, the higher levels of debt finance that HAL uses to support the regulated business and its wider group of companies.

Forecasts of passenger numbers

23. The recovery in passenger traffic in 2022 is expected to continue with growing bookings and a significant ramp up in capacity both at Heathrow airport and by airlines. The number of passengers using Heathrow was about 74% of 2019 levels in April, 79% of 2019 levels in May, and HAL has re-opened Terminal 4 in June. We expect the ramp up in demand in 2022 to set the scene for a sustained

⁵ This figure represents the “Holding price cap” in nominal terms deflated using updated inflation forecasts.

recovery into 2023 and beyond, with passenger numbers at Heathrow airport expected to broadly return to 2019 levels by 2025.

24. While this more optimistic outlook of demand is encouraging, there remains a greater than usual level of uncertainty about passenger forecasts, with potential upsides given the recent surges in passenger numbers and potential downsides associated with macroeconomic headwinds, the possibility of further difficulties associated with covid-19 and the difficulties airports and airlines have faced with recruitment and resourcing.
25. It is possible that evidence will emerge during the period of consultation on these Final Proposals and during our work to make our Final Decisions on the price control that would mean the passenger forecast used in these Final Proposals should be reviewed. We explain in the final section below the steps we would take if such circumstances arise.

Summary: context and process

Approach

26. Despite the impact of the covid-19 pandemic discussed above, Heathrow airport retains its unique position for passengers and freight owners as the UK's only hub airport and the largest airport in terms of both passenger numbers and the value of the cargo it handles.
27. HAL's airport charges are among the highest in the world, and left unconstrained, its market power has the potential to damage the interests of consumers, for example through:
- even higher prices;
 - lower quality services and facilities; and
 - inefficiencies, such as in overrunning capital projects, both in costs and time, and higher than necessary operating expenditures.
28. To further the interests of consumers, we have sought to ensure that HAL's future charges will be "affordable" in the sense of representing appropriate value for money. We do so by basing our projections on efficient costs and creating incentives on HAL both to provide an appropriate quality of service and to seek out further efficiencies in the future.
29. Our process has generated a significant volume of evidence and submissions from stakeholders on the full range of issues covered by these Final Proposals. In this context, we note that:

- HAL's submissions suggested that consumers and airlines should fund significant levels of support for its financeability, together with maintaining high levels of customer service, all financed by significantly higher airport charges; and
- airlines' submissions have focused on the importance of the H7 review supporting the recovery of passenger volumes at Heathrow by the introduction of stretching efficiency targets for HAL and significantly lower airport charges.

Our Process

The Q6 price control

30. After CAA12 came into force, the CAA determined that HAL was the operator of a "dominant airport" and granted it a licence under CAA12 in 2014. The CAA's market power assessment was based on HAL's position as the operator of the UK's only hub airport, airline network effects available at Heathrow which limit the ability of airlines to switch capacity and to constrain HAL's charges, Heathrow's good surface access options and the attractiveness of the London market to airlines.
31. The licence included a price control originally covering the years 2014 to 2018 ("Q6"). The Q6 price control was set using a RAB and a 'single till' approach.
32. After the Government's announcement that Heathrow was its preferred location for the development of a new runway in the south east of England (known as "expansion") in 2016, an extensive period of regulatory development work was undertaken by the CAA to determine how the regulatory framework could accommodate expansion. During this period, the Q6 price control was extended by the CAA successively to cover 2019 and then 2020 to 2021. These extensions were intended to align the start of the H7 period with the period during which it was anticipated that the construction work for the third runway would take place.
33. Following the Court of Appeal's judgment that the Airports National Policy Statement had not been lawfully prepared, HAL paused work on expansion. Although the Supreme Court subsequently overturned this judgment, expansion remains paused following the outbreak of the covid-19 pandemic. As a result, we focused on setting a price control for the H7 period consistent with the operation of a two-runway airport.
34. In July 2020, HAL sent the CAA a request that it should reopen the Q6 price control by making an adjustment to its regulatory asset base ("RAB") to address the shortfall in the revenue it expected to recover in 2020 and 2021 due to the severe impact of the covid-19 pandemic. HAL made a series of subsequent representations in support of its request.