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BEFORE THE COMPETITION AND MARKETS AUTHORITY

**IN THE MATTER OF AN INTERVENTION INTO AN APPEAL UNDER SECTION
25 OF THE CIVIL AVIATION ACT 2012**

B E T W E E N

HEATHROW AIRPORT LIMITED

Appellant

- and -

THE CIVIL AVIATION AUTHORITY

Respondent

- supported by -

BRITISH AIRWAYS PLC

Intervening

**APPLICATION FOR PERMISSION TO
INTERVENE**

BY BRITISH AIRWAYS PLC

TABLE OF CONTENTS

1.	Introduction	3
1.1	Overview	3
1.2	Application for permission to intervene.....	4
1.3	Legal framework	5
1.4	Key documents	8
1.5	Overriding objective.....	9
1.5	Overriding objective.....	9
2.	HAL's First Ground: Regulatory Asset Base ("RAB")	11
2.1	Overview	11
2.2	The purpose of the April 2021 RAB Adjustment	12
2.3	Risk allocation.....	14
2.4	HAL's debt structure	24
2.5	HAL's alternative case	26
3.	HAL's Second and Third Grounds: Weighted average cost of capital ("WACC").....	29
3.1	Overview	29
3.3	HAL Ground 2: The CAA's approach to estimating HAL's cost of equity and asset beta	31
3.4	HAL Ground 2A: The impact of the Covid-19 pandemic on the H7 asset beta	36
3.5	HAL Ground 2B: The CAA's estimate of the impact of the TRS mechanism on the H7 asset beta.....	39
3.6	HAL Ground 3A: Deflating the cost of fixed rate debt.....	43
3.7	HAL Ground 3B: The premium on embedded debt.....	45
4.	HAL's Fourth Ground: AK Factor	47
5.	HAL's Fifth Ground: Capex Incentives.....	53
5.1	Overview	53
5.2	The need for change	54
5.3	Proportionality.....	58
5.4	Interests and incentives of airlines	61
5.5	Principles of Better Regulation	64
6.	Statement of Truth.....	67

1. INTRODUCTION

1.1 Overview

1.1.1 British Airways plc ("**BA**", or the "**Applicant**") a company registered in England and Wales under Company Number 01777777. BA is a global airline, the United Kingdom's flag carrier airline and the largest subsidiary in the International Airlines Group ("**IAG**"). It holds an Air Operator Certificate (AOC Number 441) issued by the Civil Aviation Authority (the "**CAA**"), with London Heathrow Airport ("**Heathrow Airport**") being a key UK gateway for its global customer base.

1.1.2 On 18 April 2023, BA applied to the Competition and Markets Authority (the "**CMA**") for permission to appeal the final decision made by the CAA to modify the conditions of the licence (the "**Licence**") held by Heathrow Airport Limited ("**HAL**") to give effect to the CAA's Final Decision for the H7 price control review (operating from 1 January 2022 to 31 December 2026) contained in a notice under section 22(6) of the Act published on 8 March 2023 (the "**H7 Final Decision**").¹ HAL has also applied to the CMA for permission to appeal the H7 Final Decision ("**HAL's Appeal**", the "**HAL Appeal**", the "**HAL's Notice of Appeal**" or the "**HAL NOA**"). On 11 May 2023, the CMA granted permission to both BA and HAL to bring their appeals on all grounds raised in their respective applications.

1.1.3 In this further application, BA now seeks permission from the CMA to intervene (and, if permission is granted, to intervene) in support of the CAA in respect of HAL's Appeal, further to Part 2 (Intervention in Appeal) of Schedule 2 to the Civil Aviation Act (the "**Act**" or "**CAA12**"). As more fully set out below, this is on the basis that BA opposes HAL's Appeal and that its intervention would, among other things, be: additive (i.e. not duplicative of its application to appeal); offer an informed perspective based on its particular knowledge and expertise; provide information and/or evidence which would not otherwise be before the CMA in support of the CAA's position (particularly in relation to those grounds on which HAL sought (and has been granted) permission to appeal, but which the airlines did not seek to appeal); highlight factual inaccuracies and incorrect characterisations in HAL's Appeal; and at all times be mindful of the need to assist the CMA in meeting the overriding objective.

1.1.4 Across HAL's grounds, BA's view is that there is a failure to identify any legal error. By way of example, the £2.225 billion RAB adjustment claimed no doubt

¹ CAA, CAP2524A: *Economic Regulation of Heathrow Airport: H7 Final Decision – Summary BA NOA / Tab 1 / p.10.*

NON - SENSITIVE

reflects HAL's discomfort following the Covid-19 pandemic, but does not have any basis in the legal framework in which HAL was operating. As described in Sections 3 and 4, the "errors" in respect of WACC are objections to reasonable judgments made by the CAA; and HAL's objections in respect of the AK factor amount simply to a desire for an established mechanism to be disappplied because its application, on the facts as they are, operates to HAL's disadvantage. At heart, HAL's appeal on capex incentives amounts to a complaint that HAL should have to seek airlines' consent for capital expenditure projects (which is a feature of the current regime) and commit to measurable delivery obligations when they do so.

- 1.1.5 In addition, BA would suggest that the CAA bear in mind interlinkages when considering all of the appeals against the H7 decision. While HAL suggests that the Traffic Risk Sharing ("TRS") mechanism – designed for H7 – could be usefully commandeered to help calculate its relief in relation to its appeal on the RAB adjustment, it separately claims that the same TRS mechanism has no effect on the weighted average cost of capital in H7. Similarly, in considering whether HAL should be left to its own devices on capex projects, on the spurious basis that airlines do not have consumer interests in mind, it may be worth recollecting that HAL has continually (and self-servingly) underestimated the number of passengers travelling through Heathrow Airport as the industry recovers from the Covid-19 pandemic, creating a more difficult operating environment at the airport.
- 1.1.6 As agreed by the CMA, BA cross-refers to its Notice of Appeal dated 18 April 2023 (the "BA NOA") where appropriate in this application, but does not repeat the arguments made therein.

1.2 **Application for permission to intervene**

- 1.2.1 The Act provides that an application to intervene may be made by any person who would be entitled to appeal against the H7 Final Decision.²
- 1.2.2 Accordingly, BA has standing to make an application for permission to intervene in HAL's Appeal for the reasons set out in Section 3-5 the BA NOA, namely:
- (a) BA is a provider of air transport services as defined in the Act (as explained in paragraph 1.2.2 of the BA NOA); and

² Schedule 2 of the Act, BA NOA / Tab 56 / p.4336 / para 4(1).

- (b) BA's interests are materially affected by the H7 Final Decision (as explained in paragraph 1.2 of the BA NOA).

1.3 Legal framework

- 1.3.1 By virtue of section 30(3)(b) of the Act, in deciding this application for permission to intervene in HAL's Appeal, the CMA must have regard to the matters in respect of which duties are imposed on the CAA by section 1 of the Act. These matters and duties are addressed in more detail in Section 2 of the BA NOA.
- 1.3.2 The CMA may grant permission to intervene in an appeal if it is satisfied that allowing the applicant to intervene is "*necessary or desirable*" for the proper resolution of the appeal.³ Neither the Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) (the "**CMA Rules**") nor the Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) (the "**CMA Guide**") provide any further detail on what will constitute necessity or desirability in this context, but the Guide notes that any application should set out clearly why the applicant believes it meets this test.⁴ BA understands that the CMA will make its decision on a case-by-case basis.⁵
- 1.3.3 The CMA has not previously heard an airport licence condition appeal under section 25 of the Act or needed to consider applications to intervene in this context. However, BA notes that the CMA has experience of determining a number of licence modification appeals – including applications for permission to intervene – in the energy sector, and that such appeals are acknowledged to have a similar legal framework.⁶ In addition, there are relevant principles relating to interventions, or other procedures for joining parties to proceedings, in the English courts, such as the particular knowledge, expertise, or evidence

³ Schedule 2 of the Act, **BA NOA / Tab 56 / p.4336 / para 5(2)**. CMA, *CMA172: Airport Licence Condition Appeals: Competition and Markets Authority Rules*, **BA NOA / Tab 58 / p.4409 / Rule 8.3(a)(iv)**.

⁴ CMA Guide, **BA NOA / Tab 59 / p.4444 / para 4.15-4.16**.

⁵ CMA Guide, **BA NOA / Tab 59 / p.4444 / para 4.14**; CMA, *CMA165resp: Regulatory appeals rules and guidance: energy, water, airports, and air traffic services*, 27 October 2022, exhibited to this Notice of Intervention and marked **NOI / Tab 1 / p.24 / para 2.60**.

⁶ CMA Open letter on the CMA's licence modification appeal rules and guidance, **BA NOA / Tab 56 / p.4336 / page 1**: "*The existing sectors where there are the most directly comparable appeals regimes covering the same or similar grounds of appeal are energy and airports.*" See also CAA, *CMA165: Regulatory appeals rules and guidance: energy, water, airports, and air traffic services*, 12 July 2022, exhibited to this Notice of Intervention and marked **NOI / Tab 2 / p.45 / para 2.4** which provides "*[i]n addition to making improvements to the existing rules and guidance, taking into account the responses to the CMA's open letter, the CMA is proposing a number of changes to align the rules and guidance for each of the appeals functions as much as possible.*"

of the applicant,⁷ the direct effect on the applicant's rights,⁸ and the interests of justice.⁹

1.3.4 Drawing relevant lessons from such precedents and principles, BA considers that allowing its intervention is both necessary and desirable for proper resolution of HAL's Appeal for the following reasons:

- (a) It will assist the CMA in performing its statutory functions in accordance with the overriding objective. More particularly:
 - (i) The airlines, including BA, have particular knowledge, evidence and expertise as customers of HAL operating out of Heathrow Airport, and can provide unique insights of direct relevance to the five (5) grounds of appeal argued by HAL.
 - (ii) The importance of airlines in the context of airport licence condition appeals before the CMA has previously been acknowledged by the Minister for Transport as follows: "*...it will often be airlines that have the knowledge, motivation and resources to press the case for the improvements that end users want and that hold airports to account ... we take the role of airlines in the process seriously because of the many instances where their interests are aligned with the interests of passengers."¹⁰ (emphasis added)*
 - (iii) In the *SSE Code Modification Appeal*, the CMA granted the applications for permission to intervene by British Gas Trading

⁷ *R (Air Transport Air Transport Association of America, Inc, American Airlines, Inc, Continental Airlines, Inc, United Airlines, Inc.) v Secretary of State for Energy and Climate Change* [2010] EWHC 1554 (Admin), exhibited to this Notice of Intervention and marked **NOI / Tab 3 / p.61 / para 8**.

⁸ *The Welsh Ministers v Haydn Price and Registrar of Companies* [2017] EWCA Civ 1768, exhibited to this Notice of Intervention and marked **NOI / Tab 4 / p.91-92 / paras 60-63**; and *Stanhope Pension Trust & Anor v Registrar of Companies & Anor* [1994] BCC 84, exhibited to this Notice of Intervention and marked **NOI / Tab 5 / p.105 / page 90**. Concerning the desirability of being fully informed of the effect of the judgment on the applicant's rights: *Re Blenheim Leisure (Restaurants) Ltd (No.1)* [1999] 7 WLUK 535, exhibited to this Notice of Intervention and marked **NOI / Tab 6 / p.125-126 / pages 573-574**. For an example of a successful application by a third party to be joined to proceedings to oppose a claimant who, if the claim succeeded, would be able to recover a sum of money from the applicant, see *Gurtner v Circuit and Another* [1968] 2 QB 587, exhibited to this Notice of Intervention and marked **NOI / Tab 7 / p.143-144 / pages 602-603**.

⁹ *Re Northern Ireland Human Rights Commission (Northern Ireland)* [2002] UKHL 25, exhibited to this Notice of Intervention and marked **NOI / Tab 8 / p.16 / para 32**.

¹⁰ Hansard, Civil Aviation Bill Deb. (Bill 275), 28 February 2012, exhibited to this Notice of Intervention and marked **NOI / Tab 9 / p.175-176 / columns 104-105**. Concerning the "*important role in the regulatory system [given] to airlines, particularly on the setting of licence conditions and appeals*" due to "*airlines' proximity to passengers' interests*", see Government Response to Transport Committee's Thirteenth Report of Session 2010-12, exhibited to this Notice of Intervention and marked **NOI / Tab 10 / p.190-194**.

Limited ("**British Gas**") and Centrica plc ("**Centrica**")¹¹ who submitted that they were "*well placed to explain that the appellants had not correctly characterised the situation*" and that the relief sought by the appellant would "*be unfair and contrary to regulatory certainty*".¹² BA submits that these considerations are equally applicable here.

- (iv) The airlines can provide evidence relevant to the grounds of appeal brought by HAL which should properly be taken into account but which would not otherwise be put before the CMA.¹³ In this regard, BA notes that in the *Energy Licence Modification Appeals 2021*, the CMA granted the applications for permission to intervene by (a) British Gas, who had submitted that it would provide evidence to which the CMA might not otherwise have access¹⁴ (the CMA's decision granting permission referred to evidence from British Gas's perspective and experience as a supplier (i.e. downstream to the appellants)¹⁵) and (b) Citizens Advice, who had submitted that it offered a unique perspective as a statutory consumer advocate that had been "*heavily engaged*" in the price control¹⁶ (the CMA's decision referred to research which Citizens Advice had carried out in relation to the grounds of appeal¹⁷).
- (b) In relation to the RAB Adjustment and WACC grounds – on which both airlines and HAL have applied for permission to appeal the H7 Final Decision – the airlines' intervention will assist the CMA by providing a

¹¹ Case 50980 *SSE v GEMA*, Directions to become parties to the Appeal, BGT and Centrica, 10 February 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 11 / p.195-197**.

¹² Case 50980 *SSE v GEMA*, Summary of intervention notice of BGT and Centrica, 9 February 2021 (amended 10 February 2021), exhibited to this Notice of Intervention and marked **NOI / Tab 12 / p.198 / para 2**.

¹³ *Gaia River SA v Behike Limited, Alpha Sky Limited* [2020] EWHC 2981 (Comm), exhibited to this Notice of Intervention and marked **NOI / Tab 13 / p.202 / para 12**. Similarly, the CMA has stated that it would ordinarily regard an intervention as being of assistance to the determination of the appeal if it offers evidence or arguments which are additional to the submissions of the main parties: CMA Energy Licence Modification Appeals Rule and Guide: Response to consultation, 30 October 2017, exhibited to this Notice of Intervention and marked **NOI / Tab 14 / p.227 / para 2.48**.

¹⁴ *Energy Licence Modification Appeals 2021*, Intervention Notice, British Gas, 23 April 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 15 / p.239 / para 2.4**.

¹⁵ *Energy Licence Modification Appeals 2021*, Permission to intervene, British Gas, 6 May 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 16 / p.247 / para 8**.

¹⁶ *Energy Licence Modification Appeals 2021*, Intervention Notice, Citizens Advice, 23 April 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 17 / p.256 / para 25**.

¹⁷ *Energy Licence Modification Appeals 2021*, Permission to intervene, Citizens Advice, 6 May 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 18 / p.313 / para 8**.

fact-based check of the key arguments put forward by HAL and crystallising key areas of dispute.

- (c) In relation to the AK Factor and Capex Incentives grounds – in relation to which only HAL has applied for permission to appeal – the airlines' intervention will bring forward evidence which would not otherwise be before the CMA in support of the CAA's position.
- (d) In terms of the direct effect on airlines and their interests, it should be noted that – if HAL's Appeal were to succeed on all five grounds – the per passenger charges during the course of H7 would increase (relative to the position under the H7 Final Decision) by 28% at a cost of around £2.3bn over the course of H7. In the *Energy Licence Modification Appeals 2021*, the CMA granted the applications for permission to intervene by (a) British Gas,¹⁸ who had submitted that it was a customer of the appellants and that the amendments to the charges sought by the appellants (which were passed to British Gas) accounted for 25% of the average annual domestic energy bill of British Gas's own customers;¹⁹ and (b) Citizens Advice,²⁰ who had submitted that, over five years, consumers would pay up to £1.5 billion more under the amendments to the charges sought by the appellants.²¹
- (e) BA submits that it is appropriate for the proper resolution of HAL's Appeal and in the interests of justice for them to be allowed to intervene as they will be adversely affected if the relief sought in HAL's Appeal is granted.²²

1.4 Key documents

- 1.4.1 The facts and reasons why BA believes HAL's Appeal should not succeed are contained in this application for permission to intervene and accompanying exhibits and in expert and witness evidence (including exhibits).

¹⁸ *Energy Licence Modification Appeals 2021*, Permission to intervene, British Gas, 6 May 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 16 / p.245-247**.

¹⁹ *Energy Licence Modification Appeals 2021*, Intervention Notice, British Gas, 23 April 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 15 / p.238 / para 2.1.1**.

²⁰ *Energy Licence Modification Appeals 2021*, Permission to intervene, Citizens Advice, 6 May 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 18 / p.311-314**.

²¹ *Energy Licence Modification Appeals 2021*, Intervention Notice, Citizens Advice, 23 April 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 17 / p.252 / para 18**.

²² *The Welsh Ministers v Haydn Price and Registrar of Companies* [2017] EWCA Civ 1768, exhibited to this Notice of Intervention and marked **NOI / Tab 4 / p.92 / para 63**.

NON - SENSITIVE

1.4.2 BA has provided written evidence in support of this application in the form of:

- (a) Witness Statement of Gavin Molloy, Director of Airport Regulation and Infrastructure at BA, dated 22 May 2023 ("**GM2**"); and
- (b) *Issues raised by Heathrow Airport Limited's Appeal of the CAA's Final Decision*, an Expert Report prepared by AlixPartners LLP dated 22 May 2023 (the "**AP Intervention Report**").

1.5 **Overriding objective**

1.5.1 BA has limited its comments in this application to those that it considers are of most assistance to the CMA. Care has been taken to streamline inputs, and avoid a proliferation of documents, including by cross-referring where appropriate to the BA NOA (and related bundles) and the HAL Appeal documents. BA has also coordinated with Delta in preparing this application, with a view to minimising duplication, and has received input in relation to the application from Virgin Atlantic Limited (**VAA**)"

1.5.2 In terms of the degree of involvement in HAL's Appeal, BA would wish to have, BA considers that it would assist the CMA, if the airlines, in addition to making written submissions, are permitted to attend hearings and are allowed to make oral representations to the CMA.²³

1.5.3 If the CMA grants BA permission to intervene in HAL's Appeal, and also grants permission to intervene to any other airlines, BA requests that those interventions be considered together. BA submits that this would be consistent with furthering the overriding objective because the interventions are related and it will allow for a more streamlined and efficient process.

1.6 **Contact details**

1.6.1 **Applicant:**

British Airways plc

1.6.2 **Applicant's address:**

FAO: Andrew Fleming

General Counsel & Company Secretary

British Airways plc

²³ CMA Guide, BA NOA / Tab 59 / p.4445 / para 4.17.

NON - SENSITIVE

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2. HAL'S FIRST GROUND: REGULATORY ASSET BASE ("RAB")

2.1 Overview

2.1.1 HAL's first ground of appeal contends that the CAA erred in refusing a further adjustment to Heathrow's Regulatory Asset Base ("**RAB**") "*to reflect fully the impact of the Covid-19 pandemic on Heathrow*".²⁴

2.1.2 BA seeks permission to intervene on this ground, and submits that it is necessary and desirable that it be permitted to do so because:

- (a) First, there is a strong degree of overlap between HAL's Appeal and BA's appeal on RAB, in that the rationale or justification for any adjustment is an issue both from HAL and BA's perspective. This overlap is reflected by the fact that the CMA has joined BA's and HAL's appeals in relation to the RAB under Ground A.
- (b) BA and its customers would be directly and significantly adversely affected were HAL to succeed in establishing an entitlement to a significant RAB adjustment.
- (c) BA is well placed to address many of the matters raised by HAL. This is because, as a key stakeholder, it was involved in the detailed discussions and consultations which led to both to the 2021 RAB Adjustment and the H7 Final Decision. Further, through its operational relationship with HAL during the relevant period (and in particular during the pandemic) it can provide relevant and helpful submissions and evidence regarding the factual matters said to support HAL's case on this ground.
- (d) Furthermore, BA was involved throughout the processes which led to the historical price determinations which are said to support its case under this ground. Here, BA's understanding of the effect of those previous determinations (and their relevant context) is markedly different from HAL (as reflected in BA's own appeal on this ground).

2.1.3 BA wishes to make clear that it is not here seeking to argue points that are separately made in its own appeal. Rather, it is seeking to intervene so as to respond to HAL's ground of appeal relating to RAB. Furthermore, BA will seek to avoid duplicating what it anticipates will be the CAA's core submissions in response to this ground, but instead wishes to advance the following points:

²⁴ HAL's Notice of Appeal, paragraph 3.1.

NON - SENSITIVE

- (a) First, that a further adjustment would undermine the purpose of the RAB and, in consequence, the coherence of the price control as a whole;
- (b) Second, that HAL's assertions as to the allocation of risk under the Q6 price control are entirely without foundation;
- (c) Third, that the difficulties which HAL faced during the Covid-19 pandemic were significantly aggravated by its abnormally high debt ratios, and, as a principle of good regulation, ought to be disregarded because HAL's shareholders should bear the risks associated with HAL's high gearing, not consumers;
- (d) Finally, that HAL's alternative case (concerning depreciation) is unprincipled and cannot be supported.

2.1.4 These are addressed in turn below.

2.2 The purpose of the April 2021 RAB Adjustment

2.2.1 The proper starting point is not (as HAL at times suggests) that the CAA in May 2021 accepted that HAL were entitled to compensation in respect of losses made in the course of the Covid-19 pandemic at all let alone "fully".²⁵

2.2.2 What the CAA did was to consider a request from HAL for a RAB adjustment. That request was made because of the pandemic, and in that request that HAL contended that it was entitled to be compensated in respect of its lost revenues. However, the CAA demonstrably did not accept that such an entitlement existed and the RAB adjustment was not given on the basis that HAL were entitled to some form of indemnity or compensation for its Covid-19 pandemic losses. That is not the purpose of the price control, nor could it be justified either as a matter of regulatory principle or by reference to the CAA's statutory duties. Rather, the purpose of the RAB adjustment was to *incentivise* further investment by HAL, and to secure that an efficiently (or "notionally") financed company could finance its licenced activities at Heathrow Airport.²⁶ The CAA acted not to compensate HAL's investors for lost revenues, but rather to "*further the interests of consumers*".²⁷ BA has explained these points in some detail in the BA NOA, and they are not set out again here.

²⁵ HAL's Notice of Appeal, paragraph 3.1.

²⁶ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.755 / para 4.

²⁷ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.754 / para 3.

NON - SENSITIVE

- 2.2.3 The CAA's rejection of HAL's asserted entitlement is entirely unsurprising. This is because (as explained in the BA NOA), the RAB is a well-developed concept that is used as a tool to ensure that airport charges reflect efficient capital expenditure incurred and not paid for in whole by current consumers.
- 2.2.4 Consistent with that objective, the CAA's decision to apply an upward adjustment of £300m to HAL's RAB by its April 2021 RAB Adjustment Decision was made on the explicit basis that it was to "*secure that all reasonable demands for airport operation services at Heathrow airport are met*", by "*incentivising investment by HAL during 2021 that would further the interests of consumers*".²⁸ Furthermore, the RAB Adjustment was contingent on HAL meeting the CAA's expectation that it would be "*proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic.*"²⁹
- 2.2.5 Conversely, simply giving HAL money to compensate it for Covid-19 pandemic related losses generates no consumer benefits; there is no evidence that HAL was on the brink of financial failure and any such *ex-post* funding would simply transfer risk after the event from a regulated entity to its customers – and in a scenario that airlines, which operate in a competitive market, made very substantial losses. The role of regulation is to replicate competitive market outcomes, and demand collapses are likely to lead to losses, which should rightly be borne by HAL's shareholders.
- 2.2.6 Similarly misconceived is the suggestion that "*the CAA should, in the light of its statutory duties, have made an adjustment calibrated in proportion to the shortfall in the revenue it expected to recover in 2020 and 2021*".³⁰ This would be entirely inconsistent with the basis on which HAL is regulated, which is on the basis of the maximum average yield per passenger and not on total revenues. Furthermore, what is sought is transparently a transfer of funds from future consumers to HAL's investors in respect of a risk that (as explained in more detail below) HAL's investors bore as a consequence of the Q6 settlement.³¹
- 2.2.7 Ultimately, what HAL is and always has been seeking is for future consumers to provide a retrospective indemnity in respect of HAL's investment losses.

²⁸ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.755 / para 4.

²⁹ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.755 / para 4.

³⁰ HAL's Notice of Appeal, paragraph 3.1.

³¹ As HAL put it at HAL's Notice of Appeal, paragraph 51, they wish to "*share the risk of the catastrophic shortfall in passengers and revenue with airlines and passengers over the longer term*".

Such an outcome would be unprincipled and indefensible and inconsistent with the CAA's statutory duty to protect consumers' interests.

2.3 Risk allocation

2.3.1 What HAL requests is an adjustment of £2.225 billion – an astonishing sum - “*calibrated using the CAA’s risk sharing mechanism designed to share the impacts of catastrophic risk*”.³² This would require the retrospective application of a risk-sharing mechanism which is now proposed as part of the H7 price control to a portion of the Q6 period. There can be no justification for such a suggestion, and the very fact that it is being proposed by HAL indicates that this formed no part of the Q6 settlement. This is particularly apparent when one considers the detailed scheme set out in HAL's NOA³³, none of which is to be found on the face of the Q6 control decision.

2.3.2 Indeed, that HAL well understood that it was it that bore the risk during Q6 is clear from its response to CAA's consultation on its initial H7 proposals, with HAL welcoming the introduction of risk sharing mechanism in H7 because (amongst other things) “[t]he impact of Covid-19 has highlighted that the previous regulatory framework did not have the necessary protections to deal with the asymmetric risk faced by Heathrow.”³⁴ As against this, HAL suggests that the addition of £2.225 billion to the RAB is required by what is said to be a “*specific duty of proportionality*” imposed by section 1(4) of the CAA12.³⁵ This is wrong as a matter of law. The CAA's “general duty” is set out in s 1(1) and (2) of CAA12. This provides that:

- (a) The CAA must carry out its functions under that Chapter in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of airport operation services; and that
- (b) The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services.³⁶

2.3.3 In performing these functions, the CAA is required to “have regard” to a list of factors, including the principles that “*regulatory activities should be carried out*

³² HAL's Notice of Appeal, paragraph 3.1.

³³ HAL's Notice of Appeal, paragraphs 134 to 143.

³⁴ HAL Response to CAP2265 Initial Proposals, October 2021, NOI / Tab 54 / p. 5371 / para 1.01.

³⁵ *Civil Aviation Act*, 2012, BA NOA / Tab 55 / p.4287 / paras 1(1)-1(2).

³⁶ *Civil Aviation Act*, 2012, BA NOA / Tab 55 / p.4288 / paras 1(3)-(4).

NON - SENSITIVE

in a way which is transparent, accountable, proportionate and consistent", and that "regulatory activities should be targeted only at cases in which action is needed".³⁷ Not only did the CAA plainly "have regard" to these matters, the CAA's refusal to accede to HAL's request for a more significant RAB adjustment was entirely consistent with all of those principles. The CAA was not under an obligation (whether as a consequence of the requirement to have "due regard" to the need to carry out regulatory activities proportionately or otherwise) to compensate HAL for its Covid-19 pandemic related losses. Any such obligation would clearly conflict with the CAA's general duty to protect consumers.

2.3.4 What the Q6 price control established was the maximum permissible yield per passenger during that period. It did not purport to guarantee any minimum level of revenue or – indeed – a maximum level of revenue. This is because the revenue that HAL earns is dependent on the passenger volume. The risk that passenger volume would not be as high as HAL expected lay with HAL, in the same way that HAL benefitted from larger than expected passenger volume (and therefore higher revenue) from 2014-2019. Just as HAL's significant over-recovery during the Q6 period cannot be recouped and refunded to consumers, nor can HAL's under-recovery be recouped and funded by consumers.

2.3.5 It is true that the expected rate of return was one of the inputs into the Q6 price control. In particular, the capital asset pricing model - or CAPM – used in the calculation of the Q6 weighted average cost of capital ("WACC") is a financial model that calculates the expected rate of return having regard to each and every risk that could arise in the relevant period. This is, by its nature, an estimate based on the operation of a model. It does not come with a guarantee. The risks may not in fact materialise (in which case the investment will return more than expected) or the risks may turn out to be greater than anticipated (in which case the investment will return less than hoped). This is the nature of investment (and, indeed, the purpose of incentive regulation under which HAL is regulated). There are potential rewards, but so too are there potential risks. The purpose of price control regulation is not to make airport users an insurer of those risks (which is the effect of what HAL proposes). This is also the answer to the point made at paragraph 14.1 of HAL's Notice of Appeal concerning what is (in effect) a claim to an entitlement to a retrospective WACC adjustment. To restate:

- (a) The WACC is calculated to most accurately reflect the market wide risks based on the information set available at the time. As new information as to the extent and consequences of those risks becomes available (e.g.

³⁷ *Civil Aviation Act, 2012, BA NOA / Tab 55 / p.4288 / paras 1(3)(g)-(4).*

NON - SENSITIVE

because a global pandemic occurs), the extent of such risks may be expected to lead to a change in the WACC to reflect this in the future (i.e. when the WACC for the next period is set).

- (b) **However**, this does not mean that the WACC should be uplifted retrospectively. That would be entirely contrary to the purpose of the existing WACC which was set to reflect (amongst other things) the fact that HAL bore the risk that the outturn situation may not meet that which was predicted.

2.3.6 Nothing in HAL's selective (and out of context) quotations from previous CAA decisions suggests otherwise.³⁸ What is apparent is that HAL has in the past sought guarantees of this kind from the CAA, but the CAA has (entirely unsurprisingly), and consistent with its duties, refused to provide them. In particular:

- (a) In the Q4 period, the question of who bore passenger volume risk was expressly consulted upon.³⁹ In the Q4 preliminary proposals, the CAA explained why it considered it appropriate for volume risk to remain with airports, in particular because the cost of that risk is reflected in the WACC.⁴⁰ This was reflected in the Q4 Final Decision in unequivocal terms (emphasis added):⁴¹

“The CAA considers that it has come to a balanced settlement. The package at Heathrow gives BAA the resources and incentives to implement its investment plan. Although there is the

³⁸ HAL's Notice of Appeal, paragraphs 73 -86.

³⁹ See *Issues for the Airport Reviews consultation paper*, July 2000, exhibited to this Notice of Intervention and marked **NOI / Tab 22 / p.505-508 / page 6-9**: “Volume term – should the risk of differences between actual and forecast volumes be shared between the airport and users?.” The status quo at that point is confirmed at paragraph 3.9 which explained that “The airports are currently faced with the risk that passenger volumes can deviate significantly from the predictions.”

⁴⁰ See Q4 Preliminary Proposals, November 2001, exhibited to this Notice of Intervention and marked **NOI / Tab 41 / p.1902 / para 6.25**: “Some responses suggested that the uncertainty involved in forecasting demand and costs means that actual outcomes may differ substantially from predicted outcomes. The CAA fully agrees with this point although it notes that this does not deter firms from making substantial sunk investments in competitive markets. Capital markets ‘price’ the inherent risks and uncertainty involved. This is reflected in the cost of capital. The CAA also notes that the further ahead into the future is the forecast period, the more that forecast errors are discounted and so the less is their impact.” Further relevant discussion is at paragraphs 14.82-14.86, explaining why the CAA “did not support a standard volume term that would reduce the price cap if outputs were higher than forecast and increase the cap if outputs were lower.”

⁴¹ See Q4 Final Decision, February 2003, exhibited to this Notice of Intervention and marked **NOI / Tab 42 / p.2135 / para 5.17** (emphasis added); to similar effect see also paragraphs 4.84 and paragraph 5.2 in that decision.

possibility of BAA benefiting from out-performance, this is balanced by BAA facing all risks."

- (b) The Q5 Initial Proposals included maintaining "the current volume risk sharing (i.e. the airport bears 100% of the risk within the control period)".⁴² To similar effect were the Q5 Price Proposals.⁴³ The Q5 Decision confirmed that:⁴⁴

"There should not be a volume term for differences between the actual number of passengers at each airport in any year and the numbers expected when the airport charges formula was set."

- (c) A proposal to introduce volume risk sharing was shelved even prior to the Initial Proposals stage in Q6, with the CAA explaining that:⁴⁵

"The CAA floated at an earlier part of the review whether there was merit in introducing a traffic risk sharing mechanism. The CAA has introduced such a mechanism for its regulation of NERL. HAL did not model this concept, preferring to consider traffic risk through the medium of the traffic forecasts and the WACC. Given this lack of support for the concept and the parties' preference to handle traffic risk using alternative mechanisms, the CAA has not decided to pursue this concept for its initial proposals."

- (d) The consequence is that the Q6 proposals explicitly allocated all volume risks to HAL and its shareholders, allowing a higher rate of return for the company than would otherwise be the case to compensate for that risk. This is explained at paragraphs 3.13 and 3.14 of the Q6 Final Proposals (emphasis added):

⁴² Q5 Initial Proposals, December 2016, exhibited to this Notice of Intervention and marked **NOI / Tab 44 / p.2624 / para 19.12**; see also paragraph 19.4: "The CAA was minded to continue with the current regime in the following respects: ... • the airport would continue to bear 100% of the traffic volume risk during the course of the five year price cap".

⁴³ Q5 Price Control Proposals, November 2007, exhibited to this Notice of Intervention and marked **NOI / Tab 43 / p.2316-2319 / Table 12-1 and 12-j**. The draft regulatory policy statement at B.66 further made clear that an "interim review" of any aspect of the price control would not be expected save in the case of a "truly catastrophic event", this text was unchanged in the Final Regulatory Policy Statement which appears at E.70 of the Q5 Decision.

⁴⁴ Q5 Final Decision, 11 March 2008, exhibited to this Notice of Intervention and marked **NOI / Tab 41 / p.2868 / Table 11.1**.

⁴⁵ Q6 Initial Proposals, April 2014, exhibited to this Notice of Intervention and marked **NOI / Tab 47 / p.3617 / para 14.17**; to similar effect are the Q6 Final Proposals, April 2014, exhibited to this Notice of Intervention and marked **NOI / Tab 48 / p.3702 / para 2.58 – 2.61**.

“The CAA considers that the effects of demand shocks on traffic can be split into two: - an expected level of demand shocks, which may be accounted in the forecast level of traffic; and - variations around this expected level, which may be accounted for in the cost of capital, as these constitute risk.

*The allowances for demand shocks in the traffic forecasts and in the cost of capital are two different concepts. The CAA does not, therefore, consider that its proposals constituted double-counting. For example, the CAA may set the price control on the basis of a forecast level of shocks of 1% per annum. **However, there could be a 10% chance that the outturn level of shocks exceeds the forecast level by one percentage point or more. The risk that the outturn is different is borne by the company and its shareholders.** The CAA therefore allows a higher rate of return for the company than would otherwise be the case to compensate for this risk.”*

2.3.7 This approach is reflected in the Q6 Notice granting the Licence.⁴⁶

2.3.8 As against all of this, in respect of the relevant (Q6) period, HAL's key reference that it seeks to rely on is a statement (in the context of a discussion of HAL's credit strength) to the effect that it would be open to HAL to “request” that the CAA revisit the price control.⁴⁷ This is uncontroversial, and as a public authority exercising a statutory discretion the CAA would plainly be required to consider any such request with an open mind.⁴⁸

⁴⁶ See Q6 Notice Granting the Licence, April 2014, exhibited to this Notice of Intervention and marked **NOI / Tab 46 / p.3211 / paras A57-A60; B12; B13-B14; B18.**

⁴⁷ The passage quoted within HAL's Notice of Appeal at paragraph 37, appears in a section addressing HAL's credit strength and provides as follows: *“The CAA's proposed licence did not propose fundamental changes to the form of regulation for HAL and hence is not expected to weaken HAL's credit strength. However, the ability of a licensing regime to revisit the price control if key assumptions, such as traffic, are significantly worse than the forecast, could be a credit strength. One of the key assumptions of the CAA's financeability assessment is that the CAA's price review will not affect HAL's business risk; therefore, the CAA assumes that the regulatory risk of HAL is unchanged from credit rating agencies' current views. However, the CAA recognises that the proposed building blocks of the price cap could affect HAL's financial risk.”*

⁴⁸ This is a reflection of the public law principle that “that anyone who has to exercise a statutory discretion must not ‘shut his ears to an application’” – see e.g. *British Oxygen Co. Ltd v Board of Trade* [1971] AC 610, exhibited to this Notice of Intervention and marked **NOI / Tab 19 / p.330 / para 625D.** As Lord Browne-Wilkinson put it in *R v Secretary of State for the Home Department, ex p. Venables* [1998] AC 407, paragraphs 496-497, exhibited to this Notice of Intervention and marked **NOI / Tab 21 / p.457-458 / paras 496-497:** *“the person on whom the power has been conferred cannot fetter the way he will use that power by ruling out of consideration on the future exercise of that power factors which may then be relevant to such exercise”.*

- 2.3.9 However, that a public body may be required to consider a request to vary a price control does not mean that the entity requesting that review can have any expectation of any particular outcome. To put it another way, an agreement or obligation to revisit the price control did not (and could not) require the CAA to make any changes. It simply required consideration of whether it was appropriate to do so. One of the central errors in HAL's reasoning is to conflate the two throughout its Notice of Appeal.
- 2.3.10 Thus, what HAL had was (at its highest) that a request for a variation would be considered conscientiously by the CAA. This is *precisely* what occurred. HAL requested a RAB adjustment, which the CAA duly considered, and which did result in an adjustment for reasons which included "*providing a strong signal that the regulatory framework is consistent with enabling a notionally financed company to continue to access cost effective investment grade debt finance*".⁴⁹
- 2.3.11 What the CAA did not do and has never done is (as is asserted by HAL at paragraph 34 of its Notice of Appeal) make it "clear" that investors were to be indemnified in respect of some innominate category of "catastrophic" risk. Still less did the CAA make a representation to that effect in terms that were "*clear, unambiguous and devoid of relevant qualification*" so as to give rise to a legitimate expectation as a matter of law.⁵⁰ HAL's concession that it did not – in fact – have such an expectation (at paragraph 105 of HAL's Notice of Appeal) is fatal to this ground of HAL's Appeal.
- 2.3.12 The process leading to the Q6 determination was a lengthy and involved one. If, as HAL suggests, it was understood that there was a category of "catastrophic" risk for which HAL was entitled to compensation, this would have been the subject of consultation and would be apparent on the face of the CAA's determination.

2.3.13 Nor is HAL's point furthered by the examples referred to by [REDACTED]
[REDACTED]

- (a) [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

⁴⁹ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.754 / para 4.

⁵⁰ See e.g. *R. v Inland Revenue Commissioners Ex p. MFK Underwriting Agents Ltd* [1990] 1 W.L.R. 1545, exhibited to this Notice of Intervention and marked NOI / Tab 20 / p.362 / page 1570.

[REDACTED]

(b) [REDACTED]

(c) [REDACTED]

2.3.14 The CAA’s decision was reached in the specific context of the regulation of Heathrow Airport, and in particular the Q6 price control. For this reason, general discussions of how regulators – in different contexts, with different rules, and different levels of risk - are of no assistance. Thus, whatever the merits of Mr Bolt’s statement⁵² as an explanation of the RAB concept generally, what is material is its application in the context of a regulated entity which contends that the appropriate asset beta is in the order of 0.82 (that is, nearly double market risk at notional gearing). It follows that these RABs in different sectors are not being designed to deliver the same thing. Equity investors in water, by convention, generally expect return of their capital even in a low downside scenario. Equity investors in an airport should expect far worse outcomes to be possible. It is essential that this clear distinction in risk exposure between

⁵¹ First Witness Statement of Dr Matt Cuchra, 17 April 2023, HAL NOA / Tab 8 / p.389 / para 3.13; and UK Civil Aviation Authority Proposes New NATS Airline Charges, 27 October 2022, exhibited to this Notice of Intervention and marked NOI / Tab 49 / p.4042.

⁵² First Witness Statement of Christopher Wesley Bolt, 17 April 2023, HAL NOA / Tab 7 / p.335.

investors in water utilities and airports is borne in mind when considering the proper approach. To explain why, with reference to Mr Bolt's report:

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

(d) [REDACTED]

⁵³ First Witness Statement of Christopher Wesley Bolt, 17 April 2023, HAL NOA / Tab 7 / p.344 / para 4.9.

⁵⁴ First Witness Statement of Christopher Wesley Bolt, 17 April 2023, HAL NOA / Tab 7 / p.345 / para 5.1.1.

⁵⁵ First Witness Statement of Christopher Wesley Bolt, 17 April 2023, HAL NOA / Tab 7 / p.337 / para 2.2.

[REDACTED]

(e) [REDACTED]

(f) [REDACTED]

⁵⁶ First Witness Statement of Christopher Wesley Bolt, 17 April 2023, HAL NOA / Tab 7 / p.339 / para 3.7.



- 2.3.15 The reality is – as the Thessaloniki Forum of Airport Charges Regulators report which HAL quotes at paragraph 85 makes clear “[s]hareholders of price regulated undertakings receive a risk compensation for their price regulated activities in the form a regulatory WACC. For this reason, it is in principle appropriate to transfer the demand side risk to the shareholders.” This is – as explained above – precisely what the Q6 price control did. The consequence is that, as the report goes on to recognise, “demand side risk should according to fundamental economic regulatory principles not be transferred to users by increasing charges”.⁵⁷ It is true that this report goes on to set out a definition of “exceptional circumstances”, but this was for the purpose of recommended future legislative changes, and by reference to Dutch and Spanish legislation which adopted a different model of risk allocation to that adopted in respect of Heathrow.⁵⁸ Furthermore, the report did not (in any event) go further than suggesting that compensation may be “considered”, and that if it was considered it would be necessary to “first investigate whether the financial losses as a result of the crisis would have an unacceptable negative impact on the (long term) financial sustainability of the airport taking into account shareholders’ responsibility”.⁵⁹ This is precisely what the CAA did.
- 2.3.16 The consequence is that HAL’s repeated assertions that the risk that passenger numbers might be lower than expected as a consequence of a global pandemic was not a risk that HAL bore is simply incorrect. HAL bore that risk, just as (as explained in more detail in the following section) it reaped the rewards of the significantly higher than expected passenger numbers in the period 2014-2019.

⁵⁷ Thessaloniki Forum of Airport Charges Regulators, *Airport Charges in Times of Crisis*, 27 January 2022, exhibited to this Notice of Intervention and marked **NOI / Tab 24 / p.578 / para 4.10**.

⁵⁸ The same is true of HAL’s references to “international comparators” within HAL’s Notice of Appeal, paragraph 138.3, where are nothing more than references to different approaches taken by different regulators in different jurisdictions under different price control regimes. They provide no assistance on the proper approach under the Q6 regime.

⁵⁹ Thessaloniki Forum of Airport Charges Regulators, *Airport Charges in Times of Crisis*, 27 January 2022, exhibited to this Notice of Intervention and marked **NOI / Tab 24 / p.578 / para 4.13**.

2.4 HAL's debt structure

2.4.1 Much of HAL's submissions are directed to the financial pressures it experienced during Covid- 19 pandemic. What HAL does not do is address the fact that a material element of these pressures arose due to HAL's excessive debt levels. HAL emphasises its total pre-tax losses of £3.8 billion across 2020 and 2021,⁶⁰ but over this period its operating losses were substantially smaller at £1.4 billion and HAL's high net finance costs and fair value loss on financial instruments amounted to £2.4 billion of its total pre-tax losses (i.e. 63% of its total pre-tax losses).⁶¹

2.4.2 The CAA rightly noted this in its May 2021 decision, explaining that “[i]t has long been a principle of economic regulation that HAL's shareholders, rather than consumers, should bear the risks as well as the benefits associated with adopting its own financing structure”.⁶² This is entirely consistent with regulatory best practice.⁶³

2.4.3 Thus, the CAA (rightly) considered HAL's request for a RAB adjustment through the prism of HAL's notional (rather than actual) gearing, consistently with the intention to operate a regulatory framework which “is consistent with enabling the notional company to continue to access cost effective debt finance”.⁶⁴ There is nothing “arbitrary” in the CAA's selection of a 70% debt

⁶⁰ HAL Notice of Appeal, page 6, paragraph 3.1.

⁶¹ Heathrow (SP) Limited Annual Report And Accounts 2021, page 50.

⁶² CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, BA NOA / Tab 19 / p.759 / para 29.

⁶³ See e.g. the CMA's Water Determinations PR19, 17 March 2021, exhibited to this Notice of Intervention and marked NOI / Tab 50 / p.4100 / para 2.119 (“The allowed return is based on a notional capital structure, rather than any allowance being made for companies' choice of financing. Ofwat said that in the light of the lower allowed returns at PR19, some companies may need to take action to strengthen their balance sheets.”) and paragraph 9.39: “Both Ofwat and the CMA calculate allowed return on capital with reference to a notional company with a predetermined level of gearing. This notional approach allows companies to make their own choice about their financial structure whilst ensuring that customers only pay for costs associated with the efficient cost of capital for a notionally structured company.” To similar effect, see paragraphs 9.699-9.700, 9.791, 9.878, 9.1099, 9.1377 and 9.1382-9.1383. Note also paragraph 10.134, where the CMA made clear that if the regulated entities' own financing choices weakened their credit rating, that was a matter for them to resolve, rather than expecting regulatory indulgence in the form of a more generous price control.

⁶⁴ CAA, CAP2140: Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment, 4 May 2021, paragraph 28 BA NOA / Tab 19 / p.759 / para 28.

NON - SENSITIVE

threshold in this regard – the rationale for this is set out at paragraph 4.12 of the CAA’s May 2021 decision⁶⁵.

- 2.4.4 As such, HAL’s contention that it was “forced”⁶⁶ to obtain debt and equity injections are irrelevant, albeit its ability to obtain additional debt reflects its financiability and no new equity was raised by the Group (see further below). These were a consequence of the highly leveraged debt model which HAL adopted, and not matters which provide any right to recourse from airport users. The CAA is not required to approach price regulation on the footing that an operator is entitled to adopt whatever debt ratio it wishes. This would have the perverse consequence of incentivising operators to adopt a highly leveraged model, safe in the knowledge that it would be provided with a regulatory cushion should critical debt issues arise. This would be entirely contrary to the interests of consumers.
- 2.4.5 Furthermore, insofar as BA can tell no new equity was – in fact – injected. It appears that ADI Finance 2 Ltd issued subordinated debt (which was listed on the Guernsey stock exchange post-issue) and has now been fully repaid. The funds from this were “pushed down” in the leveraged finance structure (appearing as equity in the lower entities) but were not new equity to the group (and indeed those funds have now departed the Group). As explained more fully in GM2, in the four-year period January 2018 to December 2021, no new contribution from equity is reported in the accounts of either HAL or its parent, FGP Topco Ltd.⁶⁷ Within HAL there was some issue of new shares in 2018 and 2019, however there was no new consideration from equity holders for these additional shares issued. The 2019 accounts of HAL (for example) disclosed “*the Company capitalised £663,000,000 of unrealised profits by a bonus issue of 663,000,000 ordinary shares of £1.0 each*”.⁶⁸
- 2.4.6 Any assessment of the alleged unfairness to HAL’s (experienced and sophisticated) investors must also take into account that HAL paid substantial dividends in the years 2014 to 2020 (with a substantial dividend being paid on 27 February 2020, a matter of days before the WHO declared a global pandemic on 11 March 2020). As explained further in GM2, in the two years 2018 and 2019, in effect the totality of net comprehensive income of the airport was paid

⁶⁵ CAA, CAP2140: *Economic Regulation of Heathrow Airport Limited - Response to its Request for a Covid-19 Related RAB Adjustment*, 4 May 2021, **BA NOA / Tab 19 / p.759 / para 4.12**.

⁶⁶ HAL’s Notice of Appeal, paragraph 48.

⁶⁷ HAL is ultimately owned 100% by FGP Topco Limited (“FGP Topco”), through a number of intermediary holding and finance companies. FGP Topco is owned by a consortium of investors led by Ferrovial S.A.

⁶⁸ HAL 2019 Annual Report, 31 December 2019, exhibited to this Notice of Intervention and marked **NOI / Tab 33 / p.1499 / page 150**.

out in dividends to FGP Topco shareholders, at an effective return on equity based upon the RAB that far exceeded the equity return percentage anticipated in the WACC. That reflected a conscious decision made by HAL to distribute profits during the years of over-performance to shareholders rather than (as a notionally geared company would have done) to reduce HAL's chosen debt ratio.

2.5 HAL's alternative case

- 2.5.1 HAL's alternative case is similarly unmeritorious. This contends that HAL should "in any event" have adjusted the RAB "*to allow Heathrow to recover the depreciation on the RAB which was incurred during the pandemic*". This is said to be justified because "*Heathrow did not have a fair opportunity of recouping its investment*" during the Q6 period.⁶⁹
- 2.5.2 This is in substance simply a re-packaging of its primary case and again rests on the flawed premise that the risk that passenger numbers would be lower than forecast was not HAL's to bear. Thus at paragraph 40.2 of HAL's Notice of Appeal, HAL asserts that the "*nature of the RAB is that it is intended to secure that investors receive the return of efficiently invested capital*" (emphasis added).⁷⁰ In other words, HAL's case is (again) that it is entitled to an indemnity (payable, ultimately, by consumers) in respect of depreciation incurred at a time where passenger numbers were low, and that this is the "nature" of the RAB. This is patently incorrect, and entirely devoid of principle. The purpose of the RAB is to ensure that airport charges reflect efficient capital expenditure incurred and not paid for in whole by current consumers. This purpose would be subverted if HAL were granted the concessions it seeks. In particular, the depreciation of the RAB is inextricably linked to the maximum yield per passenger determined in the price control. This is not a matter that can simply be unpicked without undermining the integrity of the price control as a whole.
- 2.5.3 HAL asserts that "*[i]n ordinary cost accounting, depreciation of an asset is intended to match the cost of an asset to profits made from the use of that asset, on an assumed basis*".⁷¹ This is simply mistaken. The International Financial Reporting Standard IAS 16 makes clear that:⁷²

⁶⁹ HAL's Notice of Appeal, paragraph 3.1.

⁷⁰ HAL's Notice of Appeal, paragraph 40.2.

⁷¹ HAL's Notice of Appeal, paragraph 95.

⁷² IAS 16 – Property, Plant and Equipment, December 2003, exhibited to this Notice of Intervention and marked NOI / Tab 51 / p.5265-5271.

NON - SENSITIVE

- (a) *“the depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity”* (IAS 16.60);
- (b) a *“depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate”* (IAS 16.62A); and
- (c) *“Expected future reductions in selling prices could be indicative of a higher rate of consumption of the future economic benefits embodied in an asset”* (IAS 16.56).

2.5.4 In any event, the point goes nowhere. As HAL acknowledge, the use of depreciation in a RAB context is to match a share of the previous capital investment to the price control period and hence provide *“the opportunity for the return of invested capital”*.⁷³ Again, this reflects the fact that what HAL's shareholders are doing is investing – an activity which inherently carries risk. It is self-evidently not intended to guarantee the return of invested capital.

2.5.5 There is not, as HAL suggests, any “unfairness” in this outcome. This suggestion appears to be linked to the assertion in Mr Holland-Kaye's evidence that the CAA in some way “changed the rules of the game”.⁷⁴ Again, this is patently incorrect – as explained above the risk that passenger numbers might be lower than expected was borne by HAL. The CAA never (in the Q6 determination or otherwise) undertook to the contrary. Indeed, that the “rules of the game” did not provide for the outcome HAL seeks is evident from the fact that HAL itself applied to the CAA for a change of those rules (in the form of a RAB adjustment). HAL was entitled to expect that the CAA would consider that request, but it certainly did not have an expectation of any particular outcome, still less one that provided for the indemnification of its investors from loss at the expense of consumers.

2.5.6 Nor does this outcome even arguably represent a control of use of property, within the meaning of Article 1 Protocol 1 of the European Convention on Human Rights as suggested by HAL.⁷⁵

2.5.7 First, the RAB is not on any view a “possession” within the meaning of Article 1, Protocol 1. It is not (as is suggested) a shorthand for a “stock of invested capital”. It is (as explained above and the BA NOA) a mechanism by which HAL has the ability to charge future consumers for present capital expenditure

⁷³ HAL's Notice of Appeal, paragraph 95.

⁷⁴ HAL's Notice of Appeal, paragraph 41.

⁷⁵ As suggested within the HAL's Notice of Appeal, paragraph 100. See further Article 1, Protocol 1 of the European Convention for the Protection of Human Rights and Fundamental Freedoms (1950).

NON - SENSITIVE

and its depreciation represents the cost charged to current consumers. It is, in other words, part of a mechanism by which HAL *might* (but is not guaranteed to) gain revenue. It is well established that future income does not constitute a “possession” for the purposes of Article 1, Protocol 1: “*Article 1 of Protocol No.1 applies only to a person's existing possessions. Thus, future income cannot be considered to constitute “possessions” unless it has already been earned or is definitely payable.*”⁷⁶

- 2.5.8 To the extent that there is any interference with *any* possession of HAL's (which is denied), it is not in the nature of a deprivation (i.e. an expropriation) it is - if anything – a control on its use. Such a control is amply justified by the public interest considerations which underlie the Q6 and H7 price controls. HAL and its investors have made a conscious choice to invest in a regulated activity, which carries with it potential risks as well as rewards. There is nothing disproportionate or unfair in expecting those investors to take the rough with the smooth.

⁷⁶ *Anheuser-Busch Inc v Portugal* (2007) 45 E.H.R.R. 36 (Grand Chamber), exhibited to this Notice of Intervention and marked **NOI / Tab 23 / p.549 / para 64**.

3. **HAL'S SECOND AND THIRD GROUNDS: WEIGHTED AVERAGE COST OF CAPITAL ("WACC")**

3.1 **Overview**

3.1.1 HAL's second and third grounds of appeal concern specific aspects of the CAA's decision to set the WACC for H7, namely cost of equity (asset beta) and cost of debt (embedded debt). BA requests permission from the CMA to intervene to support the CAA in opposing HAL's Appeal.

3.1.2 It is necessary and desirable for BA to intervene for the following three reasons.

- (a) First, there is a strong degree of overlap between HAL's Appeal and BA's appeal on the WACC. BA appealed the H7 Final Decision on materially the same grounds, namely the cost of equity (asset beta), the cost of debt (premium on index-linked debt) and the CAA's point estimate. This is recognised by the fact that the CMA has joined BA's and HAL's appeals in relation to the WACC under Ground B.
- (b) There would be strong efficiencies in allowing BA to intervene in the HAL Appeal, which would ultimately be in the interests of the overriding objective. For instance, it would be open for the CMA to order the appellants' and the CAA's experts to debate the issues ('hot tub' style), in order to help crystallise the issues and to support the CMA in identifying the key points of contention in an efficient manner.
- (c) Second, the WACC is a key building block of the revenue that HAL is permitted to earn throughout the H7 period, and forms a very significant component of the per passenger charge. In the H7 Final Decision, the CAA set the level of the WACC at 3.18%, within the range of 2.64%-3.73%. It estimated the cost of equity to be in the range of 8.32%-5.59% and cost of debt to be 0.67%. HAL alleges that the CAA underestimated the appropriate cost of equity and cost of debt, arguing that they should be respectively 10.8% and 1.79% (HAL's actual cost of debt).
- (d) As set out in King 1, HAL's proposals would have the impact of increasing the level of the WACC to [REDACTED], significantly above the level in the H7 Final Decision (which, as explained in the BA NOA, is already too high).⁷⁷ This is demonstrated in Figure 1 below.

⁷⁷ First Witness Statement of Michael John King, 17 April 2023, HAL NOA / Tab 3 / p. 181 / para 20 – Table 1.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- (e) HAL's proposed changes to WACC would also have considerable impact on the per passenger charge, as illustrated in Table 1 below. In total, the additional cost of the H7 period would be [REDACTED]

Table 1: The impact of HAL's proposed WACC figures on the per passenger charge for H7 (2020 prices)

[REDACTED]

- (f) Given the material impact HAL's proposals have on airport charges, it is important that BA should be able to contest HAL's Appeal and ensure

⁷⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5754 / para 12.**

that consumer interests are protected, given the close alignment between the interests of the airlines and passengers.

- (g) Third, it is evident that HAL's appeal contains numerous factual errors and unsupported assertions which BA and its expert economists, Alix Partners, have identified. AlixPartners have supported BA in analysing the H7 Final Proposals and the H7 Final Decision, and therefore have a detailed understanding of the relevant issues and so are well placed to assist the CMA in determining the appeal.

3.1.3 Evidence to support BA's submission

- (a) BA, together with Delta and VAA, has commissioned AlixPartners to consider HAL's evidence on the WACC.
- (b) The AP Intervention Report demonstrates that HAL has failed to show that the CAA has erred in its H7 Final Decision. In particular, the AP Intervention Report found that:
 - (i) **HAL Ground 2:** HAL's proposed methodology raises significant problems, for instance with respect of the cross-checks;
 - (ii) **HAL Ground 2A:** it would be an error for the CAA not to adjust the beta for the risk of future pandemics;
 - (iii) **HAL Ground 2B:** HAL is wrong to argue that the CAA should not adjust HAL's asset beta to reflect the impact of the Traffic Risk Sharing ("TRS") mechanism;
 - (iv) **HAL Ground 3A:** in contrast to HAL's allegations, it is reasonable to rely on five-year inflation forecast;
 - (v) **HAL Ground 3B:** HAL's criticisms have no validity, as the CAA was correct to ignore Class B debt and failed to justify why the notional company would need recourse to non-sterling debt.
- (c) These points are explained in more detail in paragraphs 3.2 -3.6 below. BA fully endorses AlixPartners' findings.

3.2 HAL Ground 2: The CAA's approach to estimating HAL's cost of equity and asset beta

NON - SENSITIVE

3.2.1 HAL argues that the CAA's cost of equity estimate in its H7 Final Decision is "far too low"⁷⁹, and the CAA's asset beta estimate as "simply not credible".⁸⁰

3.2.2 With respect to the CAA's estimated cost of equity:

(a) HAL attempts to evidence that the estimated cost of equity is too low by comparing the H7 estimated cost of equity against HAL's (and other businesses') cost of long term debt.⁸¹ HAL claims that on the basis of the CAA's assumptions, the cost of equity of the notional company "is equivalent to a nominal unlevered cost of equity of 6.20%".⁸² HAL explains that this value is similar to the yield of the relevant iBoxx index (GBP non-financials BBB 10+) and below the cost of Class A debt which HAL has recently issued (at 7.0 % to 7.1%) and the yield of HAL's other traded Class A debt (at 6.9% to 7.1%).⁸³ HAL argues that the nominal cost of equity should, as a matter of principle, be greater than the cost of debt.⁸⁴ HAL's arguments are flawed, for the following reasons:

(i) HAL's methodology to calculate the CAA's inferred nominal unlevered cost of equity based on the CAA's assumptions for H7 is incorrect, as explained further in the AP Intervention Report.⁸⁵ The value is not 6.2%, but rather 8.4% when correctly using OBR RPI inflation forecasts for H7.⁸⁶ Although it is incorrect to assume that as a matter of principle the nominal cost of equity should be greater than the cost of debt (as discussed (ii) below), the correct nominal unlevered cost of equity value exceeds both of HAL's comparator points.⁸⁷ No reliance can therefore be placed on this observation.

⁷⁹ HAL's Notice of Appeal, paragraph 150.

⁸⁰ HAL's Notice of Appeal, paragraph 155.

⁸¹ HAL's Notice of Appeal, paragraph 151.

⁸² *Ibid.*

⁸³ HAL's Notice of Appeal, paragraph 151.

⁸⁴ Given that holders of debt always have a higher-ranking claim over business assets. HAL's Notice of Appeal, paragraphs 149 and 152.

⁸⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5760 / para 39**.

⁸⁶ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5760 / para 39**.

⁸⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5760 / para 39**.

NON - SENSITIVE

- (ii) HAL has erred in its assumption that the unlevered nominal cost of equity should always exceed the cost of debt. As explained in the AP Intervention Report, although this is generally true, it is not always the case – *“the extent of any differential will vary across companies and over time reflecting differences in the drivers of the cost of equity and debt”*.⁸⁸ This is discussed in more detail in the AP Intervention Report. Additionally, as noted in the AP Intervention Report, *“[s]ince the unlevered cost of equity is based on inflation adjusted real equity returns whilst the cost of debt is based on fixed-rate (nominal) debt, I would expect the nominal cost of debt to include an element of inflation risk that would not be included in the cost of equity”*.⁸⁹ HAL therefore cannot rely on this notion as a means to conclude that the CAA’s estimated cost of equity for H7 is too low.
- (iii) Despite HAL attempting to place reliance on analysis looking at a comparison of the asset risk premium to the debt risk premium, no weight should be given to these conclusions. This type of analysis was also submitted to the CMA for RIIO-2 where the CMA determined that the methodology *“is ... reliant on subjective assumptions”*.⁹⁰ the AP Intervention Report describes the flaws with the analysis.
- (b) In its appeal on the CAA’s estimate of the H7 asset beta, HAL criticises the CAA for *“relying on a subjective and poorly evidenced series of assumptions to derive the asset beta, in a stark departure from the best regulatory practice”*.⁹¹ HAL submits that *“there was no justification to depart from well-established regulatory best practice of relying directly on market data to estimate Heathrow’s asset beta”*.⁹² Yet, as set out in the AP Intervention Report, this overlooks two critical factors, namely (i) the impact on airport betas of the Covid-19 pandemic, and (ii) the impact of the introduction of the TRS mechanism which protects HAL

⁸⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5761 / para 41**.

⁸⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5761 / para 45**.

⁹⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5762 / para 48**; Cadent Gas Limited and Others v Gas and Electricity Markets Authority, Final Determinations, Volume 2A: Joined Grounds: Cost of equity **NOI / Tab 25 / p.832 / para 5.717**.

⁹¹ HAL’s Notice of Appeal, paragraph 3.2.

⁹² HAL’s Notice of Appeal, paragraph 159.1.

from risks deriving from passenger volumes.⁹³ Despite BA's appeal grounds concerning the CAA's errors in calibrating the adjustments required to take account of these factors,⁹⁴ the considerations "*are necessary to allow for the difference in the situation over H7 as compared to Q6*" and "*to do otherwise would constitute an error*" as emphasised in the AP Intervention Report.⁹⁵

- (c) HAL argues that the CAA's estimated H7 asset beta "*is based on the Q6 asset beta, which relies on pre-2014 data, and was itself anchored to the Q5 beta (determined in 2006)*".⁹⁶ It refers to certain changes, for example the breakup of BAA, to illustrate that "*it is not realistic to assume that the systematic risk of airports, and in particular Heathrow, has remained unchanged over this period*".⁹⁷ Yet, as noted in the AP Intervention Report, these factors "*do not directly impact on HAL's proposed beta, because none of these represents a systematic risk that would justify a higher beta*".⁹⁸
- (d) HAL further attempts to support its view that the CAA's estimated H7 asset beta is "*not credible*" by pointing to its observation that the estimated H7 asset beta falls: (i) at the lower end of the range of asset betas for comparator airports, and (ii) below the asset beta for AENA which HAL claims is "*the airport operator with the most comparable regulatory framework*".⁹⁹ HAL's reliance on these factors is misplaced:
 - (i) Whilst there are similarities between AENA's and HAL's regulatory frameworks, there are also material differences between the two. As noted in the AP Intervention Report, AENA "*is regulated in nominal (i.e. fixed price) terms, unlike HAL with a RPI-X price cap and a fully inflation indexed RAB. This leaves AENA with economic exposure to inflation from*

⁹³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5755 / para 17**.

⁹⁴ See BA's Notice of Appeal dated 18 April 2023 chapter 5 (Ground 3) and the expert report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023 known as the "WACC Report", which was filed with BA's Notice of Appeal ("**Holt 1**").

⁹⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5755 and 5757 / para 18 and 26**.

⁹⁶ HAL's Notice of Appeal, paragraph 171.

⁹⁷ HAL's Notice of Appeal, paragraph 171.

⁹⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5756 / para 23**.

⁹⁹ HAL's Notice of Appeal, paragraph 155 and 155.1.

which HAL is fully protected".¹⁰⁰ Additionally, AENA: (i) does not have traffic risk protection below a 10% level, within which most common traffic fluctuations would fall,¹⁰¹ and (ii) is much more leisure traffic focused and therefore exposed to greater traffic volume instability.¹⁰²

- (ii) As a result of the points outlined in (i), the most appropriate and well-rounded comparator reference point would be to consider AENA, Fraport and ADP together. The analysis outlined in the AP Intervention Report shows that *"Heathrow has the lowest volatility measured by the sample standard deviations, followed by ADP"* and consideration of the data around the impact of the global financial crisis (of 2007/2008) *"supports the view that Heathrow's asset beta is lower than these other airports"*.¹⁰³
- (e) HAL instead argues that the asset beta should be estimated with reference to five years' worth of historical data. Notably:
 - (i) HAL's analysis underpinning its proposed asset beta attempts to illustrate that the average airport betas remain high post Covid-19 pandemic. Nevertheless, the charts which HAL presents use a five-year data sample which means that, as noted in the AP Intervention Report, *"even his latest estimates are effectively estimating betas over the period 2018-2022, thereby encompassing virtually the whole of the pandemic period"*.¹⁰⁴
 - (ii) *"HAL has picked a point estimate of asset beta at the top end of its own range"*, as explained in the AP Intervention Report. HAL invites the CAA to adopt an asset beta of 0.82, which HAL notes is at the top end of the proposed range of 0.68-0.84.¹⁰⁵ HAL proposes the CAA adopt an asset beta range which places the

¹⁰⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5758 / para 31(a)**.

¹⁰¹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5758 / para 31(b)**.

¹⁰² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5758 / para 31(c)**.

¹⁰³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5758 and 5759 / para 33 and 32 and Figure 3-1**.

¹⁰⁴ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5756 and 5757 / para 22 and 28**.

¹⁰⁵ HAL's Notice of Appeal, paragraph 187; First Witness Statement of Peter Hope, 17 April 2023, **HAL NOA / Tab 9 / p. 466**.

most weight on the time period impacted by the Covid-19 pandemic. As noted in the AP Intervention Report, “[t]he range for the two-year estimates is 0.49-0.71, the range for the seven-year period is 0.64-0.78 and the range for the ten-year period is 0.59-0.69. All of these alternative periods give lower ranges than that chosen by HAL, since its choice of five years gives maximum weight to the covid-19 period”.¹⁰⁶

- (iii) HAL presents a range derived from historical data and argues that it would be appropriate to aim-up within the range, as a result of its view on the cost of debt as compared to the unlevered cost of equity, investment incentives, and H7 compared to comparator airports.¹⁰⁷ As explained in the AP Intervention Report, not only do these factors fail to evidence a need for aiming up, HAL fails to consider other key factors which are critical to a decision of aiming up or down in the context of consumers’ interest (and which support a case for aiming down).¹⁰⁸

3.3 HAL Ground 2A: The impact of the Covid-19 pandemic on the H7 asset beta

3.3.1 HAL argues in its appeal that “*the CAA presents little empirical or theoretical basis for [the] assumptions [underlying its estimates around the impact of Covid-19 on HAL’s asset beta], and a number of its assumptions are clearly flawed*”.¹⁰⁹ In forming its view, HAL points to factors including that the CAA wrongly: (i) relies on an assumption that the Covid-19 pandemic had an end date of March 2022, (ii) assumes that the increase in asset betas since February 2020 can be attributed in full to the impact of the Covid-19 pandemic, and (iii) assumes that all of the increase in asset betas is temporary.¹¹⁰

- (a) It is vital that the CAA takes due consideration of the impact of the Covid-19 pandemic on HAL’s asset beta. As outlined in the AP Intervention Report, “[i]t would be an error for the CAA to give full weight to the “outlier” covid-19 period in estimating asset beta; this would, in effect, be double counting and the relevant issue is estimating

¹⁰⁶ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5757 / para 29**.

¹⁰⁷ HAL’s Notice of Appeal, paragraph 186.

¹⁰⁸ See AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5759 and 5760 / para 34 and 37**.

¹⁰⁹ HAL’s Notice of Appeal, paragraph 167.

¹¹⁰ HAL’s Notice of Appeal, paragraphs 168 and 170.

beta on a forward looking basis allowing the risk of future pandemics” (emphasis added).¹¹¹ Additionally, “the CAA is correct in using judgement to determine how much weight to give to pandemic influenced periods in the estimation of beta” (emphasis added),¹¹² and “ignoring the pandemic by assuming that the last five years is typical, as HAL proposes, would be a clear error that the CAA has avoided in using its best judgement to support its assumptions”.¹¹³ More generally, as described in the AP Intervention Report, “HAL implicitly admits the covid-19 period, which is embedded in in five-year beta estimates, was an unusual period due to its £1,600 to £2,225 million RAB adjustment claim”.¹¹⁴

(b) With respect to the factors which HAL points to in order to support its assertions listed in paragraph 3.3.1 (above):

(i) Although it might be true that the Covid-19 pandemic still had some impact generally around March 2022, the pandemic’s impact on the aviation sector specifically had significantly reduced. As outlined in the AP Intervention Report, “HAL’s own traffic data records a 6.8 times increase in passenger numbers in the first half of 2022 compared to the first half of 2021”.¹¹⁵ Likewise, recent survey data included consideration of factors which impacted respondents’ willingness to travel, showed that “where travellers have concerns about air travel, covid-19 is not a major cause. Rather, economic factors are cited as the main concerns.”.¹¹⁶ This shows that factors other than Covid-19 pandemic are now influencing demand for air travel, and the CAA was correct in its approach.

(ii) There is little evidence that airports’ betas are continuing to be impacted by the Covid-19 pandemic. As discussed further in the

¹¹¹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5766 / para 62.**

¹¹² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5766 / para 62.**

¹¹³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5765-5766 / para 61.**

¹¹⁴ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5766 / para 63.**

¹¹⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5766 / para 64.**

¹¹⁶ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5767 / para 70.**

AP Intervention Report, various iterations of beta models for Fraport, AENA and ADP (as produced by AlixPartners) evidence that the respective betas have in fact returned to close to pre Covid-19 pandemic levels.¹¹⁷ Furthermore “*This clearly shows a downward trend in airport betas from their pandemic peak and that they have returned to close to their pre-pandemic levels by February 2022 (the CAA’s cut-off date for the pandemic effect in its asset beta analysis).*”¹¹⁸ HAL’s reliance on this point to evidence the continuing impact of the Covid-19 pandemic is therefore misplaced.

- (iii) [REDACTED]
[REDACTED]
[REDACTED], “*this is not relevant to systematic or beta risk, which is determined by covariability and not relative volatility*” and therefore has “*no merit*”.¹¹⁹
- (iv) The CAA have not, when estimating the H7 asset beta, erred choosing not to take account of an alleged reduction in business travel. As further discussed in the AP Intervention Report: (i) HAL does not provide evidence to show that “*revenue from leisure passengers will indeed be more volatile than the lost business traffic*”;¹²⁰ (ii) airlines have alternative responses to any reduction of business traffic, and (iii) this conclusion fails to consider [REDACTED]
[REDACTED] would be costly and could be complex for airlines to implement.¹²²
- (v) HAL’s reliance on Ofwat’s proposed methodology for PR24 is erroneous. Critically, as noted in the AP Intervention Report, the

¹¹⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5768-5770 / Figure 4-1, Figure 4-2, Figure 4-3.

¹¹⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5769 / para 74.

¹¹⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5770 / para 75.

¹²⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5771 / para 77(a)9.

¹²¹ First Witness Statement of Peter Hope, 17 April 2023, HAL NOA / Tab 9 / p. 4670 / Table 1]. First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, HAL NOA Exhibit PH1 / Tab A3 / p. 30-31 / para 3.28.

¹²² First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, HAL NOA Exhibit PH1 / Tab A3 / p. 30-31 / para 3.28; AP Intervention Report NOI / Tab 55 / p.5771-5772 / para 77.

impact of the Covid-19 pandemic “*is materially different*” on airports as compared to water companies.¹²³ This “*justif[ies] the CAA to adopt a different approach that specifically looks at appropriate beta adjustments*”.¹²⁴

- (vi) Overall, as noted in the AP Intervention Report, “[t]o assume that an event such as [the Covid-19 pandemic] should be given the same weight in H7 as it has had in the last five years of HAL’s proposed beta estimation period is unreasonable. It is not an error by the CAA to assume otherwise”.¹²⁵

3.4 HAL Ground 2B: The CAA’s estimate of the impact of the TRS mechanism on the H7 asset beta

3.4.1 The H7 Final Decision introduces the TRS mechanism. As the CAA explained in its H7 Final Proposals, “*we have assumed that the application of a TRS mechanism will reduce HAL’s asset beta, for two reasons: [(i)] because it will mitigate the impact of future pandemic-like events on HAL’s asset beta; and [(ii)] because the TRS mechanism will mitigate the impact of “business as usual” traffic volatility on HAL’s equity returns, and hence reduce the pre-pandemic asset beta*”.¹²⁶

3.4.2 HAL argues that the adjustment to the H7 asset beta to account for the TRS mechanism should be quashed.¹²⁷

3.4.3 Taking HAL’s arguments in turn:

- (a) HAL argues in its appeal that the TRS mechanism fails to have a significant impact on its revenues and risk during H7, and therefore does not “*meaningfully*” reduce its “*systematic risk (and therefore asset beta)*”.¹²⁸ It seems to point to the time lag built into the H7 price control, to protect consumers, as evidence supporting its assertions.¹²⁹ As explained in the AP Intervention Report, its assertions are incorrect.

¹²³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5772 / para 79**.

¹²⁴ *Ibid.*

¹²⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5772 / para 80**.

¹²⁶ CAA, CAP2365D: *Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Incentives and other issues*, June 2022 **BA NOA / Tab 29 / p.1606 / para 9.53**.

¹²⁷ HAL’s Notice of Appeal, paragraph 214.

¹²⁸ HAL’s Notice of Appeal, paragraph 195.1.

¹²⁹ HAL’s Notice of Appeal, paragraph 195.1.

Given that “[a]ll revenue recoveries under the TRS are done in the expectation of net present value ... neutrality”¹³⁰, any revenue recovery, even if delayed, will have the same impact on HAL’s overall risk.¹³¹ HAL’s recovery of this revenue through the RAB, where applicable, will also remain true irrespective of any changes to the CAA’s future regulatory depreciation policy, despite HAL’s assertions on this topic.¹³²

- (b) HAL is also critical of the CAA’s methodology to calculate the magnitude of the adjustment for TRS.¹³³ The CAA relies on the asset betas of regulated network utilities in order to estimate the adjustment required to take the TRS mechanism into account.¹³⁴ HAL points towards various factors which it considers evidences that Heathrow “differs fundamentally from that of network utilities”.¹³⁵ Contrary to HAL’s views, Heathrow shares many similarities with network utilities, as the CAA previously identified,¹³⁶ and discussed in the AP Intervention Report. This includes that: (i) HAL and regulated utilities are “both asset heavy”,¹³⁷ (ii) “they are subject to UK RAB regulation on five-year cycles” (as discussed in more detail in Holt 1),¹³⁸ and (iii) they both have large civil construction assets which are not impacted directly by technological advances.¹³⁹ As noted in the AP Intervention Report, protection from technological advances sets them both apart from NATS (En Route) plc (NERL) (which is directly impacted by technological advances).¹⁴⁰ These factors evidence that the CAA’s reliance on the

¹³⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5774-5775 / para 93**.

¹³¹ *Ibid.*

¹³² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5774 / para 93**; First Witness Statement of Michael John King dated 17 April 2023, **HAL NOA / Tab 9 / p.489 / page 24 and 25**.

¹³³ HAL’s Notice of Appeal, page 80 and 81, paragraph 207.

¹³⁴ CAA, *CAP2524D: H7 Final Decision: Section 3 on the financial framework*, 8 March 2023, **BA NOA / Tab 4 / p.179 / para 9.153**.

¹³⁵ HAL’s Notice of Appeal, page 80 and 81, paragraph 207.

¹³⁶ CAA, *CAP2524D: H7 Final Decision: Section 3 on the financial framework*, 8 March 2023, **BA NOA / Tab 4 / p.179 / para 9.154**.

¹³⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5774 / para 90**.

¹³⁸ *Ibid.*

¹³⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5774 / para 91**.

¹⁴⁰ *Ibid.*

asset betas of other regulated entities in the UK in its methodology was reasonable.

- (c) HAL argues that CAA's TRS adjustment is "*too large*", relying on an estimate of the benefit of the TRS mechanism with reference to the asymmetric risk allowance.¹⁴¹ The TRS mechanism protects HAL from all types of passenger traffic risk, whether that is as a result of pandemics or everyday traffic fluctuations. In contrast, the CAA's asymmetric risk allowance only recompenses HAL from "*pandemic-like events*" (even if the TRS is applied first to derive the additional asymmetric allowance).¹⁴² As described in the AP Intervention Report, this evidences that HAL's reliance on the analysis in King 1 [REDACTED] [REDACTED] is misplaced.¹⁴³
- (d) HAL claims that the TRS mechanism does not provide it with [REDACTED] [REDACTED]¹⁴⁴ To the contrary, the TRS mechanism does in fact provide HAL with certainty. With respect to immediacy, the CAA has deliberately designed the mechanism in such a way that protects consumers from higher prices where there might be lower demand (which is precisely in accordance with the CAA's primary duty to protect the interests of consumers).¹⁴⁵
- (e) HAL is wrong in its claim that the implementation of the TRS mechanism does not provide it with certainty around enforcement of the TRS mechanism.¹⁴⁶ As noted in the AP Intervention Report, the "*TRS will be incorporated in licence conditions, ensuring regulatory*

¹⁴¹ First Witness Statement of Michael John King dated 17 April 2023, HAL NOA / Tab 9 / p.489 / page 24 and 25.

¹⁴² CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, BA NOA / Tab 4 / p.206 / para 11.5.

¹⁴³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5775 / para 94; First Witness Statement of Michael John King dated 17 April 2023, HAL NOA / Tab 3 / p.201 / page 25.

¹⁴⁴ First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, HAL NOA Exhibit PH1 / Tab A3 / p. 33 / para 4.12.

¹⁴⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5756 / para 99; Civil Aviation Act, 2012, BA NOA / Tab 55 / p.4287 / paras 1(1).

¹⁴⁶ First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, HAL NOA Exhibit PH1 / Tab A3 / p. 37-38 / para 4C.2.

*commitment. This regulatory commitment is a key part of the price control mechanism”.*¹⁴⁷

- (f) HAL is critical of the lack of evidence underlying the CAA’s conclusion that 50% to 90% of the asset beta differential between Heathrow Airport and network utilities is due to traffic risk. Whilst BA has also identified errors in the CAA’s methodology regarding the extent to which traffic risk accounts for the beta differential,¹⁴⁸ HAL is wrong to argue that traffic risk accounts for *less* of the differential than the CAA’s assumption of 50% to 90%. HAL points to non-aeronautical activities as one example of a factor which could influence the beta differential.¹⁴⁹ As explained in the AP Intervention Report, “*these will mostly be indirectly related to passengers via the relationship to aircraft movements*” and “*HAL may face other risks that are not shared by network utilities but these are only relevant to the extent that they are systematic risks and not diversifiable by investors. Otherwise they have no impact on the cost of capital*”.¹⁵⁰
- (g) HAL’s analysis regarding the benefit of the TRS mechanism for HAL where there is lower than forecast passenger traffic is, as noted in the AP Intervention Report, “*misleading*”.¹⁵¹ The analysis is limited to the H7 period and not beyond, despite the CAA designing the TRS mechanism with the appropriate delays to revenue recovery so that consumers are protected.¹⁵²

3.4.4 As described in the AP Intervention Report, “*HAL’s approach seems to accept the benefit of the TRS (in reducing risk) but not to accept the consequential reduction in asset beta that the TRS entails*”.¹⁵³

¹⁴⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5775 / para 94(b)**; First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, **HAL NOA Exhibit PH1 / Tab A3 / p.37-38 / para 4.16**.

¹⁴⁸ See BA NOA, paragraphs 5.7.16 and 5.7.19

¹⁴⁹ First Expert Witness Statement of Peter Hope dated 17 April 2023, Exhibit PH1, **HAL NOA Exhibit PH1 / Tab A3 / p. 38 / para 4.20**.

¹⁵⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5775 / para 94(c)**.

¹⁵¹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5775 / para 94(d)**; First Expert Witness Statement of Peter William Hope dated 17 April 2023, Exhibit PH1, **HAL NOA Exhibit PH1 / Tab A3 / p. 39 / para 4C.4**.

¹⁵² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5775 / para 94(d)**.

¹⁵³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5775 / para 95**.

3.5 HAL Ground 3A: Deflating the cost of fixed rate debt

3.5.1 In order to set the real cost of debt allowance in the H7 price cap, the CAA has to deflate the nominal cost of HAL's fixed rate embedded debt. The CAA uses the five-year OBR inflation forecast to achieve this in the H7 Final Decision.¹⁵⁴

3.5.2 HAL disagrees with the CAA's approach, and argues that it should have continued to use a long-term inflation forecasts in line with its previous approach.¹⁵⁵

3.5.3 Specifically HAL argues:

(a) This "*is a significant departure from the established UK framework of a real returns-based regulation and the use of long-term inflation expectations*".¹⁵⁶ As explained in the AP Intervention Report, HAL is mistaken in its view:

(i) The current high inflationary environment is extraordinary, but despite this, the CAA did not previously (as part of Q6) set out an intention to rely on long-term inflation expectations.¹⁵⁷

(ii) Precedent from other regulators lacks relevance in circumstances where for the first time there is a material difference between short-term and long-term inflation forecasts.¹⁵⁸ The CAA was faced with novel circumstances regarding inflation and as described in the AP Intervention Report, "*a 5-year forecast is the best approach (particularly having regard to consumer interests and the avoidance of windfall losses/gains)*".¹⁵⁹ Of relevance is the Utility Regulator's recent final determination for GD23 (for the Northern Ireland gas networks). As noted in the AP Intervention Report, in this case, the Utility Regulator also considered an RPI forecast of five-years to arrive at its allowed

¹⁵⁴ CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, BA NOA / Tab 4 / p.147 / Chapter 9.

¹⁵⁵ HAL's Notice of Appeal, paragraph 173.

¹⁵⁶ HAL's Notice of Appeal, paragraph 222.1.

¹⁵⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5777 / para 103-104.

¹⁵⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5777 / para 105.

¹⁵⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 55 / p.5777 / para 105.

real cost of debt.¹⁶⁰ Similarly, Ofwat is also deliberating the appropriate inflation measure for PR24. The CAA's approach for H7 is consistent with Ofwat's views in its Final Methodology, as discussed in the AP Intervention Report.¹⁶¹ Relatedly, Ofgem is expected to consult on the impact of the high inflation forecasts during 2023, clearly evidencing that this is an issue which is new and merits careful consideration by regulators.¹⁶² The CAA was therefore correct to take these circumstances into consideration, and the CAA's departure from the previous approach is wholly justified.

(iii) HAL argues that use of a short-term inflation forecast will have implications on HAL's financing, including encouraging shorter term financing which HAL claims will result in *"increasing refinancing risks and transaction costs"*.¹⁶³ As noted in the AP Intervention Report, there is *"no reason why setting a fixed cost of debt allowance for H7, based on expected H7 inflation, would alter HAL's financing decisions. This is because the cost of debt allowance is fixed for the 5-year period, and HAL is still free to make its own financing decisions for either short or long term debt based on its view of the debt market and preferences of its debt and equity investors"*.¹⁶⁴

(iv) HAL argues that [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]¹⁶⁵ As noted in the AP Intervention Report, *"this would be at the cost of higher prices to consumers at a time when inflation is higher and real*

¹⁶⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5777-5778 / para 106.**

¹⁶¹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5778 / para 108.**

¹⁶² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5778 / para 109.**

¹⁶³ HAL's Notice of Appeal, paragraph 222.1.

¹⁶⁴ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5778 / para 111.**

¹⁶⁵ First Expert Witness Statement of Peter William Hope dated 17 April 2023, Exhibit PH1, **HAL NOA Exhibit PH1 / Tab A3 / p. 58 / para 6.23.**

NON - SENSITIVE

personal incomes under pressure" and would be contrary to the CAA's primary duty.¹⁶⁶

- (b) As outlined in the AP Intervention Report, it is entirely reasonable to use a five-year inflation forecast to calculate the allowed cost of debt for H7, i.e. the next five years.¹⁶⁷ This will reduce any windfall gains or losses during H7 (thereby reducing any volatility in HAL's earnings) and, contrary to the scenario if HAL's proposals of using long term inflation expectations were used, consumers are not exposed to a higher per passenger charge in real terms if inflation exceeds the average.¹⁶⁸ Overall, as described in the AP Intervention Report, "*it is in consumer interests for cost allowances to track more closely actual inflation*".¹⁶⁹

3.6 HAL Ground 3B: The premium on embedded debt

3.6.1 HAL argues that the CAA's estimate of the HAL specific premium on embedded debt is wrong. HAL argues that the premium should be around 49 to 53 bps, rather than the CAA's estimate of 8 bps.¹⁷⁰

3.6.2 Specifically, HAL argues:

- (a) The CAA was wrong to calculate the HAL specific premium with reference to HAL's Class A debt only.¹⁷¹ This argument fails when one considers the gearing levels of HAL's debt. As noted in the AP Intervention Report, the gearing implied by HAL's Class A debt is already above the CAA's 60% notional gearing level (as illustrated in Table 3 of the AP Intervention Report).¹⁷² As explained in the AP Intervention Report, the CAA was therefore "*correct to ignore HAL's Class B debt*" including because consideration of HAL's Class B debt

¹⁶⁶ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5778-5779 / para 112**; *Civil Aviation Act, 2012, BA NOA / Tab 55 / p.4287 / paras 1(1)*.

¹⁶⁷ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5776-5777 / para 100-102**.

¹⁶⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5776 / para 101**.

¹⁶⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5779 / para 113**.

¹⁷⁰ HAL's Notice of Appeal, paragraph 249; CAA, *CAP2524D: H7 Final Decision: Section 3 on the financial framework*, 8 March 2023, **BA NOA / Tab 4 / p.147 / Chapter 9**.

¹⁷¹ HAL's Notice of Appeal, paragraph 222.2.

¹⁷² AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5780-5781 / para 117 and Table 3**.

NON - SENSITIVE

*“would expose consumers to an unnecessary increase in aeronautical charges to cover a higher cost of debt”.*¹⁷³

- (b) The CAA underestimated the cost of foreign currency swaps related to HAL’s non-sterling debt.¹⁷⁴ As explained in the AP Intervention Report, a notional company might not need access to non-sterling debt markets to the same extent as HAL does¹⁷⁵ – “[t]he 60% notionally geared company would only use non-sterling debt if it was the cheapest debt solution after taking account of the additional costs of accessing non-sterling debt markets, including the foreign exchange swap costs”.¹⁷⁶

3.6.3 HAL proposes alternative methodologies to calculate the premium. It proposes the mid-point of two alternative values (51 bps).¹⁷⁷ HAL’s proposed remedy contains multiple errors, specifically:

- (a) This value is derived from HAL’s actual debt issuance and actual traded debt (instead of notional debt with lower notional gearing).¹⁷⁸
- (b) HAL, erroneously, includes Class B debt in its consideration of new debt. Inclusion of HAL’s Class B debt brings the gearing levels above the 60% level for the notional company.¹⁷⁹
- (c) For HAL’s Class A debt, reference to the A-rated iBoxx index is a departure from HAL’s Class A ratings of BBB+ and A- (from S&P and Fitch respectively).¹⁸⁰ As noted in the AP Intervention Report, *“this will overstate the premium”*.¹⁸¹

¹⁷³ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5780 / para 117**.

¹⁷⁴ HAL’s Notice of Appeal, paragraph 254.

¹⁷⁵ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5781 / para 118**.

¹⁷⁶ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 5 / p.5781 / para 119**.

¹⁷⁷ HAL’s Notice of Appeal, paragraph 255 and 256.

¹⁷⁸ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5781 / para 120**.

¹⁷⁹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5781 / para 120**.

¹⁸⁰ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5781 / para 120-121**.

¹⁸¹ AP Intervention Report, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 55 / p.5781 / para 120-121**.

4. HAL'S FOURTH GROUND: AK FACTOR

- 4.1.1 BA seeks permission to intervene on this ground, and submits that it is necessary and desirable that it be permitted to do so because:
- (a) BA has engaged throughout the previous six years in the process of consultation which led to the introduction of the AK-factor;
 - (b) BA is well placed to address factual errors, inaccuracies, and incorrect characterisations in HAL's Appeal regarding the AK-factor;
 - (c) BA (along with Delta and Virgin) has commissioned an expert report by AlixPartners which critically evaluates HAL's evidence in relation to the AK-factor; and
 - (d) BA and its customers would be directly and significantly adversely affected, if HAL should succeed in its appeal regarding the AK-factor.
- 4.1.2 BA opposes HAL's appeal in relation to the AK-factor, and supports the CAA's decision to align HAL's revenues with what it was entitled to recover in 2020 and 2021 under the Q6 price control. In order to assist the CMA, BA sets out below its specific observations, corrections and evidence relevant to HAL's AK-factor ground, based on its own knowledge and expertise and the AP Intervention Report.
- 4.1.3 BA submits at the outset that it is clear HAL's repayment of its significant over-recovery is in the interests of consumers. However, HAL takes the contrary position, stating that it is "*unreasonable*" and "*divorced from reality*" (paragraph 275 of HAL's Notice of Appeal) to suggest that the CAA's action is necessary on this basis. Looking at HAL's Appeal as a whole, it is noteworthy that when HAL under-recovers in respect of the period from 2014 to 2019, it wants consumers to make good its losses and considers it in their best interests to do so (i.e. where HAL is subject to downside risks); but when HAL over-recovers in respect of the period from 2020 to 2021, it considers that consumers (including, for these purposes, airlines) have no right to any return.
- 4.1.4 In relation to the AK-factor, this means that HAL must argue against the application of a straightforward and well-established correction factor or 'true-up' mechanism which reflects normal regulatory practice¹⁸² and results in what BA considers should be an uncontroversial outcome. HAL itself helped to create

¹⁸² CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, BA NOA / Tab 4 / p.248 / para 14.31.

the ‘true-up’ mechanism in respect of Q6 regulatory settlement for the period from 2014 to 2019, as discussed at paragraph 4.1.7(a) below.

4.1.5 By way of brief summary at the outset:

- (a) The **K-factor** in New Licence Condition C1.24 of HAL’s Licence sets out the level of over-recovery or under-recovery on a per passenger basis. This over-recovery is when HAL exceeds the maximum allowable yield (**MAY**) permitted on a per passenger basis (also referred to as over-yielding). The under-recovery is when HAL does not achieve the MAY on a per passenger basis. This over/under-recovery generally reflects a change in mix of actual passengers and movements compared to the forecasts used to set the airport charges for that relevant year.¹⁸³ This is a long-standing adjustment mechanism, as more fully set out below.
- (b) The **Additional K-factor** (the **AK-factor**) in New Licence Condition C1.22 of HAL’s Licence¹⁸⁴ is an additional adjustment mechanism included in the H7 Final Decision to compensate for HAL’s over-recovery of revenue from airport charges against the MAYs in 2020 and 2021. As the CAA set a single number as the MAY for the 2022 holding price cap, the over-recovery in 2020 was not applied at that point, and as a result there are two years’ worth of K-factor corrections to apply.¹⁸⁵ The H7 Final Decision is clear that the K-factor adjustments in respect of 2020 and 2021 (which would have fed into the calculation of the price caps for 2022 and 2023, respectively) were not made as a result of the CAA’s use of simplified interim price caps for those years, and “[a]s such the adjustments to reflect the price controls for those years remain outstanding”.¹⁸⁶

4.1.6 As set out in the AP Intervention Report, HAL’s Appeal in respect of the AK-factor focuses on a number of elements of the adjustment formula, namely: (i) the development capex adjustment; (ii) the business rates revaluation adjustment; and (iii) overyielding as against the MAY. Essentially, the

¹⁸³ HAL, Heathrow Airport – Airport Charges for 2020, Consultation Document, exhibited to this Notice of Intervention and marked **NOI / Tab 26 / p.966 / para 9.1**; and HAL, Heathrow Airport – Airport Charges for 2021, Consultation Document, exhibited to this Notice of Intervention and marked **NOI / Tab 27 / p.1020 para 8.1**;

¹⁸⁴ CAA, CAP2524E2: H7 Final Decision: Appendix C BA NOA / **Tab 6 / p.284 / para C38 and C39**.

¹⁸⁵ HAL, Heathrow Airport – Airport Charges for 2023, Consultation Document, 22 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 28 / p.1065 / para 7.1.2**.

¹⁸⁶ CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, **BA NOA / Tab 4 / p.249 / para 14.39**.

argument put forward by HAL is that neither elements (i) and (ii) “*can be described as over-recovering revenue in any meaningful way*” and whilst (iii) “*can more easily be understood as overyielding*”, it should still not be returned.¹⁸⁷ This is on the basis that HAL could not benefit from any “*windfall gains*” as it incurred losses in 2020-21. HAL states that while the correction factor is “*intended to prevent over-recovery, issues arise when outturn passengers are very low*”¹⁸⁸ as occurred during the Covid-19 pandemic. As a result, HAL considers that these revenue adjustments should not be applied – they are “*neither required nor justified for 2020/21*”¹⁸⁹ and “*it is perverse and irrational to conclude that there was an over-recovery*”¹⁹⁰ – due to the “*catastrophic financial performance*”¹⁹¹ for HAL. Nor has “[t]he CAA ... explained how these adjustments protect consumers”.¹⁹²

4.1.7 In terms of factual errors, inaccuracies and incorrect characterisations in HAL’s Appeal regarding the AK-factor ground of appeal, BA wishes to draw the CMA’s attention to the following:

- (a) HAL agreed and accepted the K-factor mechanism as part of the Q6 regulatory settlement. It is, by its own admission, “*consistent with the approach taken in Q6 and earlier periods*”¹⁹³, and this is echoed in the AP Intervention Report.
- (b) The CAA’s holding and interim price caps temporarily deferred the application of a K-factor pending finalisation of the H7 price control and in order to support HAL’s short-term working capital. However, as set out in the AP Intervention Report, the CAA made clear that it anticipated further adjustments in order to account for the correction factor. Specifically, the CAA stated that while the condition of the simplified interim price cap would “*not include any adjustment arrangements for corrections for any over recovery against the maximum yield in 2020*”, the CAA would “*replace these adjustment factors into Condition C1 (Price Control) and will take these factors into account in the truing up*

¹⁸⁷ HAL’s Notice of Appeal, paragraph 278.

¹⁸⁸ HAL’s Notice of Appeal, paragraph 270.

¹⁸⁹ First Witness Statement of Michael John King dated 17 April 2023 HAL NOA / Tab 2 / p.221-222 / para 182.

¹⁹⁰ First Witness Statement of Michael John King dated 17 April 2023 HAL NOA / Tab 2 / p.222 / para 183.

¹⁹¹ HAL’s Notice of Appeal, paragraph 270.

¹⁹² First Witness Statement of Michael John King dated 17 April 2023 HAL NOA / Tab 2 / p.223 / para 189.

¹⁹³ First Witness Statement of Michael John King dated 17 April 2023 HAL NOA / Tab 2 / p.218 / para 165.

of the holding cap against the price control we put in place following our Final Decision for H7".¹⁹⁴

- (c) Despite HAL's suggestions to the contrary, there nothing new or novel about the AK-factor – save for the CAA's amendment to allow HAL to spread the relevant adjustments over a number of Regulatory Years.¹⁹⁵ As HAL itself has previously stated, this "*permits Heathrow to determine how much of the 2020 and 2021 over-recoveries are returned in the 2023 airport charges, so long as the over-recoveries are returned in full by no later than the 2026 airport charges*".¹⁹⁶

4.1.8 Nor is the AK-factor retrospective for the reasons set out by the CAA in the H7 Final Decision.¹⁹⁷ It is, as described in the AP Intervention Report, a continuation of an agreed formula from previous price controls and simply secures that the revenues HAL has generated in 2020 and 2021 align with the price control obligations HAL was subject to at that time.

4.1.9 HAL makes a number of erroneous statements in relation to the K-factor and the AK-factor which the CMA may find it useful to note:

- (a) HAL states: "*The purpose of a K-factor is to correct for any over or under-recovery of revenue relative to efficiently incurred costs ... (as reflected by the per passenger yield cap)*"¹⁹⁸. However, HAL then cites figures concerning total aeronautical charges and operating losses in support of its argument that the K-factor was not necessary to protect consumers against windfall gains. This is a misdirection by HAL as to the relevant metric. As set out in the AP Intervention Report, the CAA's adjustment factor is clearly intended to ensure that the correct yield per passenger is recovered.
- (b) HAL states that the "*(A)K-factor is relatively crude tool that works sufficiently well in years where deviations between plan and outturn are small but breaks down in years where deviations are large*". This is also incorrect. The MAY is per passenger, so the deviation per passenger is the only relevant factor. The mechanics of the "tool", insofar as it

¹⁹⁴ CAA, CAP2524E2: H7 Final Decision: Appendix C BA NOA / Tab 6 / p.268 / para C14-C15.

¹⁹⁵ CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, BA NOA / Tab 4 / p.249 / para 14.35.

¹⁹⁶ HAL, Heathrow Airport – Airport Charges for 2023, Consultation Document, 22 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 28 / p.1059 / para 2.9.2.

¹⁹⁷ CAA, CAP2524D: H7 Final Decision: Section 3 on the financial framework, 8 March 2023, BA NOA / Tab 4 / p.248 / para 14.32.

¹⁹⁸ HAL's Notice of Appeal, paragraph 275.

NON - SENSITIVE

concerns the per passenger yield cap, are unchanged by deviations between plan and outturn.

- 4.1.10 Similarly, HAL states that the *“logic behind the calculation breaks down in extreme years where large deviations in revenue clearly require adjustments to expenditure as well that cannot be accommodated by the (A)K-factor formula”*¹⁹⁹. BA submits that this is the point of the capex adjustment element of the formula and, moreover, that the CAA was fully aware of the ‘extreme years’ argument when it constructed the AK-factor mechanism.
- 4.1.11 HAL states that, even if no revenue was recovered in a given year, the AK-factor would still calculate an over-recovery. Whilst this is correct, HAL fails to acknowledge that any such over-recovery would be calculated on actual passenger numbers through the airport, so would be negligible.
- 4.1.12 Nor does HAL draw attention to the fact that the application of a correction factor can result in a positive adjustment. Indeed, it is noteworthy that HAL is not appealing the K-factor for the H7 period (2022 and beyond)²⁰⁰ or appealing other elements of the formula of potential benefit to HAL, such as the bonus factor (which allows HAL to recover a bonus when performance on certain service quality measures exceeds a specified service standard).
- 4.1.13 In relation to airlines, HAL states that they *“deliberately chose to incur high per person charges because it made commercial sense for them, often due to other revenues such as from cargo. It would be inappropriate ... to require Heathrow to return the additional charges to airlines”*²⁰¹. This is partial at best, as the airlines argued strongly against the level of the interim holding cap which the CAA proposed in both consultation processes. Furthermore, the operation of low utilisation flights during the Covid-19 pandemic was simply an example of airlines trying to maintain service where demand existed. It is also highly relevant to note that during the pandemic HAL benefitted from significantly greater commercial revenues from cargo-only flights than envisaged at the Q6 price control. As noted in the AP Intervention Report, this helped reduce HAL’s losses, and HAL has not appealed other elements of the formula which have proven advantageous to it.

¹⁹⁹ HAL’s Notice of Appeal, paragraph 280.

²⁰⁰ BA notes that HAL is reporting an achieved maximum yield per passenger of £29.66 in 2022 (against the MAY of £30.19). This amounts to a c.£33m under-recovery that will result in a K-factor adjustment in 2024 which will increase the maximum yield by about £0.42 per passenger (based on a passenger forecast of 78.9 million in line with the H7 Final Decision) - **Decision / Tab 1 / p.14 / Table 1 at para 41.**

²⁰¹ HAL’s Notice of Appeal, paragraph 286.

4.1.14 In terms of the consumer interest, and as the AP Intervention Report makes clear, HAL has done nothing to “earn” these over-recovered revenues and its arguments can be summarised and addressed as follows:

- (a) HAL wants to retain sums intended for, and thereby earn a return on, capex that HAL has not spent. However, that is contrary to a key principle of incentive-based regulation, namely that higher returns should reflect superior efficiency. As set out in the AP Intervention Report, it is clear from HAL’s Appeal that its reduction in capex was not due to superior efficiency, but was implemented in order to manage its shortfall in revenues.
- (b) HAL wants to retain 100% (rather than 20%, as specified in the formula) of the benefit from lower business rates – thus receiving a costs allowance for costs it has not paid. Again, this is contrary to incentive-based regulation.
- (c) HAL considers it to be an error by the CAA for it to correct for the excess yield per passenger actually recovered by HAL compared with the MAY, due to the lower-than-expected level of passengers per flight during the pandemic. However, as set out in the AP Intervention Report, the CAA’s correction factor *“is clearly intended to ensure that the correct yield per passenger is recovered; i.e charges are too high (or too low) on a per-passenger basis. HAL seems to wish to put this to one side in order to obtain some retrospective protection against traffic risk”*, which is inappropriate. Furthermore, *“airlines running planes with low load factors during 2020-2021 led to airlines suffering large losses, whilst generating substantial consumer benefits for those passengers who were able to travel on those flights”* (and financial benefit to HAL in terms of cargo revenues, as set out above).
- (d) With regard to HAL’s statement that returning the relevant revenues *“would almost entirely unwind the effect of the CAA’s present RAB adjustment”*²⁰², this is effectively a request by HAL for a Covid-19 pandemic related adjustment on top of the existing £300 million RAB adjustment (with which the BA disagrees, as set out in its own appeal on this ground). However, the CAA clearly addressed this issue in the H7 Final Decision: *“... we do not consider that a further adjustment to reduce HAL’s previously established obligations to pay back the over*

²⁰² HAL’s Notice of Appeal, paragraph 276.

NON - SENSITIVE

recovery of revenue it has made would be appropriate or consistent with our statutory duties."²⁰³

- (e) BA notes HAL's statement that "*errors in the CAA's calculation means that [the CAA] has substantially underestimated the impact*"²⁰⁴ of the AK-factor adjustment and HAL's admission that it has over-recovered to a greater extent than the CAA previously understood. Specifically, HAL indicates that applying the yield calculation with the correct input data suggests that HAL over-recovered revenues of circa £91.4m in 2020 and £166m in 2021 – **£258m in total**.²⁰⁵ This revised figure from HAL is consistent with the AP Intervention Report and the airlines' own calculations based on the information available to them.
- (f) BA submits – and assumes that the CAA will agree – that it is important these errors are corrected as part of the CMA appeal process, including so the CMA can properly determine the scale of the consumer issues at stake flowing from HAL's arguments.
- (g) Apart from such corrections, it BA contends that HAL's arguments in relation to the AK-factor are without merit and should be dismissed.

5. HAL'S FIFTH GROUND: CAPEX INCENTIVES

5.1 Overview

- 5.1.1 HAL's fifth ground of appeal contends that the CAA erred by implementing a forward-looking capital expenditure (referred to in the H7 Final Decision as "**capex**") incentive framework.
- 5.1.2 BA seeks permission to intervene on this ground, and submits that it is necessary and desirable that it be permitted to do so because:
 - (a) BA has considerable experience, over many years, of working with the operators of Heathrow Airport in relation to a suite of capital projects;
 - (b) BA has engaged throughout the previous six years in the lengthy process of consultation which led to the H7 capex incentives framework;

²⁰³ H7 Final Decision Section 3 on the Financial Framework, 8 March 2023, paragraph 14.33 **BA NOA / Tab 4 / p.249 / para 14.33.**

²⁰⁴ First Witness Statement of Michael John King dated 17 April 2023, **HAL NOA / Tab 3 / p.220 / para 177.**

²⁰⁵ *Ibid.*

NON - SENSITIVE

- (c) the approach which airlines are said to have taken to the management of capex in the past is the subject of criticism by HAL, and which BA (as the largest airline operating at Heathrow Airport) ought to be permitted to respond to; and
- (d) BA ought (for similar reasons) to be permitted to respond to HAL's assertions as to the approach which airlines are likely to take in the future (and the extent to which their interests are said to diverge from those of passengers).

5.1.3 In particular, BA wishes the opportunity to set out why:

- (a) It supports the CAA's assessment of the need for change, which reflects BA's own experience of the shortcomings of the Q6 *status quo*.
- (b) It expects that the capex incentives process to be a proportionate, flexible and effective means of ensuring that capex is effectively and efficiently made.
- (c) HAL's contentions that BA (or any other airline) would in some way be incentivised to act contrary to the interests of airport users are simply incorrect.
- (d) From its involvement in the extensive consultation which preceded the adoption of the H7 capex incentives regime, BA considers the contention that the CAA failed to "have regard" to the principles of better regulation to be baseless.

5.1.4 These are taken in turn below, as supplemented by further explanation in GM2 (and also adopting the IATA Letter).²⁰⁶

5.2 The need for change

5.2.1 BA strongly supports the CAA's assessment of the need for change. This is because it is demonstrably not the case that the "*existing regime was working successfully and efficiently, and in the interests of users of air transport*".²⁰⁷

5.2.2 Under the existing process, investment decisions go through a gateway process known as the "Heathrow Gateway Lifecycle". That process relies on *ex-post* review of projects sometimes many years after the point (known as Gateway 3, or "G3") where the business case is agreed by airlines. BA's experience here

²⁰⁶ IATA Letter, Capex Governance, 19 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 40 / p.1769-1775**.

²⁰⁷ HAL's Notice of Appeal, paragraph 289.

accords with the conclusions reached by the CAA following its extensive consultations. In particular:

(a) The *ex post* review of projects, often many years after the G3 decision, is difficult and time consuming. It involves proving a negative, i.e. that the spend was inefficient, rather than assessing whether the spend was efficient by reference to transparent delivery obligations.²⁰⁸ Furthermore, this review occurs sometimes many years after the project was initiated. For example, HAL's main passenger tunnel project initiated during Q5 remains unfinished, with only preliminary works conducted. Any *ex post* review of this significant project will not take place for several years, by when many of those with the institutional memory necessary to contribute to a review may have moved onto other employment.

(b) It was also inefficient and ineffective. BA's experience is that it is extremely challenging to conduct a meaningful review of the efficiency of a project as matters stand, both because of the passage of time (especially in relation to larger, long-running, projects) and because of what the CAA rightly described as the "*inevitable asymmetry of information between the regulated company and regulator*".²⁰⁹ The difficulties faced by airlines and the CAA under the status quo in this regard are clear. [REDACTED]

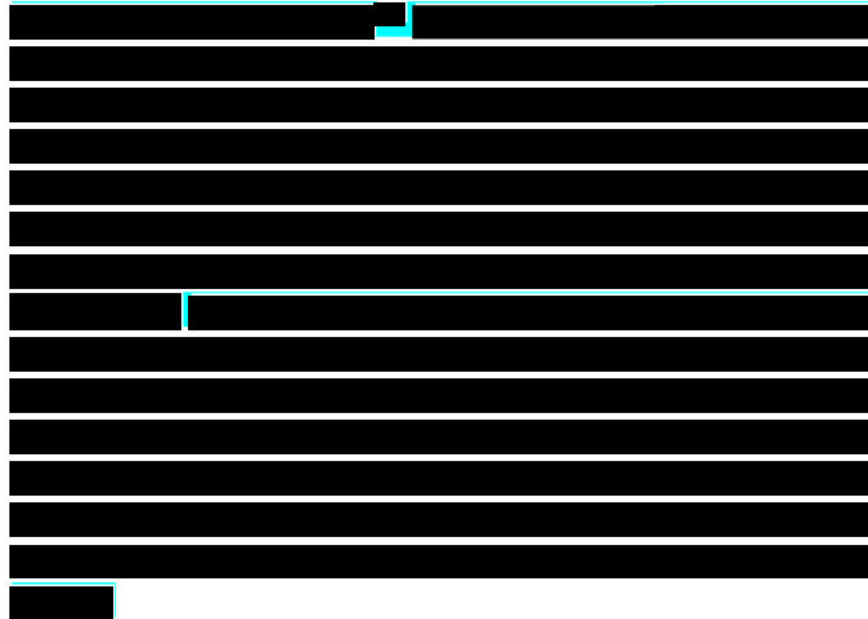
[REDACTED]

(c) Difficulties also arise at the front end of the process. Throughout Q7 HAL has failed to provide the airlines with sufficient details of its capital plans for the airlines to conduct a meaningful *ex ante* assessment of the potential for projects to achieve value for money. [REDACTED]

²⁰⁸ This difficulty was noted in the CAA, *CAP1964: Economic regulation of Heathrow: working paper on the efficiency of HAL's capital expenditure during Q6*, 22 September 2020, exhibited to this Notice of Intervention and marked **NOI / Tab 36 / p.1672 / paras 1.62-1.63**, noting that its consultants (Arcadis) had identified potential inefficiency in three projects, and that "HAL's actions may have contributed to the inefficiency of those projects" but that "*the impact of the inefficiency in these cases was difficult to quantify and/or difficult to clearly attribute to HAL*".

²⁰⁹ CAA, *CAP2524C: H7 Final Decision Section 2 on the Key Price Control 'Building Blocks'*, 8 March 2023, **BA NOA / Tab 3 / p.126 / para 7.22**.

²¹⁰ Letter from Airline Community Letter to CAA re Capital Efficiency, December 2018, **NOI / Tab 53 / p. 5368**.



5.2.3 Overall, BA considers that it is simply good project and program management for HAL to set delivery obligations for every project around cost, scope and schedule. By contrast, its experience is that the Q6 regime - without delivery obligations - simply leads to inefficiency, with HAL assuming no meaningful risk for poor delivery performance.

5.2.4 As against this, HAL points to a number of matters which are said to demonstrate the efficiency of projects delivered during Q6. Here, the evidence offered is unable to bear the weight HAL wishes to place upon it, as it suffers from the limitations identified above. In particular, all of the selected evidence is the result of *ex post* analysis which does not provide evidence that those projects were – in fact - delivered efficiently. In particular:

- (a) The “independent reviewers” referred to at paragraph 311 and paragraph 312 of the HAL NOA were not tasked with “confirming the efficiency” of capex during Q6, nor were they in a position to do so. Rather, what they demonstrate is more limited, and captured by the quotation at paragraph 311.1.2 – that “the majority” of projects were “delivered within budget (or revised budgets encompassing scope increase) and within schedule” (based on a review of end-state delivery, where both schedule and cost may have materially changed during the project lifestyle). This is not an assessment of efficiency. The Steer report

²¹¹ Airline Comments on the HAL RBP Update 1 Capital Plan, 1 September 2021, exhibited to this Notice of Intervention and marked NOI / Tab 38 / p.1748.

²¹² Airline Comments on the HAL RBP Update 1 Capital Plan, 1 September 2021, exhibited to this Notice of Intervention and marked NOI / Tab 38 / p.1756 / page 9.

referred to at paragraph 312, for example, complimented HAL's controls on costs and finances, but this does not equate to efficiency or value for money. It does not address (nor did it have the metrics to address), for example, whether quality compromises were made or projects were de-scoped (and therefore provided reduced consumer benefits) so as to bring them within budget.²¹³ Nor would it determine, or even consider, whether the projects were themselves "gold plated" (i.e. unnecessarily went beyond what was required to deliver the desired consumer benefits). For example, during Q6 (as extended by iH7) HAL, when delivering a project for the installation of automated bathroom cleaning robots, elected to install an expensive system which cleans airport bathrooms to hospital operating theatre standards.²¹⁴ Notwithstanding that the measures were implemented during the Covid-19 pandemic, the question of whether that scope is warranted simply is not considered at the *ex post* review stage.

- (b) The absence of disputes during Q6 is also not a metric of efficiency. However, BA would note that the fact that HAL is able to point to this does not support its assertion that airlines either have in the past (or are likely to) adopt an obstructive and adversarial approach to the delivery of capital projects.²¹⁵ The reality is that airlines will only escalate a dispute to the CAA where there is good reason to do so.
- (c) The fact that HAL received industry recognition for certain of the Q6 projects is, again, not evidence of efficiency. The fact that HAL won a "Technology Project of the Year Award" in respect of an automatic number plate recognition system installed by a third party does not provide any support for the proposition that the project was an efficient use of capital expenditure.²¹⁶ A project may well be innovative and at the same time provide poor value for money by reference to the consumer benefits it delivers. What was not considered by the body which granted this award was whether this project delivered value for money to consumers (by reference e.g. to other systems which would achieve the same end result, but at less cost). Neither can the considerations which an awarding body does take into account, nor the

²¹³ HAL's Notice of Appeal, paragraphs 311-312.

²¹⁴ See the Second Witness Statement of Gavin Molloy (GM2), paragraph 17.

²¹⁵ See, for example, HAL's Notice of Appeal, paragraphs 341 and 342.

²¹⁶ HAL's Notice of Appeal, paragraph 311.3.

NON - SENSITIVE

conclusions which it reaches, in respect of a given project be said to extend to all other capex projects undertaken by HAL.

- 5.2.5 It is because of these shortcomings with the *status quo* that BA supports the CAA's determination, following a lengthy consultation process,²¹⁷ that HAL is not at present appropriately incentivised to ensure the efficient delivery of capex.

5.3 Proportionality

- 5.3.1 The approach settled upon by the CAA provides for the assessment of actual performance against *ex ante* baselines and delivery obligations, permitting a more transparent assessment of Heathrow's capital efficiency. This is achieved by the adoption of a framework with the following core features:

- (a) an incentive rate of +/-25% will be applied to any under/overspend against a project's budget agreed as part of the capex governance process;
- (b) each project will be required to have agreed delivery obligations ("DOs") relating to the project's expected output(s), quality requirements and timing;
- (c) if DOs are not met, there will be a proportionate adjustment to HAL's revenues to protect consumers from consequences of non-delivery; and
- (d) there will be a cap on the overall level of capex, but with the flexibility to make adjustments where appropriate.

- 5.3.2 BA considers this to be a proportionate, flexible and effective means of ensuring that capex is effectively and efficiently used. Furthermore, it will render the

²¹⁷ This process now spans six years and includes: CAA, *CAP1541: Consultation on Core Elements of the Regulatory Framework to Support Capacity Expansion at Heathrow*, June 2017, **NOI / Tab 30 / p.1112**; CAA, *CAP1658: Economic Regulation of Capacity Expansion at Heathrow, Policy Update and Consultation*, April 2018, exhibited to this Notice of Intervention and marked **NOI / Tab 31 / p.1190**; CAA, *CAP1674: Economic Regulation of Capacity Expansion at Heathrow, Working Paper on the Cost of Capital and Incentives*, May 2018, exhibited to this Notice of Intervention and marked **NOI / Tab 32 / p.130**]; CAA, *CAP1876: Economic Regulation of Heathrow Airport Limited, Further Consultation on Regulatory Framework and Financial Issues*, January 2020, exhibited to this Notice of Intervention and marked **NOI / Tab 34 / p.1508**; CAA, *CAP1940: Heathrow Economic Regulation Policy Update and Consultation*, 23 June 2020 **BA NOA / Tab 45 / p.3925**; CAA, *CAP1951: Economic Regulation of Heathrow Airport Limited, Working Paper on Capital Expenditure Efficiency Incentives*, August 2020, exhibited to this Notice of Intervention and marked **NOI / Tab 35 / p.1590**; CAA, *CAP2139: Economic Regulation of Heathrow Airport Limited Consultation on the Way Forward*, 27 April 2021, **BA NOA / Tab 46 / p.4042**; CAA, *CAP2265D: Economic Regulation of Heathrow Airport Limited, H7 Initial Proposals, Section3: Incentives and Other Issues*, October 2021, exhibited to this Notice of Intervention and marked **NOI / Tab 37 / p.1692**; and CAA, *CAP2365C: Economic Regulation of Heathrow Airport Limited H7 Final Proposal Section 2, Building Blocks*, June 2022, **BA NOA / Tab 28 / p.1458**.

capex process transparent – it will be clearly visible to both airlines and the CAA what is going to be delivered for the budget allocated and for this to form the baseline for review of what is actually delivered, leading to the best possible outcome for consumers in terms of product delivered and value for money. What HAL asks the CMA to do, by contrast, is to overturn the entirety of the DO regime and revert to the Q6 *status quo*. Such an approach could only be justified if there was a clear error of law or discretion by the CAA. However, HAL's grounds of appeal entirely fail to identify any such error.

5.3.3 Rather, having failed to persuade the CAA as to the merit of its position during the lengthy consultation process, HAL is again maintaining the position that the capex incentive regime is disproportionate. At one level, HAL's complaints seem to relate to *any* requirement to seek airline agreement in relation to capital projects.²¹⁸ However, airline agreement is a feature of the Q6 gateway process, and is an inevitable feature of any conceivable system for the effective control of capex. What has changed with H7 is that it will be required to agree baselines and delivery obligations for capital projects. There can be no principled objection to such a requirement, which is why HAL's submissions amount (in large part) to a counsel of despair. This should be rejected. The CAA has consulted, assessed the workability of the proposals and (rightly) concluded that they are both workable and the best means of ensuring that HAL is appropriately incentivised to effectively target capex.

5.3.4 BA simply does not understand how HAL has formed the view that the new processes will increase the administrative "*workload that Heathrow expects to result from the DO-process by comparison with the work involved in administering triggered Q6 projects by approximately 90-times*", i.e. by **9000%**.²¹⁹ HAL ought already, under the Q6 process, be undertaking the same tasks which it will be required to undertake under the H7 process. In particular, the Q6 process required airlines' approval at G3 stage. The key feature of the H7 changes is a requirement clearly to articulate at that stage the output, quality and timing of the capital investment being approved. This is information that any competent project manager should be able to produce, and simply cannot be said to impose a disproportionate burden on HAL.

5.3.5 Thus, the new processes will require, as is the case at present, the agreement of airlines at G3 stage, based on the provision of information, discussion and agreement.²²⁰ What will change is the incentives for HAL to co-operate

²¹⁸ HAL's Notice of Appeal, paragraph 290.

²¹⁹ HAL's Notice of Appeal, paragraph 321.

²²⁰ Here, BA entirely agrees with the CAA's conclusion that the information required to support the setting of delivery objectives would "*naturally form part of the development of good quality project documentation*

transparently and constructively at this initial stage. This matters because at present HAL is not incentivised to provide information on a timely and transparent basis, which can lead to entirely avoidable delays in reaching agreement. For example, and as further explained in GM2, significant issues arose at [REDACTED]

[REDACTED] Under the H7 process, HAL will be incentivised to share key information on a timely basis to enable the agreement of meaningful delivery obligations²²² which it will, in turn, be incentivised to meet.

5.3.6 HAL also repeatedly suggests that the new proposals will incentivise it to break down projects into smaller projects to remove delivery risk. Here, BA's experience suggests that what HAL will, in fact, be incentivised to do is proper scoping and surveying work at the initial stages of projects to identify issues of the type HAL refer to.²²³ This is not a flaw in the new capex processes, but rather a feature – it will incentivise HAL to take proper steps to ascertain the true scope of (and potential difficulties with) a project before significant costs are incurred.

5.3.7 Finally, BA is confident that the system designed by the CAA is sufficiently flexible to address the variety and complexity of projects undertaken by HAL. The CAA were well aware of the range of projects when it was developing its proposals and it is clearly not the case that each project will involve the same level of resourcing / administration irrespective of size or scope. Furthermore, flexibility is provided by the change control process which will remain in place, recognising that changes in circumstances may justify changes to projects. Past experience demonstrates that airlines approach such requests in a pragmatic and constructive manner. [REDACTED]

as part of the process for any project being considered at G3 and, therefore, information to support the setting of DOs should be reasonably available”, CAA, CAP2524C: H7 Final Decision Section 2 on the Key Price Control 'Building Blocks', 8 March 2023, BA NOA / Tab 3 / p.50.

²²¹ IATA raised this matter with the CAA at the time: see IATA and AOC, *Response to Draft Guidance on Capital Expenditure Governance – CAP2524G H7 Final Determination*, 28 April 2023, exhibited to this Notice of Intervention and marked NOI / Tab 39 / p.1758-1759 / pages 2-3.

²²² Here, BA endorses the CAA's conclusion (at CAA, *CAP2524C: H7 Final Decision Section 2 on the Key Price Control 'Building Blocks'*, 8 March 2023, BA NOA / Tab 3 / p.132 / para 7.27), that it is essential that airlines are “sufficiently well-placed to agree capex budgets”, and that to ensure that this is the case, HAL must “provide airlines with the information and analysis they need to be able to evaluate each project's proposed scope, delivery timetable, cost and benefits adequately for the purposes of a proper assessment at project gateway G3”. Again, this is information that HAL ought already to be providing under the *status quo* to assist with the effective functioning of the G3 process.

²²³ HAL's Notice of Appeal, paragraph 337.

[REDACTED]

[REDACTED] This constructive engagement allowed the project to move ahead without undue delay, and the same process remains available to HAL and the airlines under the CAA's new capex governance framework.²²⁴

5.4 Interests and incentives of airlines

5.4.1 HAL's contentions that BA (or any other airline) would in some way be incentivised to act contrary to the interests of airport users are simply incorrect. Airlines have the direct relationship with consumers and bear the brunt of failings in delivery, and the resulting negative consumer sentiment. This is true at all stages of the customer's experience, from the decision to purchase a ticket to the point at which they leave the airport after collecting their baggage. It is for these reasons that the CAA has rightly recognised that airlines can help to promote efficient and timely investment in the interests of consumers.²²⁵ Indeed, this was an important part of the policy rationale underlying the reforms introduced by the CAA12. As Ministers explained to Parliament at the time: "*it will often be airlines that have the knowledge, motivation and resources to press the case for the improvements that end users want and that hold airports to account ... we take the role of airlines in the process seriously because of the many instances where their interests are aligned with the interests of passengers*".²²⁶

5.4.2 The starting point is that the CAA's regulation of capex is necessary because that expenditure results in increased costs to users of air transport services at Heathrow. The purpose of the capex incentives regime (in respect of which airlines' interests are aligned with those of consumers) is to ensure that such

²²⁴ See the Second Witness Statement of Gavin Molloy (GM2), paragraph 20 and IATA Letter, Capex Governance, 19 May 2023, exhibited to this Notice of Intervention and marked **NOI / Tab 40 / p.1769-1775**.

²²⁵ CAA, *CAP2524G: Draft guidance on capital expenditure governance*, 8 March 2023, paragraph 1.11 **BA NOA / Tab 10 / p.431 / para 1.11**.

²²⁶ Hansard, Civil Aviation Bill Deb. (Bill 275), 28 February 2012, exhibited to this Notice of Intervention and marked **NOI / Tab 9 / p.175-176 / columns 104 - 105**. Concerning the "*important role in the regulatory system [given] to airlines, particularly on the setting of licence conditions and appeals*" due to "*airlines' proximity to passengers' interests*", see Government Response to Transport Committee's Thirteenth Report of Session 2010-12, exhibited to this Notice of Intervention and marked **NOI / Tab 10 / p.190**.

expenditure is incurred efficiently. Whether viewed from the viewpoint of airlines or consumers, when assessing outcomes and outputs of projects, it is clearly sensible that HAL is incentivised to develop projects that have clear ambitions and delivery objectives from inception, firm and measurable objectives set by G3, and produce positive cost/benefit outputs.

- 5.4.3 HAL’s complaint appears to be that it ought not (as a matter of principle) be required to commit at the outset of a project to delivery obligations. In support of this contention, it sought to persuade the CAA that to do so would adversely affect its ability efficiently to deliver its capex programme during H7. This is the argument it maintains on appeal.²²⁷ Here, the CAA has expressly addressed what is necessary in order to “minimise any additional cost and time delay to the delivery of projects”.²²⁸ This is an objective which airlines share, and which they have been working with other stakeholders to achieve.
- 5.4.4 As explained in the H7 Final Decision, since the publication of the Final Proposals, the CAA have been “*engaging with HAL and airlines to understand how the capex governance framework could be improved*”.²²⁹ Airlines have co-operated constructively and in good faith with that engagement, and in particular with the CAA’s investigations as to the scope of work that would be required to implement the capex incentives framework. BA’s engagement included, for example, drafting and sharing draft “Delivery Obligation” documents for consideration by other stakeholders. This process would have been improved had HAL engaged with this process on a more constructive basis, rather than maintaining the reflexive opposition that it maintains in this appeal.
- 5.4.5 That engagement led to the development of *CAP2524G: Draft Guidance On Capital Expenditure Governance*,²³⁰ which forms part of an ongoing consultation by the CAA on proposals for enhancing the current governance arrangements around capex incentives intended to improve the quality of engagement that takes place on capex projects.²³¹ HAL has (consistently with

²²⁷ HAL’s Notice of Appeal, paragraph 294.

²²⁸ CAA, *CAP2524C: H7 Final Decision Section 2 on the Key Price Control 'Building Blocks'*, 8 March 2023, **BA NOA / Tab 3 / p.133 / para 7.29**.

²²⁹ CAA, *CAP2524C: H7 Final Decision Section 2 on the Key Price Control 'Building Blocks'*, 8 March 2023, **BA NOA / Tab 3 / p.133 / para 7.29**.

²³⁰ CAA, *CAP2524G: Draft Guidance on Capital Expenditure*, 8 March 2023, **BA NOA / Tab 10 / p.426**.

²³¹ CAA, *CAP2524A: Economic Regulation of Heathrow Airport: H7 Final Decision – Summary*, 8 March 2023, paragraph 61 **BA NOA / Tab 3 / p.25 / para 61**.

its continued approach of reflexive opposition) sought in its appeal at to criticise those proposals rather than to engage constructively with them.²³²

5.4.6 Insofar as HAL suggests that the requirement to share information and reach agreement at an early stage is problematic, this is misplaced. As explained above, the *status quo* requires agreement between HAL and airlines at the G3 stage (unless HAL decides to proceed ‘at risk’ outside the gateway process). Indeed, [REDACTED] showed (see paragraph 5.3.5 above), it is late provision of information by HAL that is liable to cause delays.

5.4.7 In the event that airlines and HAL reach an impasse, airlines do not have a right to exercise a veto, or frustrate a project which HAL considers is in the interests of users. This is because explicit provision is made for the CAA to act as arbiter in the event that HAL and airlines cannot reach agreement.²³³

5.4.8 HAL’s assertion that airlines do not have the necessary knowledge or experience to contribute to the setting of delivery obligations is entirely misplaced. This can be demonstrated by reference to the contribution which airlines have made to the quality of capex decision-making even under the more limited Q6 arrangements. For example:²³⁴

(a) [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] In this instance, the knowledge and experience of airlines helped to foresee adverse consequences for customers which HAL’s decision-making, which had focused on infrastructure rather than operations, had not taken into account.

²³² HAL’s Notice of Appeal, paragraph 307.
²³³ CAA, CAP2524G: Draft guidance on capital expenditure governance, 8 March 2023, BA NOA / Tab 10 / p.446 / chapter 4.
²³⁴ IATA Letter, Capex Governance, 19 May 2023, exhibited to this Notice of Intervention and marked NOI / Tab 40 / p.1769-1775.

(b) [REDACTED]

[REDACTED] This demonstrates that the knowledge and experience of the airlines extends beyond the capital projects which are directly related to airlines services.

(c) Moreover, the airlines' direct knowledge and experience is complemented in a number of areas through the input of subject matter experts ("SMEs") into the capital expenditure process. [REDACTED]

[REDACTED]

[REDACTED] The introduction activities of SMEs are designed to add value to the engagement and governance process in the early stages of the project and solution development (G0 to G3), involving direct engagement and feedback with HAL and its suppliers.²³⁶ For that process to be effective, it is therefore essential that airlines have sufficient information and are well informed, as the CAA has recognised.²³⁷

5.5 Principles of Better Regulation

5.5.1 From its involvement in the extensive consultation which preceded the adoption of the H7 capex incentive regime, BA considers the contention that the CAA failed to "have regard" to the principles of better regulation to be baseless.²³⁸ The CAA expressly directed itself to the need to have regard to the better regulation principles at paragraph 78 of the first section of the H7 Final

²³⁵ IATA and AOC, *Response to Draft Guidance on Capital Expenditure Governance – CAP2524G H7 Final Determination*, 28 April 2023, and exhibited to this Notice of Intervention and marked NOI / Tab 39 / p.1761-1762 / pages 5-6.

²³⁶ IATA and AOC, *Response to Draft Guidance on Capital Expenditure Governance – CAP2524G H7 Final Determination*, 28 April 2023, and exhibited to this Notice of Intervention and marked NOI / Tab 39 / p.1762 / page 6.

²³⁷ CAA, *CAP2524G: Draft guidance on capital expenditure governance*, 8 March 2023, BA NOA / Tab 10 / p.431 / para 1.11.

²³⁸ The obligation to have "due regard" to the better regulation principles stems from *Civil Aviation Act*, 2012, BA NOA / Tab 55 / p.4287 / paras 1(3)(g) and 1(4). The principles are that regulatory activities should be carried out in a way that is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.

Decision. It went on to explain how it had regard to those principles both in that section, and in paragraph F33 of Appendix F, which explained that:

- (a) We have also had regard to the Better Regulation Principles, in particular that:
 - (i) action is needed for the reasons, and to progress the aims, set out above; and
 - (ii) these Final Proposals are proportionate, having been designed to achieve the aim of addressing the matters set out in those paragraphs in ways that address the need for action without creating any significant increase in the regulatory burden on HAL.²³⁹

5.5.2 The matters set out at paragraph 290.2 of HAL’s Notice of Appeal do not come close to providing a basis for establishing that the CAA has failed to have due regard to the principles of better regulation. An obligation to have “due” regard is not a duty to achieve a particular result, but rather to have the “regard” to the specified matters “*that is appropriate in all the circumstances*”.²⁴⁰

5.5.3 In any event, HAL’s criticisms are misplaced:

- (a) The CAA’s assessment of the necessity of change is clearly set out in the H7 Final Decision at paragraph 7.22.
- (b) The suggestion that the CAA had in some way failed to act in a non-transparent or unaccountable way cannot withstand even the most cursory scrutiny. As explained above, the CAA has consulted over a six-year period, during which time HAL was able to place before the CAA any evidence, and make any representations, it wished. Furthermore, in both the CAA’s H7 Initial Proposals (at Appendix H) and H7 Final Proposals (at Appendix G),²⁴¹ the CAA explained how it had concluded that the capex incentives framework were appropriate having regard to its statutory duties under CAA12.

²³⁹ CAA, CAP2524E3: H7 Final Decision Appendices D-H, 8 March 2023, **BA NOA / Tab 7 / p.227 / page 12.**

²⁴⁰ HAL’s Notice of Appeal, paragraph 290 and *R (on the application of Baker) v Secretary of State for Communities and Local Government* [2009] PTSR 809, exhibited to this Notice of Intervention and marked **NOI / Tab 29 / p.1105 / para 31.**

²⁴¹ CAA, CAP2265E: *Economic Regulation of Heathrow Airport Limited: H7 Initial Proposals*, October 2021, **NOI / Tab 52 / p. 5272**; CAA, CAP2365E3: *Economic Regulation of Heathrow Airport Limited H7 Final Proposals Appendices D-K*, June 2022, **BA NOA / Tab 32 / p. 1928.**

NON - SENSITIVE

- (c) The better regulation principles do not – on any view – entail an obligation to adopt an identical approach to that taken by other airports under different regulatory schemes and (in the case of Dublin Airport) a different regulator. HAL does not address the manifold differences between the regulatory regimes which obtain at those airports (Gatwick, for example, does not have a RAB, nor are charges set by reference to a RAB).

NON - SENSITIVE

6. STATEMENT OF TRUTH

British Airways plc believes that the facts stated in this Application are true.



Signature of Authorised Representative

Elizabeth Anne Hichens

Name of Authorised Representative

Date 22 May 2023