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Draft Terms of Reference for the Independent Review of Heathrow Airport Limited's cost allocation methodology for Other Regulated Charges

Dear Stakeholder

This letter sets out further information on the work we intend to undertake with Heathrow Airport Limited (HAL) and Other Regulated Charges (ORC) users, both airline and non-airline, following our decisions earlier this year on the H7 price control. It describes the broad scope of the work that we expect the independent review of HAL's ORC cost allocation methodology to consider and sets out a draft terms of reference for stakeholder comment.

Background

The H7 Price Control Final Decision assumed ORC pricing would operate broadly on a "marginal cost" basis and that there would be no cross-subsidy from airport charges to non-airline users. As a result, the allocated costs and fixed infrastructure costs (known as "annuities") for the Specified Facilities that fall within the scope of ORCs are treated differently between users:

- the airlines' share of these fixed costs and annuities is now recovered through Airport Charges; and
- non-airlines' share (such as for staff car parking, electricity and water) form part of the ORCs.

This approach is in consumers' interests by excluding costs solely related to non-airline activities from the scope of the Airport Charges.

The H7 Final Decision¹ introduced Licence Condition C2.4² which requires HAL to procure an independent review of the cost allocation methodology it uses for setting ORCs. This review will cover the appropriateness of the cost allocation methodology used by HAL to validate whether it ensures that the costs of the “Specified Facilities” covered by ORCs are allocated between airlines and non-airline users on a “fair and reasonable” basis. The CAA will set the terms of reference of the review following consultation with stakeholders.

The appendix to this letter sets out a draft terms of reference for the independent review for stakeholder comment.

Independent Review approach

The proposed timeline for the independent review process is as follows:

- 1 November 2023 – CAA consultation on draft terms of reference for comment;
- 28 November 2023 – deadline for comments;
- Mid-December 2023 – CAA to publish final terms of reference;
- January/February 2024 – HAL procures and appoints the independent reviewer following engagement with the CAA and ORC users;
- March-May 2024 – independent review of HAL ORC cost allocation methodology;
- End May 2024 – independent review report submitted to CAA and ORC users.

The independent reviewer will be expected to have expertise in accounting practices as well as a good understanding of airport operations. In procuring the independent reviewer, HAL will need to assure their independence and that there are no conflicts of interest and/or that appropriate mitigations are put in place to manage any conflicts of interest.

The output of the study will be a report provided to the CAA, which will also be shared with the ORC governance group and other ORC users. The independent reviewer should look to engage with HAL, the CAA and ORC users in the course of the review.

¹ CAP 2524C para 8.52 “our final decisions on ORC governance and dispute resolution require HAL to: appoint an independent person, having consulted and sought agreement with ORC users and the CAA, to review HAL’s ORC prices including the appropriate allocation of fixed costs and annuities in the implementation of HAL’s marginal cost pricing for ORC services;”

² Heathrow Licence Condition C2.4 states that:

“The Licensee shall facilitate and pay for an independent review of the appropriateness of the cost allocation methodology to validate that the cost allocation methodology ensures that the costs of the Specified Facilities are allocated between airlines and non-airline users of the Specified Facilities on a fair and reasonable basis. The terms of reference of the review shall be set by the CAA after consultation with the Licensee and users of the Specified Facilities. The independent reviewer for this purpose will be appointed by the Licensee following consultation with the CAA and users of Specified Facilities, and shall report to the CAA and copies of that report shall be made available to users of the Specified Facilities. The Licensee may recover its costs for this review through ORC charges.”

The independent review will need to be completed in good time for any issues to be addressed prior to the next ORC pricing consultation for 2025 due in September 2024. To facilitate this, the independent review will need to be completed by 31 May 2024 at the latest.

Next steps

We welcome views on the draft terms of reference as set out in the appendix. We will fully consider stakeholder responses before setting the final terms of reference for the independent review. Please e-mail responses to economicregulation@caa.co.uk by no later than 5pm on Tuesday 28th November 2023.

We cannot commit to take into account representations received after this date. We expect to publish the responses we receive on our website as soon as practicable after the period for representations expire. Any material that is regarded as confidential should be clearly marked as such. Please note that we have powers and duties with respect to information under section 59 of the Civil Aviation Act 2012 and the Freedom of Information Act 2000.

This letter and appendix will also be published on the CAA website.

Yours sincerely,

David Milford

David Milford

Senior Policy Advisor

APPENDIX

Draft terms of reference

Scope of the independent review

The independent review will consider available evidence and, as appropriate, comment on and make recommendations for improvement of the cost allocation methodology for ORCs. The review will:

1. Determine whether the costs to which the cost allocation methodology applies have been sufficiently clearly and robustly identified, are appropriate and have been assessed at a reasonable level of detail to support a robust cost allocation methodology. This will determine whether the right costs are used in the methodology;
2. Assess HAL's approach to the allocation of costs to each Specified Facility for which it charges ORCs. This will determine whether the right costs are allocated to each Specified Facility;
3. Assess HAL's approach to the allocation of costs to airline and non-airlines users of the Specified Facilities to determine whether it is fit for purpose to allocate costs between airline and non-airlines users on a fair and reasonable basis. This will determine whether the costs are correctly allocated between airline and non-airline users of each Specified Facility across both ORC's and the Airport Charge; and
4. In the light of the above, assess the appropriateness of HAL's approach to the allocation of fixed costs and "annuities" to each Specified Facility and between airline and non-airlines users.

In assessing whether the costs are allocated on a fair and reasonable basis, the review shall consider whether the allocation of those costs reflect the ORC charging principles³, including those of "transparency", "cost reflectivity" and that the "user pays".

The review shall also consider:

- the operation of the cost allocation methodology used by HAL to set ORC charges for 2024;

³ CAP2591 Page 13, ORC protocol principles

- the extent to which HAL’s cost allocation methodology is informed by its obligations under competition law and other relevant legislation;
- whether HAL has considered any other matters when devising its cost allocation methodology;
- whether there are significant issues that may need to be addressed through the Licence to avoid windfall gains or losses for HAL;⁴ and
- whether improvements need to be made to HAL’s accounting and information systems/processes to improve the robustness of cost allocation for consideration by HAL, ORC users and the CAA.

Evidence guidance

Relevant sources of evidence for the independent review will include (but not be limited to):

1. CAA’s final decision and relevant guidance on ORCs;
2. HAL’s approach to consulting on its cost allocation methodology and options for pricing;
3. ORC user feedback on the cost allocation methodology;
4. HAL’s records and methodology for including:
 - a. the appropriate set of assets in the cost base for each individual Specified Facility;
 - b. an appropriate allocation of shared assets in the cost base for each Specified Facility;
 - c. an appropriate share of Operating Costs in the cost base for each individual Specified Facility and its allocation to different users; and
 - d. an appropriate share of “on-costs” and overheads in the cost base for each Specified Facility and its allocation to different users.