



Room 2044, D'Albiac House  
Cromer Road  
Heathrow Airport  
TW6 1SD  
Tel: +44 (0) 20 8757 3936  
Email: [lavers@iata.org](mailto:lavers@iata.org)



Heathrow AOC Limited  
Room 2040-2042, D'Albiac House,  
Cromer Road  
Heathrow Airport  
TW6 1SD  
Tel: +44 (0) 20 8745 4242  
Email: [Gensec@aoc-lhr.co.uk](mailto:Gensec@aoc-lhr.co.uk)

Civil Aviation Authority

Sent by email to: [economicregulation@caa.co.uk](mailto:economicregulation@caa.co.uk)

28<sup>th</sup> March 2024

## **Response to Economic Regulation of Heathrow – CAP2618: Setting Future Price Controls: Review of Approach**

Thank you for the opportunity to respond to the above consultation, reviewing the CAA's approach to the setting of future control periods of Heathrow Airport and NERL, including lessons learnt from the recent H7 and NR23 price control periods, (the "Consultation").

This submission is made jointly by the London (Heathrow) Airline Consultative Committee ("LACC") and Heathrow Airline Operators Committee ("AOC"), collectively referred as (the "Airline Community") and sets out agreed principles and outcomes that we believe the CAA's policy should aim to address.

Please note individual airlines, groups and alliances may make their own submissions detailing their specific views on the CAA's proposals.

This response should be read alongside the feedback provided to the CAA at the CAA / Airline H7 Review Workshops<sup>1</sup>, as well as the previous submissions made by the Airline Community during the H7 process, and the joint letter by the Airline Community and Heathrow Airport Limited ("HAL") in response to this Consultation ("Airline Community / HAL Joint Letter"), included within Appendix 1.

This response is set out across 7 Sections which broadly align to the Consultation, namely:

- Section 1 sets out the Airline Community's Key matters, observations and recommendations for H8;
- Sections 2 – 6 responds to the specific observations and questions (as referenced by the relevant Paragraph(s) and generally following the Chapters and Headlines) within the Consultation;
- Section 7 sets out a summary of both the Airline Community's Key Recommendations (as per Section 1) as well consolidating a number of further observations and recommendations set out across the response; and
- Appendix 1 sets out the supporting materials as referenced above.

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<sup>1</sup> As held on 15<sup>th</sup> and 21<sup>st</sup> February 2024

## **1. Overview and Key Recommendations for H8**

Throughout the H7 process the Airline Community evidenced how HAL's shareholders have, through the transfer of value from consumers, materially benefitted from Heathrow being one of the most expensive airports in the world. This is particularly in the context of having seen HAL's debt substantially rise, whilst nearly £4bn of dividends were paid out over the past ten years<sup>2</sup>. Furthermore, the latest sale agreement of £2.4bn for a 25% stake<sup>3</sup>, suggests an expectation of over-performance in the future, despite public messaging from HAL of H7 being a 'challenging settlement'.

We note the current framework for Heathrow is based on established regulatory practice and has a number of positive incentives and safeguards, developed and enhanced over time. The CAA also has specific powers at its disposal to act where required.

However, whilst the CAA's Final Determination did result in an overall lower charge to that of HAL's egregious and continuous efforts to more than double it, as set out previously to the CAA, this, in the Airline Community view, ultimately did not go far enough.

By way of example, Jacobs' latest reports<sup>4</sup> highlight that the H7 settlement still leaves Heathrow as one of the most expensive airports in the world across a number of metrics, including most expensive for aeronautical charges.

Against this context of high charges which consumers are ultimately bearing, the Airline Community are strongly of the view that there are both: (i) underlying structural challenges, as well as; (ii) targeted enhancements in the process and the corresponding incentives and calibration of the building blocks to be learnt from the H7 process, which could and should be reviewed and addressed by the CAA for H8.

As addressed further in this response, the Airline Community have set out, with rationale, these specific learnings and proposals based on our experiences, and which look to build on the existing framework and process.

These recommendations are cognizant of the CAA's timetable as set out within the Consultation, though we would press on the CAA the need to both properly define, plan and resource for this further, including taking forward the recommendations within, in a timely manner.

We very much look forward to engaging on these further with the CAA and HAL.

### **1.1 Underlying challenges with the economic regulation of Heathrow**

#### **1.1.1 Addressing the Regulated Asset Base (RAB)**

The RAB is a core foundation of the make-up of the level of charge at Heathrow, driving some 90% of the charge<sup>5</sup>. However, outside of the adjustments for expenditure, depreciation and inflation (and in some exceptional circumstances) this has had limited focus in either the setting of the price control, or in any wider review or audit, particularly when compared to other aspects of the regulatory building blocks.

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<sup>2</sup> Accounts of FGP Topco, HAL's parent company 2012 - 2022

<sup>3</sup> <https://www.reuters.com/markets/deals/ferrovial-sell-its-25-stake-londons-heathrow-3-billion-2023-11-28/>

<sup>4</sup> Review of Airport Charges 2023, Jacobs and Airport Performance Indicators 2023, Jacobs

<sup>5</sup> £8bn out of £8.7bn in aeronautical revenues for H7

HAL's RAB now stands at circa £20bn, a near 50% increase since the start of Q6<sup>6</sup>. Whilst these can be tracked through the adjustments for investments and depreciation, it is notable that inflation is not only a primary driver for its growth, but that use of both RPI and the extraordinary (in recent times) levels means HAL are receiving significant gains. Whilst the principle of an inflation-indexed RAB is well established in economic regulation, given the significant bearing this has on what ultimately the consumer is (over) paying, it is right the RAB is fully assessed, and particularly where the current use of RPI is at odds with international standards of representative inflation series.

The Airline Community both welcome and are fully supportive of the CAA's plans to consider how it treats inflation<sup>7</sup> of the RAB, however we would encourage this to go further. A full review should consider wider opportunities for addressing the size and growth of the RAB including a review of the current approach to allocate the costs for 'Leadership and Logistics' onto the RAB as a blanket [REDACTED] of total capital costs – for context this accounts for circa [REDACTED] of the total H7 capital spend – as well as assessing and considering liquidating under-performing, non-core assets.

Further comments can be found in Section 5.7 of this response, and with further analysis provided directly by member airlines as well.

### 1.1.2 CAA Proactiveness, Monitoring and Enforcement

In responding to the Government's "Call for Evidence on the Effectiveness and Efficiency of the CAA", the Airline Community set out its recommendation for a review of the economic regulation of Heathrow which specifically included considering

*"The appropriate regulatory and incentive model for Heathrow airport, and the required: resources (size and skillset); regulatory culture and framework, to effectively manage such" and "Consequences on the Licensee for poor or inappropriate behaviours."*<sup>8</sup>

In support of this and given the challenges experienced at Heathrow as set out within, the Airline Community also identified specific opportunities, as addressed further in this response, which we would strongly encourage the CAA to consider as part of strengthening its role in the regulation of Heathrow. Broadly these include:

- (i) Removing – or at least minimizing – a reliance on HAL for information including those that has a direct bearing on which the charges are set or service standards HAL should achieve; and where such information is required, that HAL is properly incentivised to do so;
- (ii) A greater proactiveness to engage and take ownership in material matters as they arise during the control periods, particularly where HAL's response goes against the interest of consumers<sup>9</sup>; and
- (iii) Whilst recognising the need for due process, improvements in the CAA's decision making, notably on the time taken.

We recognise that such changes are most likely to require an increase in levels of resource to which, with the assurance of efficiency and effectiveness, we are supportive of; particularly where strengthening the CAA's 'commercial' and 'operational' understanding, as well as being able to establish full control of consumer research and monitoring of HAL's performance. It is incumbent

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<sup>6</sup> Heathrow Airport Regulatory Accounts

<sup>7</sup> Paragraph 2.46 of the Consultation

<sup>8</sup> Airline Community response to the DfT's consultation, 27<sup>th</sup> January 2023

<sup>9</sup> By way of example, HAL's delay in re-opening of Terminal 4

upon the CAA to prioritise establishing a fully resourced team. This should be sized and with the appropriate skillsets in place to ensure an increased ability to deliver the H8 decision in a timely manner and to provide a high-quality overall decision that meets the consumers' needs and the additional work outlined in this response.

## 1.2 Acute Challenges within H7

In addition to the above matters raised under Section 1.1 above, covid-19 had a significant bearing on the overall process and outcomes in setting H7. As such it is important, particularly where considering lessons learned and applying to future periods, that those issues are isolated and considered within the latest context.

Whilst specific aspects are covered further within this response, two further 'core themes' arose for particular consideration when considering the process and focus for H8.

### 1.2.1 The Financeability of HAL and the Overall Balance of Incentives;

As set out in our response to the Final Proposals<sup>10</sup>, the H7 settlement ultimately significantly shifted the balance of risk through the introduction of Traffic Risk Sharing (TRS) model; an asymmetric risk allowance; timing of the return of the Ak factor; a RAB Adjustment.

Whilst recognising the unprecedented impact of covid-19 and challenges in responding, the Airline Community were broadly critical as to what it saw as an approach by the CAA that

*"...appears irrational in placing undue weight on short-term financeability considerations at the expense of balancing its primary duty to consumers<sup>11</sup>" with particular concerns raised at the time that "the overall challenges of Covid and the financial impact on HAL is casting a 'shadow effect', with short-term challenges having a disproportionate bearing on the longer term. For example, setting a passenger forecast which appears particularly pessimistic when compared to broader industry analysis, or setting a cost of capital that is predicated on Heathrow's financeability.<sup>12</sup>"*

Whilst the CAA sought to address some of these points raised – for example updating the WACC to reflect the TRS, these elements are now structurally embedded within the current framework.

Notwithstanding the merits or otherwise of particular interventions (as covered further in this response), we would note that it is imperative the CAA review the appropriateness, application, and balance of the current risk / reward, asymmetry / symmetry, and incentives in a post-pandemic environment.

In particular, the assessment on the WACC and calibration of the TRS should reflect the reduced risk of HAL, particularly in a 'post pandemic' environment, and seek to ensure the balance of decisions sits first and foremost with consumers.

A full review of HAL's actual performance must also be a key input into this lessons learnt process.

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<sup>10</sup> A.1 (3) The Balance of Risk, Airline Community Response to CAP2365 H7 Final Proposals

<sup>11</sup> A.1 Summary, Airline Community Response to CAP2265 H7 Initial Proposals

<sup>12</sup> A.3 General Concerns, Airline Community Response to CAP2265 H7 Initial Proposals

### 1.2.2 Clarity, Timing and Enforcement of the Process

As per the Airline Community / HAL Joint Letter, it has been well documented and recognised that the overall H7 process was particularly challenging, with various iterations, moving timetables, and unclear direction at times.

Notwithstanding this, we note this was made all the more difficult with HAL's frustrating of the Constructive Engagement process. The full details of the challenges experienced were set out in multiple responses, but are captured by our summary at the time that:

*"The consequence of these failings has unfortunately concluded that the CE process has not been effective." and "Whilst the Airline Community welcome the efforts by individuals in the engagement of CE, the process itself has fallen well short of expectations, particularly with regards to the provision of detailed, quality information....."<sup>13</sup>*

Despite these observations and frustrations being raised at the time, HAL continued to fail to meet specific expectations set by the CAA;

*"Furthermore, the continued failings by HAL in producing fully formed plans, despite CAA instructions, has also been particularly challenging"<sup>14</sup>.*

This raised wider questions on the enforcement process, including the timing for intervention. For example, HAL failed to sufficiently develop scenarios, or provide full justification or detail for its proposed capital investments despite specific requests from the CAA.

Whilst there are always likely to be areas of differences, a:

- (i) lack of strategic alignment sought by HAL;
- (ii) reliance by the CAA on information from HAL – which turned out to be of poor in quality at times; and
- (iii) limited consequences on HAL in meeting expectations set by the CAA

meant the process did not deliver on what was intended.

It was telling that at no point did HAL's plans materially change in relation to feedback provided by the Airline Community either during or after Constructive Engagement.

As set out further in Section 3.4 below, we are supportive of the concept of the Constructive Engagement process and believe there are a number of lessons learnt to be applied in relation to:

- (i) the setting upfront of clear expectations;
- (ii) addressing the engagement structure, including the role of the CAA; and
- (iii) more effective commissioning and use of independent, subject matter experts.

With regards to implementation of the H7 settlement, the Airline Community have been particularly frustrated, and previously escalated to the CAA, a number of issues, notably around the new capital

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<sup>13</sup> Section B.3, Airline Community feedback on H7 Constructive Engagement

<sup>14</sup> Section A.3, Airline Community response to CAA's Initial Proposals

incentive framework as well as specific instructions on matched pricing under ORCs. Furthermore, where HAL were given some latitude on implementation, we have seen them act in their own interest, for example their response to delay returning the Ak factor.

Whilst these matters are being, or have been, reviewed by the CAA, the Airline Community have been disappointed that HAL have been able to delay or frustrate elements it has disagreed with, which has only led to further delay in implementing the settlement in full and / or decisions we would deem not in the best interest of consumers.

By way of example, despite the Airline Community raising with both HAL and the CAA in the summer 2023<sup>15</sup> on the need to start the rollout of Delivery Obligations, it has taken Airline Community escalations and been nearly six months post the CMA appeal decision for these to be fully rolled out. Similarly, HAL's approach on 'Matched Pricing' under ORCs has been at odds with the CAA instructions and taken a significant period of time, and escalation by the Airline Community, for the matter to start to be addressed.

For the reasons set out here and further within this response, we do not agree therefore that the *"issues around implementation of price controls, monitoring and enforcement"* should be *"excluded"* as proposed in the Consultation<sup>16</sup> as we believe these will have a bearing in the overall process, including resourcing.

### **1.3 Key Recommendations for H8:**

In reflection on the above, and as set out with further evidence within this response, the Airline Community would strongly commend the following recommendations as priorities for H8 and encourage the CAA to begin actioning as a matter of urgency, particularly in order to meet the proposed timelines:

#### 1.3.1 Strategic Intent and Objectives

The CAA should clearly set out a statement of regulatory intent in how it discharges its duties, including in relation to the balancing of a fair risk and reward. Alongside this, we would encourage setting clear objectives, particularly in relation to protecting consumers and addressing the level of charges at Heathrow, in line with expectations set out in Civil Aviation Act 2012 that *"airport operators provide the services demanded by passengers at minimum cost"*<sup>17</sup>

#### 1.3.2 Review of the RAB

Given the significant bearing it has on the overall charge, a full review of the RAB should be undertaken, including, but not limited to the impact of inflation; the value of continuing with the approach to Leadership and Logistics; and identifying opportunities to reduce the RAB through the selling off of non-value or poor performing investments.

#### 1.3.3 Ensuring an effective Constructive Engagement Process

Attention should be given to developing a Constructive Engagement process that builds on the process to date but is improved further by early, robust planning; and the setting out of clear expectations and timescales. Furthermore, the CAA should look at putting in place enhanced incentives, measures and enforcement (where necessary) to ensure HAL's future business plans

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<sup>15</sup> Capital Portfolio Board, August 2023

<sup>16</sup> Paragraph 2.19 of the Consultation

<sup>17</sup> Paragraph 36b, Civil Aviation Act 2012

are appropriate, timely, and based on properly informed and debated choices, with independent, expert input. This should also include the use of third-party models and subject matter expertise, as required. The process should also be enhanced by incorporating the recommended enhancements set out in 1.3.4 and 1.3.5 below.

#### 1.3.4 Strengthening the CAA's Proactiveness, Monitoring and Enforcement

As a priority, the CAA should ensure it has the appropriate level of resource, engagement model, and internal governance structure in place to not just deliver an effective process in setting H8, but to also undertake a more active role in engaging in the recommendations raised now, as well as the ongoing monitoring and enforcement of HAL.

#### 1.3.5 Targeted Improvements in Developing the Building Blocks

These recommendations are made alongside the proposed targeted improvements in further calibrating the building blocks, as set out further in this response. These include:

- (i) Building on the CMA H7 appeal by drawing lessons learned on the WACC from market evidence and understanding the allowed returns to actuals to the risk and incentive models, including TRS;
- (ii) the CAA's early development and primary use of independent models for opex, commercial revenues and passenger forecasting; built on actual, bottom up and industry informed data.
- (iii) A review on the Other Regulated Charges (ORCs) framework with particular reference to the role of airlines in agreeing to any cost and scope changes to airline only ORCs.
- (iv) Ensuring further development of:
  - a. the Outcome Based Regulation (OBR) framework including: ensuring a fully informed understanding of security and control post performance and the advantages of daily measurements; as well as taking ownership of consumer research and performance monitoring; and
  - b. the capital governance framework, particularly through utilising the opportunity for further lessons learned through the independent assessments intended within H7.

### **1.4 Strategic issues addressed in Chapter 3**

As set out further in Section 6 of this response, whilst supportive in principle of a wider review of certain topics set out within Chapter 3 of the Consultation; given the scale of some of these matters; the proposed H8 timetable; and resource challenges identified in the Consultation, outside of the CAA's assumptions it is considering for H8, we believe these issues are more appropriately addressed outside of this Consultation.



## 2. Chapter 1 and 2: Purpose / Scope of the Review and Timetable

### **2.1 Purpose / Scope of the Review**

#### 2.1.1 Basis of the Review

As set out in Section A.2 of the Airline Community's response to the CAA's Final Proposals<sup>18</sup>, and IATA's response to the Government's Independent Review of the CAA<sup>19</sup>, undertaking a review of the economic regulation of Heathrow has been a key and consistent ask from the Airline Community given the number of key challenges experienced and opportunities identified, as set out Section 1 of this response. The CAA's review, as per this Consultation, is therefore welcomed.

The Airline Community also broadly agree that aligning this review with the recommendation from the Government's Arm's Length Body review<sup>20</sup> is also a sensible starting position on which to form the basis of its review, particularly where this work is supported with independent, expert input, as proposed within the Consultation.

#### 2.1.2 Concerns of the Scope of the Review

However, as set out further in this response, the Airline Community are strongly of the view that reviewing the CAA's capacity, capabilities and its ongoing monitoring and enforcement of HAL is necessary in order to build on the current regulatory framework.

We are particularly concerned therefore that, whilst the Consultation covers many 'process' aspects, notwithstanding some specific questions on governance, it does not explicitly seek to consider the extent to which the CAA is structured, engages nor enforces matters in the developing and ongoing execution of the price control.

Furthermore, Paragraph 2.9 of the Consultation explicitly excludes "*issues around implementation of price controls, monitoring and enforcement*" despite this being an issue already raised by the Airline Community with the CAA, such as the delayed introduction of Delivery Obligations and failure to implement 'Matched Pricing' for ORCs.

We therefore propose, and is a primary ask of the Airline Community, that the scope of the review should consider the CAA's monitoring enforcement activities, with independent assessment and input to support the CAA in ensuring it is set up to deliver on the recommended improvements.

#### 2.1.3 Independent Assessment

The Consultation states that the CAA will be using independent input, including the use of an expert advisory panel, the role and make-up of which the CAA will seek to finalise "*in the coming weeks*".<sup>21</sup> It is unclear from the Consultation how this independent assessment will feed into the process. We believe the CAA should be clear on this and we welcome further guidance on this development.

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<sup>18</sup> "Section A.2, Airline Community response to H7 Final Proposals

<sup>19</sup> "Section on Economic Regulation, IATA Input into the independent review of the UK Civil Aviation Authority", dated 2<sup>nd</sup> December 2022

<sup>20</sup> Paragraphs 1.7 – 1.9 and 2.8 of the Consultation

<sup>21</sup> Paragraph 1.4 of the Consultation



#### 2.1.4 External Support

Under Paragraph 1.5 of the Consultation, the CAA have set out suggested areas that external input might be sought on which the Airline Community are supportive. We do note however that:

- (i) As set out further in this response, whilst supportive of advice on assessing costs (as set out further under Section 5.4 of this response) it is important the CAA gives the independent advice the due weight, particularly given our concern on the incentives for HAL within setting the relevant allocations; and
- (ii) The scope of peer reviews of lessons learnt is limited to “UK regulated sectors”. Whilst we note the challenges and variances, we believe the CAA should be considering any lessons from non-UK airports.

We also note the proposed Mid-Term review for OBR and the independent assessments that are planned during H7 in relation to ORCs<sup>22</sup> and the new capital governance framework<sup>23</sup>. The outcome of these assessments should also be considered by the CAA.

#### 2.1.5 Regulation of Other Airports

IATA notes that the focus of the Consultation is on HAL and NERL, as opposed to the economic regulation of any other airport<sup>24</sup>. In the interest of maintaining the focus of this response to its primary purpose we do not address the issue further here other than to note this should not be taken as any indication of agreement (tacit or otherwise) of the current regulation or assessments of other UK airports.

## **2.2 Timetable**

### 2.2.1 Clarity and Assurance

The Airline Community note the proposed timetable as set out in the Consultation which would start the process this year (2024) and begin H8 in 2027 and our response is based on this basis.

In particular, and as set out in Section 1 of this response, the proposals and recommendations made by the Airline Community within this response are intended to meet the timetable as presented. We would stress however that certain elements will require the CAA to act in a timely manner.

We note however that the timetable remains at a very high-level and we have already seen delays in the process through the later publication of this Consultation. Coupled with the delays and movements seen through the H7 process, we would encourage the CAA to provide much greater clarity on the deliverability of the proposed timetable by setting out clearer timescales, milestones, resource levels at each stage, and dependencies.

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<sup>22</sup> CAA Independent Review of ORC Assessment

<sup>23</sup> Independent Review of Processes, as introduced for H7

<sup>24</sup> Paragraph 2.6 of the Consultation



### 2.2.2 Critical Aspects of the Timetable

It is important that the timetable is structured to ensure the feedback from this Consultation is fully considered, particularly in relation to ensuring the right governance and resourcing structures are in place.

Robust, upfront planning and clear expectations should help the CAA to further define the timetable including the requirements and dependencies to deliver.

Furthermore, the Airline Community would stress the importance in ensuring suitable time is set and protected for the engagement process, particularly around Constructive Engagement and timings for assessing the CAA's proposals.

### 2.2.3 Shared Common View

The Airline Community note the timetable as a common theme identified and covered within the Airline Community / HAL Joint Letter.

### 3. Chapter 2: Process for Setting the Price Control

#### **3.1 Market Power Assessment of HAL (Paragraph 2.16 – 2.17)**

The Airline Community agree with the CAA's conclusions<sup>25</sup> that there have been no material developments that would change the conclusion of the market power assessment of Heathrow undertaken in 2014.

Indeed, as set out in our responses to the various CAA consultations on H7, covid-19 saw some airlines consolidate operations into Heathrow or take the opportunity for ad-hoc flying out of Heathrow. Since then, Heathrow has also seen a full return of passenger volumes – being significantly above those levels in 2014<sup>26</sup> - and operations close to the movement cap.

Any suggestions for undertaking a market power assessment would need to meet a very high bar, with clear rationale and evidence for the requirement to undertake.

#### **3.2 Objectives (Paragraph 2.18)**

##### 3.2.1 Importance of Vision and Objectives

The Airline Community believe that setting out a clear vision and objectives for H8 is critical for ensuring that the process sets targeted outcomes, with all parties clear on the CAA's expectations and direction the price control period(s) should be seeking to deliver.

As set out in Section 1, the Airline Community were particularly concerned throughout the H7 process on both the overall balancing of the CAA's primary duty to consumers, with its secondary duty to HAL's financeability.

Whilst concerns on financeability were understandably heightened at the outset of covid-19, a lack of a clear objective within the H7 process, and HAL's efforts to fully insulate itself from any losses, meant this framed much of the engagement and focus.

##### 3.2.2 Recommended Objectives and Outcomes for H8

For the reasons set out in Section 1 and 3.2.1 above, the Airline Community believe two key objectives for H8 should be to:

1. fully review and ensure an appropriate balance of the risk and reward within the framework and based on the CAA's primary duty to the consumer; and
2. seek to address the overall level of charges at Heathrow.

##### 3.2.3 Priorities within Future Plans

Whilst we are at the early stages within the process, the Airline Community would highlight that future plans from HAL must look to address and balance the key opportunities and challenges facilitating growth; improving airport performance and resilience; and supporting industry efforts on sustainability, whilst balancing against the overall affordability of the airport (aeronautical charges,

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<sup>25</sup> Paragraph 2.16 – 2.17 of the Consultation

<sup>26</sup> 73.4m passengers in 2014



cost of operations, capital investment). We believe these are fully aligned with consumer priorities and look forward to engaging further with both HAL and the CAA on these matters.

### **3.3 Proportionate & Transparent Regulation** (Paragraph 2.19 – 2.23)

#### 3.3.1 Principles

The Airline Community agree with the principle of regulation being proportionate and transparent though note the structure and delivery of regulation should both reflect the outcomes it is aiming to achieve and seek to identify and minimise incentives for 'gaming'.

Noting our comments on HAL's market power and a number of issues that have been required to be raised with the CAA throughout and outside this process), the Airline Community would be deeply concerned and not be supportive on any 'lightening' of the regulation of HAL.

#### 3.3.2 Role of the CAA

As set out further in this response, the Airline Community have encouraged a greater level of engagement from the CAA both directly in the process of setting the price control, but also in the ongoing monitoring and engagement.

This should not only help support better outcomes for consumers but given it would ensure a greater degree of transparency and enable a more efficient and timely process in addressing (or potentially avoiding) escalations we do not believe that it is at odds.

#### 3.3.3 Role of Airlines and the Airline Community

Notwithstanding the above comments in 3.3.2 on the role of the CAA, the Airline Community would reiterate the CAA rebuttal to the comments made by HAL during the H7 process that airlines should not be considered to represent consumer interests. The current frameworks act as safeguards for consumers and enables a level of representation not seen or readily available in other regulated sectors.

It is in all parties' interests to ensure the engagement process remains proportionate. To that end, we would emphasise that it is both in the interest of airlines to ensure such processes are efficient and value adding, and that history has shown airlines and HAL have, on the whole, been pragmatic in finding solutions to work together, for example on the recent work on the implementation on Delivery Obligations<sup>27</sup>.

### **3.4 Constructive Engagement** (Paragraph 2.24)

#### 3.4.1 Principle

The Airline Community support the principle and intention of the engagement process but note, not least given the challenges experienced throughout the H7 process, a targeted overhaul is required.

#### 3.4.2 H7 Process

Notwithstanding the challenges from covid-19, as set out in full in the Airline Community feedback to Constructive Engagement, ultimately it was not effective. These have been raised in the Section 1 but can be summarised by a lack of credible or detailed plans and information from HAL, the

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<sup>27</sup> As observed by the CAA through their attendance at the Programme Airline Working Group (HAL and airlines)



CAA's reliance on information from HAL, and the CAA's failure to intervene early to address shortcomings.

These issues only further seem to be exacerbated as the process continued into engaging on the CAA's proposals, with a widening of views with each iteration of HAL's updated plans.

### 3.4.3 Areas for Targeted Overhaul

The Airline Community have identified a number of areas and rationale, as covered further throughout this response, which would support an overhaul of the CE process:

1. The CAA establishing a robust framework, including:
  - a. a clear vision and objectives;
  - b. development of a robust timetable with sufficient time held for engagement;
  - c. ensuring sufficient resources and governance structures in place;
  - d. clearly defined roles including the use, and engagement, of consultants and CAA's own consumer insight and research;
  - e. identifying early the structure and expectations on engagement of specific matters that will have both a material bearing on future plans (such as sustainability, and growth aspirations), as well as the specific building blocks themselves; noting the core areas and drivers being likely to closely follow those of Q6 and H7.
2. The CAA setting clear expectations on HAL's Business Plans, including:
  - a. the level of information required;
  - b. guidelines or instructions on specific data sets, methodologies, models to be used;
  - c. evidence of the extent to which HAL has engaged and agreed on the strategic direction and priorities within the plan with airlines and the Airline Community, both in advance of publishing initial plans (this could be something akin to the 'engage constructively' concept that was introduced under the pre-covid-19 CE process) and subsequent changes thereafter; and
  - d. Setting out Consequences on HAL for not addressing specific requests or instructions from the CAA.
3. Early identification and engagement of required resources including engaging consultant, and work activities that could be informed in advance or early in early stages of Constructive Engagement.
4. During the process, the CAA being proactive in engaging on matters where required, with regular check-points and tracking of issues (including possible joint documentation)

### 3.4.5 Shared Common View

The Airline Community note improvements for engagement as a common theme identified and covered within the Airline Community / HAL Joint Letter.



### **3.5 Timetable**

Comments relating to the Timetable are covered under Section 2.2 above.

## 4. Chapter 2: Governance Around Price Controls

### **4.1 Management of Process** (Paragraph 2.27 – 2.28)

The Airline Community highlight two broad themes throughout our response in relation to the CAA's own reflections in Paragraphs 2.27 and 2.28

#### 4.1.1 Planning, Governance, Resources, and Incentives for Delivery

As set out in Section 1 and throughout the H7 process, the Airline Community were particularly frustrated with HAL slowing the process with delays in providing plans or supporting information. Setting clearer and stronger incentives on HAL, and with earlier intervention from the CAA where required, should enhance the price control process and is supported by the Airline Community.

This is also incumbent however on the CAA addressing the points raised on clear process planning and governance, as well as having the appropriate resources itself to support the delivery in a timely manner.

#### 4.1.2 CAA Decision Making

The Airline Community are generally agnostic to the internal structure of the CAA's governance arrangements, though understand some challenges and delays may have, in part, resulted from a need for the CAA Board to sign off certain positions or consultations.

The CAA exploring improved options for focused decision making is supported, particularly where it allows for efficiencies within the processes and enables the CAA to address the challenges and recommendations raised, such as delivering decisions to time.

#### 4.1.3 Shared Common View

The Airline Community note 4.1.1 (in part) and 4.1.2 as a common theme identified and covered within the HAL / Airline Community Joint Letter.

### **4.2 Engagement and Taking Account of Stakeholder Views** (Paragraph 2.29 – 2.32)

#### 4.2.1 Engagement Principles

As set out within this response, the Airline Community concur with the importance of high-quality information and transparency. It is important that these principles not only apply to the CAA's engagement<sup>28</sup>, but is a requirement on HAL as well.

#### 4.2.2 Access to the CAA

Notwithstanding the specific process comments covered under Constructive Engagement, the Airline Community broadly welcome and appreciate the access granted to the CAA, including opportunities to present to the Board, monthly update meetings, and dedicated workshops as required.

That being said, the Airline Community do note that, outside of formal consultations, this access is not codified, but rather based on culture and 'best practice'. We would encourage the CAA to consider the establishment of a more formalised role and engagement model with airlines,

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<sup>28</sup> Paragraph 2.29 and 2.30 of the Consultation





particularly in light of upcoming changes within the leadership of the CAA economic regulation team, and how this could also help support the efficiency in engaging on specific matters and wider consultations.

#### 4.2.3 Consumer Views

The Airline Community continue to remain a strong advocate for consumers. Ultimately these are airlines' customers with whom they hold the direct relationship.

As set out further in our response to Service Quality (Section 5.2) beyond relying on HAL's consumer research, it was unclear the extent to which consumer views were collected and incorporated into the price control by the CAA.

Given the reliance on HAL, the Airline Community are strongly supportive of the CAA taking a primary ownership on consumer insights.

### **4.3 Guidance and Information Gathering (Paragraph 2.33)**

#### 4.3.1 Guidance

For the reasons set out in Section 1 and the HAL / Airline Community Joint Letter regarding the importance for all parties for clear guidance, the Airline Community welcome the CAA's proposal to make guidance more effective and introduce measures to secure high quality business plans and information from HAL in a timely manner.

The Airline Community would recommend not only that specific dates be set for the delivery of each phase of the HAL's business plans but, given the challenges, that the CAA specified what level of detail the business plans are delivered to and what scenarios they should cover.

#### 4.3.2 Consequences

It should be made clear to HAL if specific guidance is not followed then HAL would be subject to some form of penalty(ies). This framework should be clear in advance of the process but could consider matters such as disallowing related revenues or the CAA imposing its own version of the business plan (either in entirety or on specific sections (eg Capital)).

#### 4.3.3 Timely Information Requests

Given the challenges on timings we would also recommend that the CAA make specific information requests to HAL at an early stage in the process to facilitate the CAA (or its external consultants) gathering evidence and building its own Opex, Commercial Revenue, and passenger forecasts models, which should form the starting position and primary focus of decisions on the building blocks.

In addition, early requests for MTI data to understand the impact of daily performance measures/targets is also recommended.

#### **4.4 Expert Advice and Quality Assurance (Paragraph 2.34)**

##### 4.4.1 Consultant Support and Outputs

Notwithstanding specific issues raised in our feedback to the CAA's Proposals and Final Determination, on the whole the Airline Community were welcoming and supportive of the outputs from the CAA's consultants and encourage their on-going use.

##### 4.4.2 Targeted Improvements

As set out in the Airline Community response to the Final Proposals:

*"...the CAA appear to have ultimately relied upon much of this information [HAL's] in reaching certain positions; and in some cases, going further towards HAL than their own independent advice suggest. We note this particularly in relation to assessment and allocation of aspects of the operating costs, commercial revenues and the capital plan, as described further in Section C of this response, and where in many cases airlines and the Airline Community have not had visibility of such information<sup>29</sup>"*

We would note again that the CAA should place a stronger reliance on the output of the external consultants reports and, given the incentive on HAL, that the external consultants reports should take precedence over, and the burden of proof lie with, HAL.

##### 4.4.3 Timely Engagement

In addition to the CAA's placing a greater weighting on the input of their own advisors, the Airline Community would highlight that engagement is undertaken in a timely manner nor necessarily needs to wait for work to start being undertaken, particularly on those activities and historical data which experience tells us will be required, such as security for example.

##### 4.4.3 Potential Future Engagements

The Airline Community note the current process relies on expertise support across a number of building blocks to which the Airline Community, airlines, HAL and the CAA have all engaged relevant consultants.

In the interest of overall efficiency, and supporting more collaborative decision making, the Airline Community would be open to considering bi- / tri- lateral engagement of consultants to support the development and / or review of certain positions or information, where there is a clear opportunity(ies) identified to do so.

Such an approach could also go some way towards addressing the current imbalance between the parties in relation to the use of consultant support.

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<sup>29</sup> A.2 Context and General Comments, Airline Community response to Final Proposals

## 5. Chapter 2: Approach to Key Price Control Issues and Building Blocks

### **5.1 Passenger Forecasting** (Paragraph 2.35 – 2.36)

The passenger forecast is, and remains, a fundamental pillar in determining the overall level of charge, the strategic direction of business plans, and the outcome of many of the other building blocks.

#### 5.1.1 Challenges in the Process

As set out extensively during in our feedback to the CAA, and in particular the Airline Community response to H7 Final Proposals<sup>30</sup>, passenger forecasting was one of material challenges which had a direct bearing on not only the process but also behaviours by HAL. In particular:

- (i) HAL, and the CAA, consistently outturning forecasts which did not fully reflect industry outlooks, nor 'business as usual' discussions, at the time<sup>31</sup>;
- (ii) Lack of full access to the HAL model despite multiple requests and offers to address confidentiality concerns raised by HAL, which ultimately required the CAA to consider wider sources of information; and
- (iii) The incentivisation on HAL to create materially pessimistic forecasts

#### 5.1.2 Future Models

Given the challenges, we strongly support the CAA's undertaking a review of its process, including commissioning external expert resource to support the development of a forecasting model, to be used the production of the CAA's own Heathrow passenger forecast for H8. This should be commissioned in a timely manner so that it forms the centre of the CAA's traffic forecast and should be used, as instructed by the CAA, by HAL in its HAL's Business Plan.

All parties should similarly have full access and understanding, in order to address the issues experienced in H7.

#### 5.1.3 Outturn Performance and Information Balance

Whilst considerations in 'hindsight' and covid-19 challenges need to be considered carefully, both the outturn of recent forecasts and HAL's prompt upgrading of forecasts post the CMA appeals shows there is a clear imbalance which must be corrected for when considering future forecasts.

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<sup>30</sup> Section B.1 Passenger Forecasting, Airline Community response to CAA Final Proposals

<sup>31</sup> For example, when considering investment requirements on Security

**Table 1:** Passenger Forecasts for H7 (CAA Final Determination) vs Latest Available Information

Year	HAL Forecast (Mid Case)  (Dec 22)	CAA Final Determination (Mar 23)	Airline Community Assessment (Aug 22)	Actuals / Latest HAL Forecast
2023	66.6m	73m	80.4m	79.2m
2024	69.8m	78.9m	82m	81.4m

We note the CAA should put greater weight on the input from airlines, who have intimate knowledge of future booking patterns and fleet plans, and industry has a significantly greater bearing in future considerations, over HAL’s.

5.1.4 Correlation with Traffic Risk Sharing Model

Notwithstanding the comments on TRS set out in Section 5.3 below, the CAA should give consideration that, should it maintain TRS and subject to its calibration, this provides a degree of protection in the frequency of forecasting.

**5.2 Service Quality** (Paragraph 2.37 – 2.38)

5.2.1 Challenges in the Process

The process in establishing the OBR framework was, on the whole, particularly challenging with both HAL and the Airline Community unable to find agreement on a number of issues. This led to protracted delays on which the CAA were, in the Airline Community’s view, late in responding to. In particular we summarised our view on the Final Proposals at the time of

*“Our overarching view is that the Final Proposals have shown a lack of operational understanding that underpin consumer outcomes with airline evidence ignored or not sufficiently considered. This also appears to have led to a lack of sufficient challenge on targets and measures and will, in our view, ensure poorer consumer outcomes than should otherwise be the case. This is exemplified by the CAA proposing consumers now pay HAL a bonus for meeting the same level of performance in security that they experienced during Q6.”*

Notwithstanding this, the Airline Community note there are opportunities to address these issues through the development of a clear scope of the issues, the path towards which we believe needs further development over the coming months.

5.2.2 Scope of the Mid-Term Review

The Airline Community note that the CAA are due to be undertaking and consulting on the scope of the Mid-Term review imminently. We suggest this forms a useful point on which to set out the specific areas that need to be considered both for the review itself, or, if time is not permitting, as part of the review for the H8 process, as set out in 5.2.1 above.

### 5.2.3 Specific Matters for consideration

Notwithstanding the above approach, the Airline Community would note in advance specific matters in the current framework it is keen, and believe in the consumers interest, to address, including;

- (i) A full study on the benefits of moving to daily, per passenger measurements;
- (ii) Bonus targets should be more stretching, or in some cases removed;
- (iii) Introduction of automated queue measuring in H8; and
- (iv) Greater incentivisation for baggage system performances

Further detail on the rationale can be found in the Airline Community response to the Final Proposals<sup>32</sup>

### 5.2.4 Consumer Research

For H7 and previous Q's the CAA has relied on HAL to commission consumer research and provide consumer insights. This situation led in H7 to HAL taking the lead in designing what the Outcome Based Objectives should be and also resulted in the CAA being reliant on HAL in telling the CAA what the consumer needed. Airline input to the process seems to have been discounted as the airlines could not back up their operational understanding with consumer survey evidence.

As set out further in this response, the Airline Community are strongly in support of the CAA taking and resourcing to, particularly in relation to the ownership of consumer research and performance monitoring.

### 5.2.5 Timing

In all of this, the Airline Community would highlight the need for a number of recommendations to begin being actioned now, or shortly after confirming the scope of the Mid-Term Review.

## **5.3 Traffic Risk Sharing (Paragraph 2.39)**

### 5.3.1 Introduction

The Airline Community agree with the CAA that "*traffic risk sharing arrangements can provide useful protections for both the regulated business and consumers*<sup>33</sup>.", though on the basis that these are properly calibrated to ensure an appropriate balance; particularly for the consumer with whom the CAA's primary duty rests with.

During H7 the CAA introduced TRS as a mechanism to help address concerns following the collapse in passenger numbers as a result of covid-19. In response to the Final Proposals, the Airline Community set out why: (i) it believed a further downward adjustment on the WACC was required to reflect the reduced risk on HAL; and (ii) the symmetric calibration was incorrect, given the expected stability and outturn of passenger volumes by the time of the settlement.

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<sup>32</sup> C.2 Outcome Based Regulation, Airline Community response to CAA Final Proposals

<sup>33</sup> Paragraph 2.39 of the Consultation

### 5.3.2 TRS Future

In order to support the continued ongoing use of TRS for H8, the Airline Community would need to see a stand-back assessment of its calibration, particularly in relation to the off-setting of the WACC, the bandings, and symmetry. This is only further required given the exceptional impact of covid-19 which influenced much of H7, has now passed.

On the point of symmetry, we would note that it should be applied to expected outcomes and consequences, as opposed to the mechanism, as is currently the case. By way of reminder, for Heathrow there is a capacity cap on the upside but no floor on the downside. Furthermore, as demonstrated in 2022, HAL has powers that can directly impact volumes<sup>34</sup> (as seen in the capacity caps in 2022)

Consideration must also be given to the calibration of the passenger forecast. As set out in Section 5.1.3, CAA estimates have been (or are forecasted) below actuals, as per the below. Whilst TRS does at least provide some relief that wouldn't have otherwise been the case, HAL are protected in the short-term due to the delay in repaying over-performance.

## **5.4 Cost Assessment (Paragraph 2.40 – 2.42)**

### 5.4.1 Challenges

The Airline Community raised a number of challenges in the assessment of costs, as summarised in our response to the Final Proposals, including HAL's use of a top-down model approach and insufficient weighting by the CAA of its own consultants' outputs:

*"...we would note HAL's continued failings in producing sufficient plans and information as clearly required and expected by the CAA....."*

*Despite this, the CAA appear to have ultimately relied upon much of this information in reaching certain positions; and in some cases, going further towards HAL than their own independent advice suggest. We note this particularly in relation to assessment and allocation of aspects of the operating costs, commercial revenues and the capital plan, as described further in Section C of this response, and where in many cases airlines and the Airline Community have not had visibility of such information.<sup>35</sup>"*

As such the Airline Community are supportive of the CAA undertaking a review on how it undertakes cost assessments.

### 5.4.2 Independent Assessment on Approach to Cost Assessment

As set out in Section 2.1.4 of this response, the Airline Community are supportive of the CAA seeking independent advice on appropriate approaches and methodologies to assessing costs.

The Airline Community are also strongly of the view that it should be the basis of the CAA's analysis, supported by independent expert input, which forms the starting point for future plans – as opposed to HAL's input.

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<sup>34</sup> Where HAL enacted enforced capacity constraints in Summer 2022

#### 5.4.3 Ongoing Assessment including by the CAA

Both capital and ORCs have established forums between airlines and HAL which, in part, are tasked with the ongoing cost assessment of investments and expenditure. However, despite a number of positive steps, there remain a number of fundamental challenges in relation to

1. asymmetry and transparency of information with requirements driven by HAL;
2. a wide breadth of costs in relation to resource; and,
3. particularly in the case of ORCs, challenges around governance (as set out further under Section 5.8 ORCs).

In addition to supporting the Airline Community's role with further enhancements to governance processes, as highlighted in our comments around Constructive Engagement, part of the challenges around post and future investment cost assessments was in relation to the Airline Community, and the CAA, accessing and providing, information in a timely manner, particularly when engaged in a number of areas across the building blocks.

A more timely and iterative assessment on HAL's overall opex and commercial revenue performance across the capital business cases and material updates (for example publication of accounts) would improve both the assessment process, but also the efficiency of the process in setting the price control.

#### 5.4.4 Targeted Areas in advance of Business Plans

Both the Q6 and H7 processes, have highlighted particular key drivers in relation to cost, for example Security.

In line with 3.4.3 and 5.4.3 above, the Airline Community believe such areas can already start to be identified and work begun to ensure the appropriate level of information is being considered and requested in advance and which should also support the targeting of Constructive Engagement.

Furthermore, the current Constructive Engagement process is, to a large extent, the assessment of HAL's *output* of its plan. We would note a focus in future should be a greater consideration and assessment on the choices being considered within the plan and potential *outcomes* it is seeking to achieve. This should encourage greater engagement and earlier engagement in the strategic aims which in turn should help with a greater alignment on the key drivers, for example seeking cost efficiencies in the security process.

In the case of capital expenditure, we also make particular observations that:

1. there are a number of underlying cost drivers related to HAL's approach to Procurement; Risk; Cost Assurance and Leadership and Logistics. We would strongly encourage the CAA to both consider and support the Airline Community in seeking these to be part of the scope for the independent assessments, as introduced in H7; and
2. whilst the establishment of 'programmes' should help for better and more iterative planning in future, HAL have already identified [REDACTED] of expenditure within H8 and beyond<sup>36</sup>. Whilst some of this will be rollover from committed projects, such as Terminal 2 Baggage and Security, this excludes any new large-scale requirements that may be

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<sup>36</sup> March 2024, Future Portfolio Group



needed in H8, particularly in relation to “Long-Term Growth”. Having early sight and understanding by the CAA now will allow early consideration of the overall ‘affordability’ with regards to future capital allowances in H8, and support better decision making on specific investments as we progress through H7.

## **5.5 Opex and Capex Incentives** (Paragraph 2.42 – 2.43)

### 5.5.1 Balance

The Airline Community note that the current structure whereby HAL are liable for opex increases during the control period (before being reassessed), but earn a return on capital investment, could incentivise solutions and optioneering that lend itself to the latter.

Whilst the capital governance process allows for some safeguards and opportunities for challenge on the approach, under the current framework the Airline Community are generally only engaged on such initiatives where, outside of the cost being an ORC, HAL have already taken the ‘capex vs opex’ decision.

This again highlights an imbalance in information and decision making. Whilst it is for HAL, within the regulatory safeguards set out by the CAA, to run its business, it is important to understand and keep monitoring this balance.

### 5.5.2 Opex and Revenue Incentives

Outside the above point in 5.5.1 above, the Airline Community would further note that the current incentive can (or be seen) to encourage regulatory gaming, with decisions being timed to fall either side of control periods<sup>37</sup>. Furthermore, savings or new revenue initiatives are unlikely to be considered in time for the next period.

Whilst supportive of having incentives on HAL to outperform, this issue should be considered to ensure appropriate safeguards are in place to ensure no excessive ‘wind falls’ can be banked within the period, for example by not allowing the introduction of material new initiatives not considered within business plans or some level of sharing within the period.

### 5.5.3 Capex Incentives

The Airline Community have welcomed the introduction of ex ante, including the establishment of Delivery Obligations (DOs) and remain committed to working with HAL and the CAA in embedding them within the process.

Furthermore, the introduction of Subject Matter Experts (SMEs) and Independent Assessments were also further builds that we are confident will both enhance the current engagement and decision-making process, as evidenced by the SMEs work on Terminal 2 baggage, as well as support identifying improvements for future control periods.

Given the early stages of the new arrangements the Airline Community do not have any further observations at this stage, but we will: (i) continue to monitor and engage with the CAA as matters arise; and (ii) encourage consideration of a more formal review in due course to better understand and build on the latest developments.

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<sup>37</sup> By way of example, HAL’s recent announcement on increase charges for Fast Track

## **5.6 ORCs (Paragraph 2.55)**

### 5.6.1 Importance of ORCs

ORCs constitute a material cost to airlines and providers operating at Heathrow and therefore their levels and governance are a key concern for the Airline Community.

### 5.6.2 Issues with ORCs

Whilst ORCs was an area within the Constructive Engagement process that was broadly agreeable in the developments, particularly given the ongoing engagement through the Other Regulated Charges Group (ORCG), the challenges experienced through ORCG, and in particular the recent escalation in relation to the ORC Protocol and 'Matched Pricing' evidences clear and existing areas of challenge.

The extended arguments and disagreements on the contents of the ORC Governance Protocol (the "Final" version published by HAL is still a matter of dispute by the airline community in 12 areas, as set out in in Appendix 1) is clear evidence that changes to the regulatory framework are required.

Whilst inputting into the Independent Review, as raised directly by the AOC to the CAA there are particular material matters this may not address.

### 5.6.3 Earlier CAA Intervention

Given the challenges set out above, we do not agree therefore with the CAA's proposed approach of waiting to see the impact of changes to governance arrangements and the results of the independent review is a reasonable and proportionate way forward.

Instead, we would push the CAA to address the governance issues raised which should further support the ongoing development of ORCs. This would also ensure this is done in a manner that would allow such changes to be implemented in advance, or at least for, H8.

## **5.7 Economic and Regulatory Framework (Paragraph 2.46 – 5.54)**

### 5.7.1 Summary

The Airline Community set out its primary observations in relation to the matters raised on Inflation Indexation, Cost of Capital, RAB, Package of Incentives and Risk Sharing, and Financeability, in Section 1 of this response.

In summary, we are broadly supportive of the CAA reviewing the points raised within the Consultation and have highlighted particular areas where these should go further in the case of the RAB assessment.

### 5.7.2 Incentives

The Airline Community agree on the need for an overall review of the balance of incentives in relation to the risk / reward. Furthermore, we note there are particular tightening of incentives on OBR and capital, as well as greater consideration for opex, as set out under the relevant paragraphs of this Section 5.

### 5.7.3 Further Engagement

We look forward to engaging further on the matters through the technical review session(s), and support further evidence on the challenges provided by member airlines.

## **5.8 Contributing to UK Aviation Reaching Net Zero (Paragraph 2.44 – 2.45)**

### 5.8.1 Overview

The Airline Community are invested, supportive and fully engaged in the aviation industry's efforts on sustainability, particularly in relation to reaching net zero. We also note that carbon reduction is a core strategic initiative of HAL which has led to a raft of initiatives under its sustainability strategy<sup>38</sup> and supported by a [REDACTED] capital investment programme.

Notwithstanding that the Airline Community may not always be in a position to support particular initiatives or practices proposed by HAL, it is unclear to the Airline Community what further steps might be required by the CAA under the economic regulation of HAL that are not already available within the existing regulatory and UK environmental frameworks – or conversely what is currently preventing HAL from meeting its obligations?

### 5.8.2 Considerations regarding Investments

Throughout the H7 process, the Airline Community's primary concerns in relation to HAL's approach to sustainability was around a poorly defined capital plan. Whilst the Airline Community continually raised the matter, the quotes below from the Airline Community response to the H7 Final Proposals<sup>39</sup> highlights the concerns which still remain and should be avoided in future.

- *"It is clear from the Arcadis and CAA assessment that much of the Carbon and Sustainability programme remains undefined and there are concerns on those sampled cost estimates that suggests a level higher than should otherwise be the case. Despite this the CAA have allocated the total amount requested by HAL."*
- *The Airline Community would highlight an inconsistency in application of guidance. Despite the comments on Carbon and Sustainability re a lack of definition, the CAA have taken a 'judgement call' over and above the Arcadis review and comments based on the importance they see consumers place on this."*

For the avoidance of doubt, the Airline Community are strongly supportive and committed to investments that demonstrably support reaching net zero. We note in particular a concern however that sustainability is not allowed (or could be perceived) to be an 'open door' to unjustified capital expenditure. Rather, the overall size of the programme, prioritisation of benefits and initiatives, and delivery models must be clearly set out and independently validated against associated net zero outcomes, whilst also balancing the overall affordability of the airport.

### 5.8.3 Caution on Roles

We would caution the CAA on placing too much emphasis on individual organisations playing "a wider role in the changes needed across the aviation sector in order to achieve net zero."<sup>40</sup> The entire aviation value chain needs to play its part with a particular and primary focus on what it is

<sup>38</sup> [Heathrow 2.0 Sustainability Strategy | Heathrow](#)

<sup>39</sup> Page 33, The Airline Community's response to the H7 Final Proposals

<sup>40</sup> Paragraph 2.45 of the Consultation



within its direct control. Indeed, we would highlight that addressing net zero is an over-arching theme and strategic priority across the UK (and wider) aviation sector, not least evidenced by airlines' demands significantly outstripping supply of Sustainable Aviation Fuels.

Regulatory intervention on individual organisations *could* encourage perverse or conflicting incentives which, whilst may work for HAL, may create unintended conflicts elsewhere within the value chain. By way of example, the aircraft engine trade-off of noise vs NOx emissions.

#### 5.8.4 Sustainability within Future Processes:

Given the recognised strategic importance Government policies, industry strategies and influence sustainability are likely to have on HAL's H8 (and beyond) plans, we would suggest this could be considered as a 'building block' in its own right through Constructive Engagement, particularly if the CAA set any specific objective or further guidance on this matter<sup>41</sup>.

Notwithstanding any particular support in setting any over-arching objectives, this focus in Constructive Engagement will also allow, and we would encourage, the Airline Community and the CAA to utilise input from relevant Subject Matter Experts in relation to setting scope, benefits, estimated costs, and possible models for delivery.



## 6. Chapter 3: Broader Strategic Issues

There are several topics within Chapter 3 of the Consultation which the Airline Community believe warrant further exploration, in particular the regulation of the structure of charges and HAL's approach to enforcing their conditions of use under the Airport Charges Regulation.

Notwithstanding the above, given the potential scale of the topics proposed; the relatively shortened timescale given to respond to this Consultation; as well as the CAA running a further consultation in parallel<sup>42</sup>, the Airline Community question the rationale of consulting on these matters within this Consultation. Indeed, this view is only further compounded given the CAA's own comments within the Consultation of the challenges of resources and the overall timetable.

We agree in the CAA setting out and consulting on certain assumptions it is considering for H8, for example that it is not considering Heathrow Expansion at this stage, or if were to set specific environmental objectives, however we would also highlight that in some instances some of the proposed topics, in our mind, go beyond the scope of the economic regulation of airports.

As such, the Airline Community has kept its focus on the primary questions on the H7 lessons learned and recommendations for H8.

We note here however that we reserve the right to comment further and fully in due course on the matters raised in Chapter 3 and ask that should the CAA wish to fully consult on such issues, we request it does so in its own right, and at a more appropriate time.

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<sup>42</sup> Reference for CMA Remittals consultation

## 7. Summary of the Airline Community Recommendations

Given the number of observations and recommendations made, the below seeks to consolidate these matters in a high-level, summary form. For full rationale and further details, please see the relevant Sections of this response.

### **7.1 Key Recommendations for H8: (Replicates 1.3 of this Response)**

In reflection on the above, and as set out with further evidence within this response, the Airline Community would strongly commend the following recommendations as priorities for H8 and encourage the CAA to begin actioning as a matter of urgency, particularly in order to meet the proposed timelines:

#### 1.3.1 Strategic Intent and Objectives

The CAA should clearly set out a statement of regulatory intent in how it discharges its duties, including in relation to the balancing of a fair risk and reward. Alongside this, we would encourage setting clear objectives, particularly in relation to protecting consumers and addressing the level of charges at Heathrow, in line with expectations set out in Civil Aviation Act 2012 that "*airport operators provide the services demanded by passengers at minimum cost*"<sup>43</sup>

#### 1.3.2 Review of the RAB

Given the significant bearing it has on the overall charge, a full review of the RAB should be undertaken, including, but not limited to the impact of inflation; the value of continuing with the approach to Leadership and Logistics; and identifying opportunities to reduce the RAB through the selling off of non-value or poor performing investments.

#### 1.3.3 Ensuring an effective Constructive Engagement Process

Attention should be given to developing a Constructive Engagement process that builds on the process to date but is improved further by early, robust planning; and the setting out of clear expectations and timescales. Furthermore, the CAA should look at putting in place enhanced incentives, measures and enforcement (where necessary) to ensure HAL's future business plans are appropriate, timely, and based on properly informed and debated choices, with independent, expert input. This should also include the use of third-party models and subject matter expertise, as required. The process should also be enhanced by incorporating the recommended enhancements set out in 1.3.4 and 1.3.5 below.

#### 1.3.4 Strengthening the CAA's Proactiveness, Monitoring and Enforcement

As a priority, the CAA should ensure it has the appropriate level of resource, engagement model, and internal governance structure in place to not just deliver an effective process in setting H8, but to also undertake a more active role in engaging in the recommendations raised now, as well as the ongoing monitoring and enforcement of HAL.

#### 1.3.5 Targeted Improvements in Developing the Building Blocks

These recommendations are made alongside the proposed targeted improvements in further calibrating the building blocks, as set out further in this response. These include:

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<sup>43</sup> Paragraph 36b, Civil Aviation Act 2012

- (i) Building on the CMA H7 appeal by drawing lessons learned on the WACC from market evidence and understanding the allowed returns to actuals to the risk and incentive models, including TRS;
- (ii) the CAA's development and primary use of independent models for opex, commercial revenues and passenger forecasting; built on actual, bottom up and industry informed data.
- (iii) A review on the Other Regulated Charges (ORCs) framework.
- (iv) Ensuring further development of:
  - a. the Outcome Based Regulation (OBR) framework through: ensuring a fully informed understanding of security performance and the advantages of daily measurements; as well as taking ownership of consumer research and performance monitoring; and
  - b. the capital governance framework, particularly through utilising the opportunity for further lessons learned through the independent assessments intended within H7.

## 7.2 Consolidated Observations and Recommendations from Sections 2 – 6

In addition to the Key Recommendations above, the Airline Community highlight particular cross Section themes or proposals that build on those set out in Section 1.3.

This is not exhaustive and Sections should continue to be read in full.

Themes / Topic	Summarised Comments / Observations	Material References
Scope of the Review	Must include the assessment of CAA monitoring and performance	2.1.2
Timing and Planning	Critical the process and timelines and are fully detailed and shared.  Notable a number of recommendations need to begin shortly in order to support the timetable.	2.2  4.3.3
Clear Direction from CAA	Important the CAA set clear strategic direction and objectives, with Airline Community recommendations provided.  Furthermore, CAA should develop models and work should form the basis of plans, as opposed to re-acting to HALs	3.2 & 4.3
Role of the CAA	Encourage a greater proactiveness from the CAA in both the process and monitoring and enforcing during the period.	1.1.2; 3.3.2 & 3.3.3  4.1.2



	Support improved decision making	
Information Gathering	CAA should seek to remove the reliance on and ensure greater enforcement and consequences for the timely provision of information from HAL	4.3
CAA Resources	Support for ensuring right sizing of the team and with relevant skillset, particularly where encouraging to take a more active role  Support improved decision-making process	1.1.2 4.1.2
Consumer Insight and Performance Monitoring	Proposing the CAA takes an ownership	4.2.3 & 5.2.4
Use of Consultants	Supportive in both the CAA utilising in the process and expertise input in the CAA establishing models and cost assessments.  Greater weighting should be given to their reports which should form the basis. Airline Community are also open to considering future engagement models.	2.1.3; 2.1.4 & 4.4
Constructive Engagement	Targeted overhaul with specific recommendations provided	3.4
Passenger Forecasting	Support CAA developing and using own model with access for all	5.1.2
Service Quality	Propose to use the Mid-Term Review to set out priorities to address for H8, with specific proposals given	5.2
Traffic Risk Sharing	Recalibration required	5.3
Cost Assessment	Encourage independent reviews to form the baseline of plans. Welcome more ongoing engagement from CAA with targeted areas identified	5.4
Opex and Capex Incentives	Seek to build on existing incentives, with consideration for opex. Need to be cognizant on the balance of opex / capex	5.5
ORCs	Seeking earlier CAA intervention	5.6
RAB	Full review required beyond inflation	1.1 & 5.7



WACC, Financeability and Balance of Incentives	Needs a full and technical review to ensure appropriate balance – which the Airline Community do not believe is correct at the moment.  Should also consider HAL actual performance and sharpening incentives on OBR, capital and opex	1.2 & 5.7
Net Zero	Supportive but need to be mindful of the points raised. Suggested topic for Constructive Engagement	5.8
Strategic Choices	Question the rationale for undertaking now; should be addressed as part of a wider Consultation	6

## Appendix 1 – List of Material Submissions to be Incorporated

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Notwithstanding references within the response, the following documents, previously submitted to the CAA, provide a comprehensive history of the issues raised and should be read alongside this submission:

1. "Airline Community's written feedback re H7 Constructive Engagement", October 2020;
2. "Airline Community response to CAA CAP2365: H7 Final Proposals", 9<sup>th</sup> August 2022
3. "Airline Community response to DfT Evidence on the Effectiveness and Efficiency of the CAA", 27<sup>th</sup> January 2023
4. "AOC Letter to CAA re ORC Protocol", 20<sup>th</sup> February 2024
5. "Joint Heathrow and Airline Community Response to the CAA re CAP2618: Setting Future Price Controls" 28<sup>th</sup> March 2024 (included below for reference)

