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British Airways Response to CAP2980
Economic regulation of Heathrow airport:
H7 final issues, as well as other matters

Thank you for the opportunity to respond to the consultation on the *Economic regulation of Heathrow airport: H7 final issues* (CAP2980) ("**Consultation**"), specifically on:

- the matters that were remitted to the Civil Aviation Authority ("**CAA**") by the Competition and Markets Authority ("**CMA**") by its Final Determinations of the appeals of the CAA's Final Decision on the H7 price control.
- limited matters that the CAA had been unable to resolve prior to making its H7 Final Decision; and
- additional issues relating to:
 - a formula error identified in Condition C1.6 of the Licence issued to Heathrow Airport Limited ("**HAL**").
 - the inclusion of capital triggers and service quality bonuses in the "starting point" for the calculation of the 2024 charges; and
 - HAL's further request to adjust the price control for energy and electricity distribution costs.

We have outlined in Annexure A our response to the Consultation. We also address further issues related to the Terminal Drop Off Charge ("**TDOC**") and the requirements for HAL to provide an annual Certificate of Adequacy of Resources that we understand that HAL believes ought to be addressed as part of the Consultation. These matters were detailed in a letter from HAL to the Joint Steering Board dated 19 April 2024 ("**Additional HAL Matters**").

This response is structured as follows:

- **Part One:** Executive Summary.
- **Part Two:** AK Factor.
- **Part Three:** Premium applied to index-linked debt costs.
- **Part Four:** Shock factor applied to passenger forecasts.
- **Part Five:** Opex allowance in respect of Pension Deficit Repair Costs in H7.
- **Part Six:** Opex allowance in respect of Business Rates in H7.
- **Part Seven:** HAL's commercial revenues, "Pod parking" and the single till.
- **Part Eight:** Other issues arising from the Final Decision.
- **Part Nine:** H7t calculation error.
- **Part Ten:** Recommended Licence Changes and their impact.
- **Part Eleven:** Terminal Drop Off Charges.
- **Part Twelve:** Certificate of Adequacy of Resources.



British Airways plc, Virgin Atlantic Airways Limited and Delta Air Lines, Inc ("**the Airlines**") jointly engaged AlixPartners to produce expert analysis of the matters raised by the CAA in the Consultation, as well as the Additional HAL Matters.

Annexed to this response is a copy of AlixPartner's report dated 1 May 2024 ("**AP Report**") containing that analysis (**Annexure B**). Our response below contains cross-references to the AP Report's detailed technical analysis, which has partly informed our response to the Consultation as well as the Additional HAL Matters.

Yours sincerely,

Michael Petrides

Head of Economic Regulation
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ANNEXURE A

British Airways' Response to CAP2980 Economic regulation of Heathrow airport: H7 final issues, as well as other matters



1. PART ONE: EXECUTIVE SUMMARY

1.1 We have considered the CAA's proposals and recognise the progress that has been made on several aspects of the price control in response to the CMA's findings in its Final Determinations of the appeals of the CAA's H7 Final Decision, as well as the additional issues addressed in the consultation. In particular, British Airways (**BA**) welcomes the CAA's proposals to:

1.1.1 Distribute the AK Factor adjustment equally into the remaining years of H7 to ensure transparency, regulatory certainty, and timely return of HAL's over-recovery for the benefit of customers.

1.1.2 remove the £84 million allocated for Pension Deficit Repair Costs from HAL's Opex allowance for H7 and to address any Pension Deficit Repair Costs payable from 2023 to 2026 during the H8 price control review process.

1.1.3 Not to accept HAL's request and reopen its decision on energy costs and electricity distribution costs as outlined in the H7 Final Decision.

1.2 In addition, we note the following:

1.2.1 We acknowledge that, in respect of the development capex and business rate adjustments within the AK factor, the CAA has adopted the approach outlined by the CMA by recalibrating these adjustments by applying the proportion of outturn passengers to forecast passengers to the original figures.

1.2.2 We agree with the CAA that it is important to find as close a benchmark as possible for T5 pod parking. However, we believe the CAA should conduct a fuller evaluation at H8 to identify the costs attributable to pod parking, including whether a premium is still justified and examine how costs are allocated.

1.3 However, we have identified several aspects of the CAA proposals that we consider require reassessment to align with the CAA's statutory duties, including its duty to carry out its functions 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 also the principles of transparency, accountability, proportionality, and consistency.¹ Our key areas of concern are as follows:

1.3.1 **AK Factor:** Our primary concern relates to the CAA's proposal regarding the 'volume mix adjustment' within the AK Factor. Allowing HAL to retain 50% of the over-recovery contradicts the principle of the AK Factor, which is to correct any over-recovery in full. The proposed approach would unjustly benefit HAL at the expense of airlines and, ultimately, customers. The AK Factor should be adjusted to reflect the actual over-recovery made by HAL during the pandemic, without retention by HAL of any over-recovery. Indeed, the amount of additional revenue made by HAL was pure over-recovery against the regulated settlement based on actual traffic volumes/mix.

1.3.2 **Premium applied to Index-linked debt:** We acknowledge the CAA's decision to remove the index-linked premium from the WACC calculations. However, as detailed in the AP Report, it would be appropriate for a negative index-linked adjustment of at

¹ Section 1, Civil Aviation Act 2012.



least -10bps to be applied to reflect the lower costs HAL could achieve by issuing its own index-linked bonds. This adjustment also accounts for the benefits of inflation protection that these bonds afford investors, aligning with market realities and regulatory practice in other sectors.

- 1.3.3 **Shock factor:** We disagree with the CAA's proposal to maintain the 0.87% shock factor applied to passenger forecasts. The current methodology for calculating the shock factor is flawed, as it potentially includes economic downturns that are already factored into econometric models and fails to account for positive rebounds following negative shock. We recommend a more comprehensive review of the shock factor to ensure it accurately reflects only non-economic shocks to prevent inflated charges that do not correspond to actual risks. This reassessment would align with the CAA's statutory duties and promote fairness and transparency in setting the passenger charge.
- 1.3.4 **Business rates adjustment:** The CAA should implement the business rates adjustment in the H7 period to prevent the carryover of the adjustment into H8 and provide clarity against an uncertain re-evaluation in two years' time. This would ensure regulatory certainty and consistency.
- 1.3.5 **Formula error in Condition C1.6:** We are concerned by the CAA's proposal to address the formula error in Condition C1.6 by modifying HAL's licence rather than issuing an erratum notice. The CAA's reluctance to issue an erratum notice due to the time elapsed since the H7 Final Decision is inconsistent with the CAA's acknowledgement that the issue ought to be corrected promptly in line with good administrative practice. In any event, it should be corrected prior to HAL's statutory charges consultation due in Summer 2024.
- 1.4 In addition to the above, as outlined at paragraph 66 of the AP Report, an error has been identified in the CAA's calculation of the H7t factor which has material implications for the accuracy of airport charges and ought to be rectified. This miscalculation results in an understatement of the negative H7t adjustment by £0.067 in 2025 and £0.076 in 2026.
- 1.5 In Part Ten we have proposed several necessary modifications to the CAA's proposed H7t factor to reflect the recommendations outlined in this response. Taken together, these license changes will have a £186 million impact on airline users over 2025-26 (nominal prices).
- 1.6 In relation to the issue raised by HAL to the Joint Steering Board in respect of amending the Licence condition for calculating the Terminal Drop Off Charge (TDOC), whilst we consider the CAA is best positioned to clarify the intention of the risk-sharing mechanism, risk sharing should apply to elements that are beyond HAL's control such as the uncertainty related to net traffic volumes to and from the airport. The CAA has previously excluded TDOC from the Traffic Risk Sharing mechanism with the expectation that HAL would take a commercial approach to setting them and maximising its revenues. On that basis, to the extent that any revenue shortfall is due to HAL's decision not to price to the CAA's forecast revenue or operational inefficiencies, this should not be borne by customers. The principle of risk and reward allocation is fundamental to ensuring that HAL is incentivised to make efficient and economically sound decisions. It is also important to consider the interplay between terminal drop-off traffic and HAL's other revenue streams, such as car parking and public transport, which we believe the CAA should address in its upcoming review on TDOC revenues in the second half of 2024. Finally, as the 2022 K factor has already been calculated in the 2024 charges that underwent consultation and are currently in effect, any additional retrospective adjustment should only be allowed, if justified, in the context of the CAAs' upcoming review.



- 1.7 In respect of HAL's request for a Licence modification to replace the requirement for an independent auditor's report on operational resources with a declaration from its Chief Operating Officer and a nominated Board member, we recommend that the CAA implement a robust and independent verification process similar to that used for Air Operator's Certificate assessments. This should involve an independent and thorough review of HAL's operational resources to ensure they are sufficient for the following two-year period.

2. PART TWO: AK FACTOR

- 2.1 The AK Factor mechanism is designed to adjust or 'true-up' HAL's revenues to correct any over or under-recovery that has arisen due to differences between outturn and assumptions in forecasted figures that were used to set the maximum allowable yield. The three main adjustments addressed by the AK Factor are:

2.1.1 A development Capex adjustment, to account for differences between the forecasted and actual capex on airport development projects ("**development capex adjustment**").

2.1.2 A business rates adjustment, to account for any variance between the forecasted and actual business rates paid by HAL ("**business rate adjustment**"); and

2.1.3 A passenger volume mix adjustment, to account for any additional revenues collected by HAL due to forecasting errors in the volume mix of passenger types, aircraft movements, and aircraft parking, resulting in a higher yield per passenger than the price cap allows and therefore HAL collected additional revenues relative to overall passenger volumes ("**volume mix adjustment**").

- 2.2 In response to HAL's appeal of the CAA's application of the AK Factor to the years 2020 and 2021, the CMA determined that the CAA "*did not err in law or in the exercise of a discretion in deciding that an AK factor should apply at all. It was not wrong to apply any AK factor in the light of the losses HAL made in 2020 and 2021*".²

- 2.3 However, the CMA did find that the CAA had not appropriately considered the exceptional circumstances of the Covid-19 pandemic.³ In particular, the CMA found that the CAA had applied the AK Factor 'mechanistically', without due consideration to the actual revenue over-recovery by HAL, specifically in relation to:

2.3.1 HAL's capex underspend in 2020 and 2021.

2.3.2 An over recovery caused by HAL's business rates out-turning at levels lower than the Q6 allowance; and

2.3.3 An over-recovery in per passenger charges during 2020 and 2021, resulting from flights being operated with fewer passengers due to the pandemic.⁴

- 2.4 The CMA found specifically that "*the CAA was wrong because it did not give due consideration to whether, in the exceptional circumstances that applied as a result of the pandemic, HAL did actually over-recover revenues to the extent a standard application of the correction factor would imply and that it was appropriate to provide for the recovery of those amounts... The*

² CMA Final Determinations, paragraph 10.117.

³ CMA Final Determinations, paragraph 10.120.

⁴ CMA Final Determinations, paragraphs 10.118 and 16.14.



CAA was wrong not to have considered whether it was more appropriate to calibrate each component of the AK factor adjustment more closely to HAL's actual over-recovery of relevant revenues during the years 2020 and 2021'.⁵

- 2.5 The CMA therefore remitted for reconsideration the CAA's decision in relation to the manner of its application of the AK factor in 2020 and 2021.⁶

CAA's Proposal on the AK Factor remittal from the CMA

- 2.6 The CMA outlined 'worked examples' for the development capex and business rates adjustments, and the CAA has confirmed in the Consultation that it is proposing to adopt the CMA's analysis and mechanism for calculating these two elements.⁷ However, the CAA has recognised that "*[w]hile the CMA set out an alternative approach to making adjustments for the Dt and BRt terms and was clear that the approach used in the Final Decision exaggerated the level of HAL's over recovery, its criticisms of the issues around passenger mix were made in less forceful terms. The CMA did not point to an alternative means of assessing the appropriate level of this adjustment*".⁸

- 2.7 The CAA has therefore considered two options for addressing the volume mix adjustment:

2.7.1 Option A: Pro-rate the actual number of passengers seen in 2020 and 2021, consistent with the approach for capex and business rates.

2.7.2 Option B: Retain 50% of the additional revenue received by HAL, acknowledging that HAL cannot be held wholly responsible for the variance during the pandemic.⁹

- 2.8 The CAA proposes to adopt Option B.¹⁰

BA's response

- 2.9 The CMA found that the CAA was not wrong to apply any AK Factor at all and remitted the AK Factor to the CAA for reconsideration due to the exceptional circumstances of the pandemic. We agree with the CMA (and the CAA) that "*the fact of 2020 and 2021 being exceptional COVID-19 impacted years – in that passenger numbers turned out to be significantly lower than forecast – does not in itself provide a reason for departing from the approach that would otherwise have been expected to apply in relation to identified under- or over-recovery.*"¹¹ We therefore do not expect this issue to arise in the future for correction factors - beyond the context of these limited and exceptional circumstances where the CAA makes a similar error by taking a mechanistic approach to the application of any correction factor.

⁵ CMA Final Determinations, paragraph 10.120.

⁶ CMA Final Determinations, paragraph 16.15 and CMA Final Determination Order, paragraphs 8 and 9.

⁷ CAP2980, paragraph 8.

⁸ CAP2980, paragraph 1.31.

⁹ CAP2980, paragraph 1.36.

¹⁰ CAP2980, paragraph 1.37.

¹¹ CMA Final Determinations, paragraph 10.114.



- 2.10 In respect of the development capex and business rate adjustments, we acknowledge that the CAA has adopted the approach outlined by the CMA by recalibrating these adjustments by applying the proportion of outturn passengers to forecast passengers to the original figures.¹²
- 2.11 In respect of the proposed volume mix adjustment, as noted at paragraph 39 of the AP Report, *"the issue arises not through the recovery of expenditure variances over actual or forecast traffic volumes but because of variances in HAL's own forecast of the volume mix passengers and aircraft movements which meant that the actual revenue per passenger received by HAL exceeded the regulatory price cap"*.
- 2.12 Consistent with the analysis outlined at paragraph 40(a) of the AP Report, we:
- 2.12.1 agree with the CAA that Option A is not the correct approach - it is crucial that HAL is not granted additional compensation for reduced passenger traffic beyond the adjustments already factored into the Regulatory Asset Base ("**RAB**").
 - 2.12.2 disagree with the CAA's proposed Option B. As outlined at paragraph 43-44 of the AP Report, the same general principle applied in respect of business rates and development capex adjustment proposals, should equally apply to the volume mix adjustment. Specifically, the AK Factor should address the actual over-recovery by HAL as a result of flights carrying fewer passengers. The CAA's H7 Final Decision correctly adjusted for the passenger volume mix, as the amount of additional revenue made by HAL was pure over-recovery against the regulated settlement based on actual traffic volumes/mix and therefore ensured that HAL did not benefit from over-recovery. Option B, however, proposes a departure from this principle, allowing HAL to retain half of its over-recovery. We disagree with this proposal as it effectively transfers the risk associated with lower traffic volumes from HAL, a monopolist, to the airlines which operate in competitive markets where profitability is closely tied to maintaining high load factors.
- 2.13 As noted at paragraph 45 and 48 of the AP Report, permitting HAL to benefit from *ex-post* windfall revenues would undermine the regulatory contract, whereby HAL is regulated on a yield per passenger basis, by retrospectively shifting the risk of lower traffic volumes onto customers. This shift is not only contrary to the risk allocation principles under HAL's licence, but providing HAL with *ex-post* windfall revenues also provides no benefit to customers and could incentivise forecast manipulation, given that HAL could retain revenues above the regulated price cap. This risk of this occurring is particularly high in scenarios such as pandemics, where accurate forecasting is challenging.
- 2.14 Therefore, the principle that the CAA proposes to apply to the development capex and business rates adjustments should also be applied in respect of the volume mix adjustment. As outlined at paragraphs 44-50 of the AP Report, the AK Factor should correct the full extent of HAL's over-recovery of revenues. The over-recovery is a result of HAL collecting more revenue per passenger than permitted by the regulatory price cap due to lower passenger load factors during the pandemic.
- 2.15 Further, as outlined at paragraphs 46-48 of the AP Report, in its Final Determinations, the CMA questioned whether the standard working of the per passenger yield price control provided an appropriate basis for determining over-recovery related to the passenger mix¹³, given that airlines chose to not to reduce flights in proportion to the reduction in passengers

¹² CAP2980, paragraph 1.30.

¹³ CMA Final Determinations, paragraph 10.114.



during the pandemic.¹⁴ Whilst it is appropriate for the CAA to consider this, the CAA should nevertheless ultimately decide it is appropriate for HAL to refund the over-recovery based on actual revenues for 2020 and 2021. In addition to the reasons outlined above, this approach also reflects that:

- 2.15.1 It is common for airlines to operate flights with fewer passengers during downturns, such as after security threats or financial crises, due to fixed costs like airport slots and aircraft leases; and
 - 2.15.2 Allowing HAL to retain excess revenue due to forecasting errors would further risk manipulative forecasting practices referred to at paragraph 2.13 above if HAL believes that it might not have to return the full over-charge in the K Factor. This concern is heightened by the typically lower scrutiny of the annual forecasts used for setting the airport charge.
- 2.16 In summary, and as outlined at paragraphs 42-50 of the AP Report, the AK Factor should be determined as follows:
- 2.16.1 The AK Factor should be adjusted to account for the actual over-recovery made by HAL during 2020 and 2021 based on the lower passenger numbers, without any retention of additional revenue by HAL.
 - 2.16.2 The CAA should require HAL to refund 100% of the over-recovery for the volume mix, as there is no justification for a 50/50 split; and
 - 2.16.3 The recalculated AK Factor should reflect the full amount that HAL over-recovered.
- 2.17 Ensuring that the AK Factor is adjusted to accurately reflect HAL's actual revenue over-recovery during the Covid-19 pandemic, without permitting HAL to retain any portion of this over-recovery is consistent with the purpose of the AK Factor, which is to ensure that charges correspond to the actual costs and revenues, rather than allowing HAL to benefit on the basis of projected figures that failed to materialise due to the unforeseen circumstances of the Covid-19 pandemic.
- 2.18 Further, this approach reflects:
- 2.18.1 the CAA's primary statutory duty to carry out its functions "*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*".¹⁵ Requiring HAL to refund the entirety of the over-recovery for the volume mix is a matter of fairness and regulatory necessity. It ensures that airlines, and ultimately customers, are not unfairly burdened with unjustified costs and also acts as a deterrent against forecast manipulation by HAL; and
 - 2.18.2 the principle which the CAA must have regard to under section 1(4) of the Civil Aviation Act 2012 (**CAA2012**), that the CAA's "*regulatory activities be conducted in a way that is transparent, accountable, proportionate, and consistent*".¹⁶ By requiring HAL to refund the full amount of the over-recovery, we are advocating for a

¹⁴ CMA Final Determinations, paragraph 10.115.

¹⁵ Section 1, Civil Aviation Act 2012.

¹⁶ Section 1(4), Civil Aviation Act 2012.



transparent and accountable process that does not permit HAL to benefit from additional revenue that was not justified by the actual traffic volumes and mix during the pandemic.

- 2.19 The licence changes required to implement our above proposal are outlined at paragraph 68 of the AP Report, and Part Ten below. As outlined at paragraph 51 of the AP Report, these changes would increase the AK Factor (£ million CPI-2020) for 2020 from £29 million to £37 million and for 2021 from £48 million to £65 million. As outlined at paragraph 51 of the AP Report, when accounting for the indexation uplift, revised pre-tax WACC, and equal split over 2025-26, it would increase the CAA's estimate of the estimated reduction of the price cap through the AK factor from -£0.718 in 2025 and £0.748 in 2026 to -£0.956 in 2025 and -£0.996 in 2026.
- 2.20 Finally, we support the CAA's proposal to split the AK factor adjustment equally into the remaining years of H7 (2025 and 2026)¹⁷ to ensure transparency, regulatory certainty and timely return of over-recoveries.

3. PART THREE: PREMIUM APPLIED TO INDEX-LINKED DEBT COSTS

- 3.1 The index-linked premium was incorporated into the H7 price control to account for any difference in the cost of index-linked debt relative to fixed nominal debt.
- 3.2 In its H7 Final Decision, the CAA determined that the index-linked debt would carry a premium of 15 basis points ("**bps**") over fixed-rate debt on a nominal basis.¹⁸ As noted at paragraph 2.2 of the Consultation, this assumption was informed by HAL's Revised Business Plan and the CAA's analysis of five of HAL's Class A bonds and led to an increase in the WACC used for the H7 Final Decision.¹⁹
- 3.3 In response to the Airlines' Appeals, in its Final Determinations, the CMA found that the CAA erred in matters of fact and in law in including a premium of 15bps in the cost of index-linked debt when calculating the WACC. Consequently, the CMA remitted the issue back to the CAA for further consideration, ensuring that the CAA:
- 3.3.1 Apply an index-linked premium of 15bps only if it has sufficient robust evidence that this level of premium is appropriate; or
 - 3.3.2 Apply a revised index-linked premium at a level which the CAA has calculated on the basis of appropriate and robust evidence; or
 - 3.3.3 Not apply an index-linked premium, if the CAA decides upon further consideration that the available evidence is insufficient to constitute robust evidence for the calculation of an appropriate level of indexed-linked premium.²⁰

CAA's Proposal on the Index-Linked Premium remittal

- 3.4 Based on a new analysis provided by Centrus ("**Centrus Report**"), the CAA has concluded that the evidence is not strong enough to support the existence of a systematic index-linked

¹⁷ CAP2980, paragraph 1.41.

¹⁸ CAP2524D, paragraph 9.177

¹⁹ CAP2980, paragraph 2.2.

²⁰ CMA Final Determinations, paragraph 16.10.



premium. On that basis the CAA proposes to remove the premium from the WACC calculations, which would reduce the H7 RPI-real cost of debt allowance from 0.80% to 0.62% and the H7 RPI-real WACC from 3.18% to 3.16%.²¹

- 3.5 As outlined at paragraph 6 of the AP Report, this approach aligns with regulatory practices in other sectors, including the gas and water sectors, where no index-linked premium has been used.

BA's response

- 3.6 We agree that a positive premium should not be applied in respect of the index-linked premium.
- 3.7 However, in our view, there is a strong case for a negative index-linked adjustment of at least -10bps, to reflect the lower costs HAL could achieve by issuing its own index-linked bonds and the benefits of inflation protection that such bonds provide to investors.
- 3.8 The analysis at paragraphs 9-11 of the AP Report outlines that, whilst helpful, the Centrus Report adopted a limited approach to comparing index-linked bond spreads to nominal bond spreads. In particular, the Centrus Report fails to consider the full scope of the index-linked premium, which should reflect the yield difference between index-linked and nominal bonds. Centrus' analysis only accounts for the liquidity premium and the extended repayment periods of index-linked bonds, while failing to account for the negative premium that arises from the protection against inflation that these bonds offer.
- 3.9 As outlined at paragraph 10 of the AP Report, the index-linked premium should be influenced by two contrasting factors: a liquidity premium on index linked bonds, against the negative premium from avoidance of inflation risk. However, the methodology used in the Centrus Report overlooks the potential for a negative premium associated with the inflation protection characteristic of index-linked bonds, as it incorrectly incorporates the higher yields of nominal Gilts compared to index-linked Gilts.
- 3.10 In addition, the analysis outlined at paragraphs 13-16 of the AP Report, which focuses on government gilts, also indicates that:
- 3.10.1 The market typically expects a lower return on index-linked bonds due to their inherent inflation protection. This is substantiated by the fact that nominal gilt yields are consistently higher than index-linked yields once adjusted for expected inflation.
- 3.10.2 Based on historical data dating back to 2009, which matches the period looked at by the CAA, a negative premium of 0.57% was applied for embedded debt. For new debt, more recent data suggests a negative premium of 0.78%; and
- 3.10.3 In the regulated corporate sector, as seen with GB energy network companies during RII0-2, index-linked debt was issued at rates 11bps lower than equivalent nominal debt. AlixPartners concludes that this supports the case for a negative adjustment of approximately -10bps for HAL's index-linked debt.
- 3.11 Therefore, a negative adjustment of approximately -10bps is not only supported by this analysis of government gilts but also by the practical experience of regulated companies issuing index-linked debt at a lower cost than nominal debt.

²¹ CAP2980, paragraph 2.15.



- 3.12 Further to the AlixPartners' analysis referred to above, we consider that adopting a negative index-linked premium is the correct approach as it:
- 3.12.1 promotes transparency and fairness in the regulatory process by ensuring that the costs passed on to customers through airport charges are based on realistic financing options available to HAL. It also acknowledges the actual market dynamics, where index-linked bonds typically command lower yields due to the inflation protection they offer, a factor that should logically reduce HAL's cost of debt
 - 3.12.2 aligns with the precedent set in other regulated sectors, such as the GB energy network companies, as part of the RIIO-2 regime, where the issuance of index-linked debt at lower rates than nominal debt has been observed; and
 - 3.12.3 would further the interests of customers by potentially lowering the cost of airport services but also uphold the principle of regulatory consistency and economic efficiency. It is crucial that the CAA's approach to setting the price control for HAL is grounded in robust financial evidence and reflects best practice across regulated industries.
- 3.13 Paragraph 70-71 of the AP Report notes that this adjustment can be accommodated by recalibrating the 2025 and 2026 prices in the Price Control Model ("PCM") and amending the H7t factor in licence condition C1.23. Further as noted at paragraph 17 of the AP Report, this change reduces HAL's overall pre-tax WACC from 4.01% (assumed in the Consultation) to 3.99%.
- 3.14 The amendments to the CAA's proposed H7t factor required to implement this change, as well as the change on Business Rates (and possible further changes due to the shock factor), and their respective impacts on the passenger charge are outlined in Part Ten below.

4. PART FOUR: SHOCK FACTOR APPLIED TO PASSENGER FORECASTS

- 4.1 In the CAA's H7 Final Decision, a 'shock factor' was applied to the passenger forecast and was intended to account for unforecastable non-economic downside risks that could negatively impact passenger numbers. This adjustment is intended to reflect asymmetric non-economic risks such as adverse weather, volcanic eruptions, terrorism, or strikes.²²
- 4.2 In its H7 Final Decision, the CAA applied a shock factor of 0.87% to the years 2023 to 2026, where passenger numbers were not yet known, to produce a risk-weighted forecast based on an updated estimate that HAL had applied in its Revised Business Plan ("RBP") Update.²³
- 4.3 The Airlines appealed against the CAA's use of a 0.87% shock factor in its passenger forecasts on the basis that it constituted double counting of downside risks already accounted for in the 2023 forecast and in the cost of capital calculations. The Airlines also contended that applying the shock factor to the whole of 2023 was incorrect, given the availability of partial outturn data for that year, and that the magnitude of the adjustment was arbitrary and unsupported by evidence.²⁴

²² CAP2524B, paragraph 1.28.

²³ CAP2524B, pg. 7, footnote 3.

²⁴ CMA Final Determinations, paragraphs 9.293 and 9.309(c).



- 4.4 The CMA, in its Final Determinations, determined that the CAA erred by failing to properly assess the validity of HAL's calculation of the 0.87% shock factor. In particular, the CMA found that the CAA had not adequately validated the calculations and methodology, leading to a decision without sufficient evidential foundation.²⁵

CAA's proposal on the shock factor remittal

- 4.5 The CAA has assessed HAL's calculation of the 0.87% shock factor and has found that HAL's judgements on the start and end dates of shocks, as well as the estimated passenger numbers that would have prevailed without the shocks, were reasonable. The CAA has replicated HAL's estimate and noted a reduction in the prevalence of downside shocks since 2014, which could suggest a lower shock factor in the future. Consequently, the CAA has concluded that HAL's calculation was reasonable, and proposes to maintain the 0.87% shock factor without further adjustments.²⁶

BA's response

- 4.6 We disagree with the CAA's proposal to maintain the 0.87% shock factor applied to the passenger forecasts. As outlined at paragraphs 21 to 34 of the AP Report, HAL's shock factor calculation is flawed for several reasons, including:
- 4.6.1 Economic downturns, which should be excluded from the shock factor, contaminate the estimate. The shock factor is intended to account for non-economic shocks, such as major volcanic eruptions, terrorism events, and wars, not economic downturns. As outlined at paragraph 24-25 of the AP Report, economic shocks are already included in econometric models used for forecasting, and HAL's passenger shock model erroneously conflates these with non-economic shocks, leading to an overestimation.
 - 4.6.2 There is insufficient evidence to support the assumption that the base traffic forecasts are unshocked. If HAL's econometric models are calibrated to raw traffic data that includes shocks, this could lead to double counting when the shock factor is applied; and
 - 4.6.3 The methodology overlooks the possibility of positive rebounds following negative shocks, such as rebooked flights after cancellations. HAL's model fails to account for this effect, which could significantly reduce the shock factor.
- 4.7 We acknowledge that, in its Final Determinations, the CMA endorsed the CAA view that the passenger shock factor should exclude economic shocks²⁷ and we agree with this. However, as outlined at paragraph 29 of the AP Report, it appears that the CAA has not conducted a thorough investigation into the underlying calculation of the shock factor and seems to have missed the erroneous inclusion of economic shocks. Therefore, by failing to properly validate the calculation of the shock factor, the CAA mistakenly permitted HAL to factor in economic shocks into its calculation, contrary to the intended exclusion of such shocks.
- 4.8 Given the above, we recommend that the CAA undertake a thorough reassessment of the shock factor calculation to ensure that:

²⁵ CMA Final Determinations, paragraph 16.11.

²⁶ CAP2980, paragraphs 3.10-3.16.

²⁷ CMA Final Determinations, paragraph 9.246(b).



- 4.8.1 Economic downturns which are already accounted for in the econometric models used for forecasting are excluded.
 - 4.8.2 The base traffic forecasts are unshocked to prevent double counting. If the forecasts are already adjusted for shocks, applying an additional shock factor would not be justified; and
 - 4.8.3 Positive rebounds following negative shocks are accounted for. As outlined at paragraph 34 of the AP Report, an alternative assumption of 100% traffic rebound for shocks lasting less than 12 months should be considered.
- 4.9 In our view, this approach aligns with the CAA's statutory duties to further the interests of users of air transport services, as it promotes the fairness and affordability in setting airport charges by:
- 4.9.1 ensuring that the shock factor accurately reflects only non-economic shocks and avoids double counting, therefore preventing the potential for inflated charges that do not correspond to actual risks which are passed onto customers; and
 - 4.9.2 accounting for positive rebounds following negative shocks, the proposed reassessment ensures that the resilience of the aviation industry is appropriately considered, and customers are not unduly charged for temporary disruptions.
- 4.10 As above, we have outlined the necessary modifications to the CAA's proposed H7t factor required to reflect the recommendations in this consultation response, as well as their potential impact on the passenger charge in Part Ten. However, as noted at paragraph 67 of the AP Note, it has not been possible to fully articulate the deficiencies in the passenger shock factor as this would require more work, and full access to the econometric model, before a reliable factor can be estimated.

5. PART FIVE: OPEX ALLOWANCE IN RESPECT OF PENSION DEFICIT REPAIR COSTS

- 5.1 HAL's Opex allowance for H7 includes various costs related to the day-to-day operation of the airport. Among these costs are pension deficit repair costs ("PDRCs") related to a defined benefit pension scheme for employees who joined before 2008.
- 5.2 In its H7 Final Proposals, the CAA proposed an allowance of £99 million for PDRCs within the overall opex allowance. However, this was conditional on the receipt of compelling evidence from HAL to justify the necessity of this allowance.²⁸ Subsequent information provided by HAL indicated that while the overall pension scheme was in surplus at the time of the 2021 actuarial valuation, HAL's notional share showed a deficit.²⁹ Despite this, the Government Actuary's Department ("GAD") suggested that PDRCs were not required for the period covered by the 2021 valuation.³⁰
- 5.3 Given the late availability of this information and the materiality of the amounts involved, the CAA decided to continue reviewing the PDRCs beyond the H7 Final Decision. A further GAD Report, which the CAA commissioned following its H7 Final Decision, concluded that there

²⁸ CAP2365C, paragraph 4.72.

²⁹ CAP2980, paragraph 4.5.

³⁰ CAP2980, paragraph 4.6.



was no regulatory requirement for HAL to pay PDRCs at present, as the scheme was in surplus and there were no formal sectionalisation arrangements in place.³¹

CAA's proposal on PDRCs

- 5.4 The CAA has proposed to reduce HAL's opex allowance by £84 million, reflecting the absence of a need to account for PDRCs from 2023 to 2025, as indicated by the further report from GAD which the CAA commissioned following its H7 Final Decision.³²
- 5.5 This reduction will be implemented by the CAA through a licence modification. However, there remains some uncertainty for the period beyond 2025, particularly in relation to the 2024 valuation. The CAA acknowledges the possibility that HAL may need to resume PDRC payments in 2026 and has proposed to assess any PDRCs payable from 2023 to 2026 during the H8 review process.³³

BA's response

- 5.6 We agree with the CAA's conclusion that setting airport charges based on an opex allowance that assumes HAL will be making PDRCs is not in the best interests of customers, and therefore not in accordance with the CAA's primary statutory duty. We therefore support the CAA's proposal to remove £84 million allocated for PDRCs from HAL's opex allowance for H7 to ensure that the airport charges are more accurately aligned with the actual costs incurred by HAL and do not pre-emptively account for expenses that may not materialise within the H7 period. This approach promotes transparency and fairness, ultimately benefiting customers by preventing undue increases in airport charges based on speculative future costs.
- 5.7 We also support the approach of recalculating and reducing HAL's maximum allowed yield for 2025 and 2026 accordingly. Should HAL incur PDRCs towards the latter part of H7, we support the CAA's proposal to address these costs through the H8 price control.

6. PART SIX: OPEX ALLOWANCE IN RESPECT OF BUSINESS RATES IN H7

- 6.1 HAL's opex allowance also includes an allowance in respect of business rates.
- 6.2 At the time of the H7 Final Decision, the 2023 business rating list had been published by the Valuation Office Agency ("VOA") indicating that HAL's expected business rates for the H7 period would be approximately £80 million less than the figures initially proposed at H7 Final Proposals.³⁴
- 6.3 On that basis, in its H7 Final Decision, the CAA determined that the business rates allowances should be based on the 2023 VOA estimates and undertook to review the costs arising from the 2023 rating revaluation in the second half of 2023.³⁵
- 6.4 Since the H7 Final Decision, the VOA has confirmed that it intends to undertake another revaluation of the business rates within the H7 period, with the new rates coming into effect

³¹ CAP2980, paragraph 4.11.

³² CAP2980, paragraph 4.18.

³³ CAP2980, paragraph 4.20.

³⁴ CAP2980, paragraph 5.4.

³⁵ CAP2524C, paragraph 4.47



from April 2025. It is anticipated that the revised level of business rates will be payable for the final nine months of the H7 period.³⁶

CAA's proposal on business rates

- 6.5 The CAA proposes not to make any downward adjustment to the H7 business rates allowance set in the H7 Final Decision at this time. Instead, the CAA proposes to 'log up' the £85 million reduction in opex allowance that would otherwise be due now against any future increase in business rates for 2026 and then reconcile this amount during the H8 price control review, once the outcomes of the next VOA revaluation are known.³⁷

BA's response

- 6.6 Consistent with the views outlined at paragraphs 53-57 of the AP Report, we disagree with the CAA's proposal to defer the downward adjustment to HAL's business rates allowance on the basis that this approach:

6.6.1 Lacks transparency and consistency regarding the recovery of costs within the regulatory period in which they are incurred, which is a fundamental principle of good regulation and which in our opinion would be regulatory best practice and consistent with the requirement for the CAA to have regard to the principle that regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent³⁸. This is also supported by the Better Regulation Task Force Principles of Good Regulation which outline that "[r]egulation should be predictable in order to give stability and certainty to those being regulated"³⁹; and

6.6.2 Is, in any event, inappropriate given that HAL may not be liable for any potential increase, or a significantly smaller increase than the £85 million reduction in H7, in business rates resulting from the VOA's revaluation until the commencement of the H8 period.

- 6.7 We also consider that the CAA's proposal to be inconsistent with the statutory requirement for the CAA to have regard to the principles that regulatory activities should be carried out in a manner that is transparent, accountable, proportionate, and consistent, as per section 1(4) of the CAA2012. In addition to the above reasons, the CAA's proposal:

6.7.1 is not accountable to the current period's stakeholders, who may not benefit from a future adjustment, and it is disproportionate, given the value of the adjustment and uncertainty surrounding HAL's liability for increased business rates in the H8 period.

6.7.2 significantly increases regulatory uncertainty. By deferring the adjustment, the CAA sets a precedent that could encourage similar deferrals in the future, leading to a lack of certainty in the regulatory regime. This uncertainty could have adverse effects on investment decisions and other financial planning, while also diminishing stakeholder confidence in the consistency of the CAA's regulatory approach; and

³⁶ CAP2980, paragraph 5.7.

³⁷ CAP2980, paragraph 5.14.

³⁸ Section 1(4), CAA2012.

³⁹ <https://www.rqia.org.uk/RQIA/media/RQIA/Resources/Better-Regulation-Task-Force-Principles-of-Good-Regulation.pdf>, see pg. 5.



- 6.7.3 is not appropriate or in the best interests of customers, in particular by allowing HAL to 'log up' a saving owed to customers against an event with uncertain timing, scope and outcomes.
- 6.8 Further, and as outlined at paragraph 54-56 of the AP Report:
- 6.8.1 the CAA's rationale for deferring the £85 million reduction only has merit if it ensures a smooth trajectory for HAL's charges and if all other cost elements remain the same. The CAA should consider the overall impact of any increase in business rates in H8 on the total charges against all other building blocks, including passenger forecasts and other allowances, rather than focusing on business rates in isolation.
- 6.8.2 higher average passenger volumes are also expected in H8 and therefore the overall unit costs are likely to decrease, which should mitigate the effect of any significant rise in business rates on the overall profile of charges. This further undermines the justification for deferring the adjustment.
- 6.8.3 any increase in business rates during 2026 could easily be rolled into H7 since the amounts will be relatively small and most likely absorbed in higher passenger numbers anticipated for H8.
- 6.9 Given the CAA's ongoing review on '*Setting future price controls – review of approach*' (CAP 2618), we also cannot exclude the possibility that the CAA may decide to extend the current H7 period. This possibility underscores the need for adjustments to be made within the current H7 period, to avoid further delay compounding the uncertainty and to ensure that the CAA's decision is responsive to the prevailing circumstances.
- 6.10 In conclusion, for the reasons outlined above, implementing the business rates adjustment in the H7 period is the most straightforward and transparent solution, and furthers the interest of customers by preventing the carryover of the adjustment into H8 and providing clarity against an uncertain re-evaluation in two years' time.
- 6.11 The necessary modifications to the CAA's proposed H7t factor required to reflect the recommendations in this consultation response, as well as their potential impact on the passenger charge are provided in Part Ten.

7. PART SEVEN: HAL'S COMMERCIAL REVENUES, "POD PARKING" AND THE SINGLE TILL

- 7.1 Capex related to HAL's Terminal 5 Pod Parking product ("**Pod Parking**") was excluded from the RAB and 'single till' revenue calculations used to set the price control in the Q5 and Q6 price control periods.⁴⁰

CAA proposal

- 7.2 Based on the CEPA analysis, the CAA has proposed adjustments to account for capex related to Pod Parking and used the H7 PCM to calculate the impact of this on charges. The CAA estimates these changes will reduce the level of commercial revenue in the single till calculation and increase airport charges by just under £4 million (CPI, 2020) over H7.⁴¹

⁴⁰ CAP2980, paragraph 6.2.

⁴¹ CAP2980, paragraph 6.10.



- 7.3 HAL's preferred approach for estimating the average incremental revenue yield from Pod Parking was to compare the average yield per Pod Parking space with the average yield per parking space for all business parking facilities at Heathrow. This method resulted in an estimated premium of 73%.⁴²
- 7.4 The CAA proposes to compare the pod parking revenue per space and the revenue from the T5 business car park.⁴³ As noted at paragraph 61 of the AP Report, this comparison indicates a premium of approximately 50% for the year 2019, which is consistent with the upper range observed during the pre-pandemic years from 2015 to 2019. The premium calculations for much of 2022 were affected by the temporary closure of the T5 business car park and the gradual recovery of parking volumes later in the year.

BA's response

- 7.5 Consistent with paragraph 62 of the AP Report, we agree with the CAA that it is important to find as close a benchmark as possible for T5 pod parking. Passenger mix, demand for carparking spaces and consumer willingness to pay for car parking close to the terminal will all vary between terminals and so basing the T5 pod premium on T5 business parking is clearly the correct approach.
- 7.6 However, we consider that further scrutiny is required at H8 in relation to the premium applied to Pod Parking revenues. Given that the Pod Parking system has been operational for over a decade, it is reasonable to question whether it should still command a premium over other parking products. As such, the CAA should consider whether the novelty factor that may have justified a higher price initially has now diminished to the point where the premium is no longer warranted.
- 7.7 Additionally, if Pod Parking is indeed positioned as a premium product, it is necessary to examine whether there should be a corresponding premium for operational expenditures, such as the annuities for electricity that are associated with its operation. It is also unclear how costs are allocated to the Pod Parking product, particularly in relation to shared infrastructure, such as the entrance in Terminal 5. The CAA should ensure that there is transparency and fairness in the allocation of these costs.
- 7.8 In the light of the above, we request that the CAA to conduct a thorough evaluation of the costs associated with Pod Parking as part of the H8 process. This should include an analysis of whether differences in occupancy rates are attributable to a premium or other factors. Following this evaluation, the CAA should determine whether the current exclusion of Pod Parking from the RAB remains justified.

8. PART EIGHT: OTHER ISSUES ARISING FROM THE FINAL DECISION

ENERGY COSTS

- 8.1 HAL has claimed that the CAA's H7 Final Decision was based on outdated energy cost forecasts from December 2021 and that the actual energy costs, based on a more recent forecast from November 2022, are expected to be £70 million higher (in 2020 prices) over the H7 period. HAL also claims that the H7 Final Decision used nominal figures for electricity distribution costs from 2021 without accounting for Retail Price Index (RPI) inflation, leading

⁴² CAP2980, paragraph 6.7.

⁴³ CAP2980, paragraph 6.16.



to a real-term reduction in the Opex allowance of £14 million over H7. HAL contends that the CAA should adjust the price control to take account of the updated forecasts.⁴⁴

CAA Proposal

- 8.2 The CAA proposes not to reopen the H7 price control to make the adjustments in respect of energy costs and electricity distribution costs sought by HAL on the basis that:
- 8.2.1 The H7 Final Decision had already specified which areas were left open due to insufficient information from HAL, and these have been addressed
 - 8.2.2 Reopening individual elements of the price control to adjust for specific costs would shift the model towards a "costs pass-through" approach, which would diminish the incentive effect of the price control and reduce the protection it offers to consumers; and
 - 8.2.3 It would not be in consumers' interests to revisit parts of the price control that have already undergone consultation and decision-making processes.⁴⁵
- 8.3 The CAA also notes that HAL had the opportunity to challenge these issues in its appeal to the CMA but did not do so.

BA's response

- 8.4 We support the CAA's decision not to reopen its decision on energy costs and electricity distribution costs, as outlined in its H7 Final Decision, for the reasons referred to at paragraph 8.2 above.
- 8.5 In addition, making the adjustments now sought by HAL (after the H7 Final Decision and the conclusion of the CMA appeal process) would be contrary to the principles of transparency, accountability, proportionality, and consistency to which the CAA must have regard under section 1(4) of CAA2012.
- 8.6 As noted by the CAA, HAL had the opportunity to appeal this point to the CMA but chose not to do so and is now out of time. Reopening the H7 Final Decision on this point would undermine the correct statutory CMA appeal process that HAL should have adhered to had it wished to raise it as an issue (a process it was well aware of).
- 8.7 To allow for retrospective changes now would not only undermine the CAA's established regulatory practice but also set a precedent which would lead to future regulatory uncertainty and would be fundamentally at odds with the *ex-ante* regulatory framework under which HAL operates. The *ex-ante* model is designed to provide a balance between risk and incentive, encouraging efficiency and investment while protecting customers from potential excessive charges. Allowing for a costs pass-through approach, as HAL suggests, would erode those incentives for cost control and efficiency that are central to the *ex-ante* model, potentially leading to higher costs for customers without corresponding improvements in service. This is particularly the case where HAL has only proposed pass-through in relation to individual elements of the overall H7 price control package that have moved adversely from HAL's perspective, without considering other elements that have moved favourably from HAL's perspective (such as greater passenger numbers than those previously forecast).

⁴⁴ CAP2980, paragraph 7.26.

⁴⁵ CAP2980, paragraph 7.27.



FORMULA ERROR IN CONDITION 1.6

8.8 The CAA has identified that the formula set out in Condition C1.6 contains a manifest error that means that it would not deliver a profile of charges that is consistent with the Final Decision.⁴⁶

CAA proposal

8.9 The CAA recognises that it is in the interests of consumers this issue is addressed consistent with good practice in public administration.

8.10 Rather than issuing an erratum notice to correct, the CAA considers that the best way to address this error is to modify HAL's licence pursuant to the process under CAA2012 to correct the issue as the CAA considers that an erratum notice would be appropriate to correct "*a typographical error in the Licence identified shortly after the Final Decision*", however it considers that such an approach "*does not seem appropriate now that a year has passed since the Final Decision was published*".⁴⁷

BA's response

8.11 We agree that formula set out in Condition C1.6 contains a manifest error, which should be corrected by, in effect, inserting "-1" after "X" in the formula, as outlined in paragraph 7.14 of the Consultation.

8.12 However, we consider the CAA's proposed approach to delay the correction of the error by modifying HAL's licence rather than issuing an erratum notice to be inconsistent with prompt and effective regulatory action.

8.13 The CAA's position that an erratum notice would be appropriate for a typographical error identified shortly after the Final Decision but not a year later is incongruous. The passage of time does not diminish the importance of correcting an error, particularly when the error in question has a direct impact on the profile of charges and, consequently, on customers. If anything, the delay in identifying and proposing to correct the error should compel the CAA to act with greater urgency, not less. The proposal to further postpone the correction contradicts the CAA's own recognition of the need to correct errors "*as and when they come to [the CAA's] attention*".⁴⁸

8.14 Therefore, we urge the CAA to reconsider its approach and issue an erratum notice immediately to correct the error in Condition C1.6. In any event, the CAA must ensure that the error is corrected prior to HAL's statutory charges consultation due in Summer 2024.

CALCULATION OF CHARGES FOR 2025 AND 2026

8.15 We, in conjunction with the London Airline Consultative Committee and the Airline Operator's Committee, wrote to the CAA by letter dated 15 January 2024 raising a concern regarding the inclusion of £0.25 per passenger, which was intended for capital triggers and service quality

⁴⁶ CAP2980, paragraph 7.3.

⁴⁷ CAP2980, paragraphs 7.12-7.13.

⁴⁸ CAP2980, paragraph 7.12.



bonuses, in the maximum revenue yield per passenger would result in an overstatement of the charge for 2024.

CAA proposal

- 8.16 The CAA considers that the formulae in the Licence accurately calculate the charges for 2024 and the subsequent years, aligning with the figures presented in the CAA's Final Decision and the published price control model.⁴⁹
- 8.17 However, the CAA also acknowledges that including the £0.25 per passenger in the maximum revenue yield per passenger for 2023 is "anomalous" and could cause confusion regarding the charges for 2024 and beyond. Despite this potential for confusion, which was highlighted in the Final Decision, the CAA determined that there was no error in the calculation of charges for 2024. Consequently, the CAA proposes not to take any action.⁵⁰

BA's response

- 8.18 As outlined at paragraph 74 of the AP Report, whilst we acknowledge that the calibration of the PCM currently in use may allow for this inclusion, we consider that this approach is not transparent and could potentially distort the understanding of the charges for 2024. In particular, the inclusion of a one-off bonus in the base yield sets a precedent that could lead to an inflated baseline for future charges, which does not accurately reflect the ongoing costs or charges that should be borne by passengers.

9. PART NINE - H7T CALCULATION ERROR

- 9.1 Paragraph 66 of the AP Note outlines that there appears to be an arithmetic error in paragraph D9 that leads to an understatement of the negative H7 adjustment by £0.067 in 2025 (i.e. -£0.864 rather than -£0.798) and £0.076 in 2026 (i.e. -£0.901 rather than -£0.825). We therefore request that the CAA review this apparent error and make any appropriate adjustment.

10. PART TEN - RECOMMENDED LICENCE CHANGES AND THEIR IMPACT

- 10.1 AlixPartners has performed the calculations necessary to change the AK and H7 factors to rectify the issues identified in this response related to the AK Factor (see Part Two above), the index-linked premium (see Part Three), shock factor (see Part Four) and business rates (see Part Six) as well as the H7t calculation error referred to in paragraph 9.1 above. As noted above, it was not possible to fully articulate the deficiencies in the passenger shock factor as this would require more work before a reliable factor can be estimated.
- 10.2 As outlined at paragraph 68 of the AP Report, the licence changes required to implement our recommended approach to the AK factor (i.e. requiring HAL to refund its over-recovery of volume mix) is in condition C1.22(b) of HAL's Licence as follows:

10.2.1 C1.22(b)(i) OR2020 is equal to ~~£29~~ £37 million in 2020 RPI-real prices; and

10.2.2 C1.22(b)(ii) OR2021 is equal to ~~£48~~ £65 million in 2021 RPI-real prices.

- 10.3 The corrected numbers above are those given in paragraph 2.19 above.

⁴⁹ Paragraph 7.23, CAP2980.

⁵⁰ Paragraph 7.25, CAP2980.



10.4 Paragraph 70 of the AP Note outlines that all the remaining changes recommended in this response can be accommodated by recalibrating the 2025 and 2026 prices in the PCM and amending the H7t in licence condition C1.23. Table 1, extracted from paragraph 70 of the AP Note details the changes required to the PCM.

Table 1: Changes required to PCM

Issue	Changes to PCM
Index linked premium in cost of debt	Sheet: L_series Row: 336-338, 341-342, 348
Passenger forecast shock factor	Sheet: L_series Row: 17, 22, 24
Business rates allowance	Sheet: L_series Row: 159

Source: AlixPartners analysis.

10.5 The licence changes required to implement our view of the H7 factor (i.e. correction of arithmetic error, negative index linked premium of 10bps and reduction in business rates) is in condition C1.23 as follows:

10.5.1 for 2025, $H7_{2025} = -0.798 - 1.684$; and

10.5.2 for 2026, $H7_{2026} = -0.825 - 1.755$.

10.6 AlixPartners' detailed calculations are outlined in the appendices to the AP Report.

10.7 As noted above, AlixPartners has concluded at paragraph 72 of the AP Note, that taken together, these licence changes will have a £186 million impact on airline costs, for the benefit of customers, over 2025-26 (nominal prices).

11. PART ELEVEN - TERMINAL DROP OFF CHARGES

11.1 By letter to the Joint Steering Board dated 19 April 2024, HAL outlined its intention to, among other things, request a Licence amendment in respect of risk sharing for terminal drop-off charge (TDOC) revenues for the period 2022-2023⁵¹. In this letter, HAL argues that, as currently drafted, the Licence only includes risk sharing for the period 2025-2026. HAL has not explained the reasons for requesting this change in its letter, for instance any purported shortfall in TDOC revenues.

BA's response

11.2 HAL contends that the CAA intended for the risk-sharing mechanism to cover the entire H7 period, including 2022-2023, which is a point the CAA is best positioned to clarify. The CAA is also in the best position to comment on the intent of the sharing mechanism – notably the 65:35 risk share – including whether it was intended to cover the risk of shortfalls.

11.3 However, as outlined at paragraph 64 of the AP Report, from an economic incentive perspective, risk sharing should apply to elements that are beyond HAL's control, such as the uncertainty related to net traffic volumes to and from the airport. The CAA has previously

⁵¹ Condition C1.19 of HAL's Licence.



excluded TDOC revenues from HAL's Traffic Risk Sharing mechanism,⁵² with the expectation that HAL would take a commercial approach to setting the TDOC and maximising its revenues.⁵³ Therefore, to the extent that any shortfall is due to HAL's decision not to price to the CAA's forecast revenue or operational inefficiencies, this should not be included in a true-up of the risk-sharing mechanism.

- 11.4 In addition, to the extent that HAL's request amounts to a reopening of the opex and commercial revenue plan set by the CAA in the H7 Final Decision, for instance to factor in any inefficiencies or HAL's commercial choice not to price to the forecast revenue, we refer to our comments at paragraph 8.7 above in respect of HAL's request to reassess energy and electricity distribution costs. Indeed, such a reopening of the opex plan contradicts the CAA's acknowledgement that reopening parts of the price control post-consultation and decision is not generally in the interests of customers. This is reinforced by the CAA's comments in paragraph 7.27 of the Consultation, which highlight that HAL had the opportunity to address energy costs through an appeal to the CMA but chose not to do so (see also paragraph 8.6 above).
- 11.5 Further, as outlined at paragraph 65 of the AP Report, it is important to consider the interplay between terminal drop-off traffic and HAL's other revenue streams, such as car parking and public transport. A decrease in terminal drop-off traffic could potentially lead to an increase in car park usage or public transport revenues. The CAA needs to consider these issues in the round, notably in its expected review of TDOC revenues that it has signalled it will be conducting in the second half of 2024.⁵⁴
- 11.6 Finally, true-ups for 2022 have already been considered in the K factor applied to the 2024 charges. These charges have undergone consultation between August-October 2023 and are currently in effect. Therefore, any additional retrospective adjustment should only be allowed, if justified, in the context of the CAAs' review above.

12. PART TWELVE – CERTIFICATE OF ADEQUACY OF RESOURCES

- 12.1 The letter from HAL referred to at paragraph 11.1 above also outlined a request from HAL for a modification to its Licence to provide a single signed declaration from its Chief Operating Officer and a nominated Board member confirming that HAL has sufficient operational resources available to meet the Licence obligations for airport operations for the next two years, in lieu of a report prepared by an independent auditor demonstrating that HAL's operational resources have been independently verified.

BA's response

- 12.2 In relation to the issuance of Air Operators Certificates, the CAA mandates a rigorous process for applicants, which includes a thorough assessment to verify that the operator meets the minimum applicable requirements.⁵⁵ In the same vein, the CAA should ensure that it independently and objectively verifies HAL's claim of having sufficient operational resources. The CAA's oversight in this context would serve as a crucial check to ensure that HAL's self-

⁵² CAP2265B, paragraph 1.17.

⁵³ CAP2365 Final Proposals, paragraph 5.74.

⁵⁴ CAP2524C, paragraph 5.8.

⁵⁵ <https://www.caa.co.uk/commercial-industry/aircraft/operations/air-operator-certificates/preparing-and-applying-for-an-air-operator-certificate/>



assessment aligns with the standards expected by the regulator and that the airport's operations are conducted with the requisite level of resources.



ANNEXURE B

AlixPartner's report dated 1 May 2024 ("AP Report")