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Review of H7 Terminal Drop Off Charge Revenue Allowances

Thank you for the opportunity to provide a representation to the CAA's workstream to review the H7 Terminal Drop Off Charge Revenue Allowance (TDOC). This response addresses the following aspects:

- The application of the risk sharing arrangements on TDOC revenues on both upside and downside.
- Inconsistencies in the application of the TDOC.
- Answers to CAA's specific consultation questions (Annex A).
- A legal opinion in support of Heathrow's position on the applicability of the TDOC risk-sharing mechanism in the case of revenue shortfalls (Annex B).

Validity of the risk sharing arrangements on TDOC revenues on both upside and downside:

At the time of the CAA's H7 Final Proposals and Decision (H7 Final Decision)[1] there was uncertainty in relation to the level of revenue that would be collected from TDOC. This was primarily due the novelty of the scheme, being implemented for the first time amidst the context of the Covid-19 pandemic, which drastically affected passenger volume. Furthermore, the CAA recognised the possible impacts arising from the Parking (Code of Practice) Act 2019, where the Government was intending to introduce a statuary code of practice which would have limited Heathrow's ability to collect TDOC revenues.

On this basis, the CAA defined two main ways to manage that uncertainty. First, the CAA set out that a review process would have to be conducted in 2024 to assess the impact of the Parking (Code of Practice) Act (this current review). Second, and crucially, the CAA introduced a risk-sharing mechanism to account for fluctuations in revenues, ensuring any gains or shortfalls in relation to TDOC forecast revenues would be shared with airlines. This would be implemented through the inclusion of a specific adjustment – the *TDOt* term – in Heathrow's Maximum Allowable Yield formula in the Licence.

The natural meaning of a risk-sharing mechanism is that risks are shared. However, the CAA *stated* in its H7 Final Issues Decision that it "*consider[s] that the approach set out in the Final*

[1] Economic regulation of Heathrow Airport: H7 Final Proposals (CAP2365) and Economic regulation of Heathrow Airport Limited: H7 Final Decision (CAP2524).

Decision was designed to address the risk of revenues from TDOC being higher than forecast, not lower as has turned out to be the case".[2]

Heathrow considers that this interpretation is neither consistent with the Licence implementation of the mechanism, following the clear meaning of risk sharing, nor consistent with the previous statements of the CAA through the H7 consultation process and the contents of its engagement with Heathrow. If the CAA had intended to create an asymmetric risk-sharing mechanism it would have been explicit about it, and the licence implementation would have also made this clear.

Instead, the Licence is drafted consistent with the CAA's policy intent, such that TDOC risk-sharing covers both revenue over and under-recovery:

- The formula to calculate Heathrow's Maximum Allowable Yield and the *TDOt* term as defined are symmetric. Conditions C1.4, C1.5 and Conditions C1.18 and C1.19 respectively do not include any term or set out any adjustment element that could suggest that the risk-sharing mechanism is not applicable to revenue shortfalls.

- The calculation of the *TDOt* term, as described in Conditions C1.18 and C1.19 of the Licence, sets out a 100% protection for the event in which a change to legislation comes into force that *prevents Heathrow from recovering the full amount of the forecast revenue*. It then follows that the subsequent hypothesis in this Condition, setting a 65/35 risk-sharing mechanism for the event in which such legislative change does not happen, applies to revenue shortfalls too.

Heathrow has made management decisions about the approach to charging for TDOC reliant on, amongst several factors, the CAA's determination of a two-sided risk-sharing mechanism. If the CAA were now to simply change the policy set out in the Licence, it would be in contradiction to the clear approach set in the determination and cause material financial impact at Heathrow. Cumulative TDOC revenues from 2022-24 have been £130.2m, which is £12m below CAA forecast for the same 3 years in nominal terms (£142.2m).

It is important to note that the introduction of TDOC has not led to higher revenues for Heathrow from other surface access modes compared to the assumptions made in the CAA's determination. Annex A below shows that the surface access mode shares for parking, the Heathrow Express, and Picadilly Line, the modes where Heathrow's income is related to traffic, are significantly below the assumptions the CAA made in their H7 Final Decision.

Therefore, consistent with the Licence and the correct interpretation of the H7 Final Decision, Heathrow believes the CAA needs to change the position set out in its H7 Final Issues Decision and in this consultation letter from 12 December 2024, to confirm that the risk-sharing arrangement is symmetrical, applying to TDOC revenue upsides and shortfalls. This view is further supported by Towerhouse LLP, commissioned by Heathrow to provide a legal opinion on this matter (please refer to Annex B).

Application of TDOC risk-sharing since 2022 and inflation uplift

Heathrow's response to CAA's H7 Final Issues Consultation outlined an inconsistency in the implementation of the TDOC in Heathrow's Economic Licence (Licence). While the H7 Final

[2] Economic regulation of Heathrow Airport Limited: H7 final issues – decision (CAP3001), paragraph 7.30.

Decision and Notice of Licence Modifications expressly determine that the risk-sharing mechanism for TDOC revenues takes effect from the regulatory year 2022[3], the Licence only allows its implementation from 2024. The absence of a formal mechanism to implement the TDOC adjustment through the charging process for the years 2022 and 2023 should be fixed, so that the Final Decision can be implemented correctly.

In addition, as also outlined in Heathrow's response, the formula to calculate the yearly TDOC amounts set in the Licence considers 2020 prices as a baseline and omits the adjustment to adjust these numbers for inflation. This unduly penalises Heathrow with real term losses due to price increases over time.

In their Decision on the Final Issues consultation (H7 Final Issues Decision), the CAA indicated that because this matter had not been formally consulted on, no changes to the Licence could be made at that stage to address those issues. The CAA has also indicated that it would further review Heathrow's request for inflation adjustment during this TDOC review. Furthermore, the CAA decided to leave other H7 issues pending a final resolution: the CAA stated that the appropriate contributions to the opex allowance "building block" used in the H7 price control for pension deficit repair costs (PDRCs) and business rates issues would be finalised as part of the H8 price review.[4]

Considering the above, Heathrow restates that the inconsistencies related to the TDOC application – validity since 2022 and required inflation adjustment – need to be corrected. To this end, Heathrow proposes that these matters are dealt with during the H8 price review as part of a wider reconciliation together with the resolution of PDRCs and business rates issues. This approach will ensure the fair and correct application of the TDOC while also avoiding creating additional overlapping consultation processes at a time when focus should be in developing the H8 settlement.

As outlined in Heathrow's response to CAA's H8 Method Statement (CAP3044), the TDOC has been in operation for a few years and is now a mature commercial revenue product. Therefore, moving forward to H8, Heathrow's view is that it is appropriate for H8 to treat it similarly to other commercial revenue streams and to remove the risk sharing allowance.

However, Heathrow notes that airport and other parking charges remain a potential area where further discussion is required, and the risk of regulatory or legislative changes affecting this area cannot be ruled out. Heathrow therefore considers that it continues to be appropriate for the CAA to include an adjustment mechanism for H8 if drop-off charges can no longer be applied or any changes restrict Heathrow's ability to recover revenues.

Yours sincerely

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[3] Economic regulation of Heathrow Airport: H7 Final Decision Section 2: Building Blocks (CAP2524C), paragraph 5.40; CAA CAP2305 - Notice of licence modifications (interim), 22 December 2021, para 1.47; CAA CAP2515 - Notice of licence modifications (interim), 1 February 2023, Summary para 9.
[4] Economic regulation of Heathrow Airport Limited: H7 final issues – decision (CAP3001).

Appendix A

1. The effects on TDOC revenues during H7 to date arising from the Parking (Code of Practice) Act 2019, and anticipated effects expected over the remainder of the H7 period.

The proposal to introduce changes in the Parking (Code of Practice) Act 2019 was withdrawn in 2022. Heathrow has not observed any impact on TDOC revenues. It is also Heathrow view that, if later introduced as proposed, it will not be applicable to the airport.

2. The anticipated impact on HAL TDOC revenues during H7 as a result of the non-statutory code of practice for private parking firms introduced in 2024 for BPA and IPC members.

The "private parking sector single Code of Practice" is the non-statutory code introduced in 2024 for both the British Parking Association (BPA) and the International Parking Community (IPC), outlining standards for private parking firms; it came into effect on October 1st, 2024.

At this moment Heathrow does not anticipate impacts on TDOC revenues as a result of this new regulation. However, as referred to above, it is important that the CAA's settlement for H8 ensure the necessary safeguards are in place to mitigate the risk of any future change to the code or its application that could generate undue losses to Heathrow or restrict Heathrow's ability to recover revenues.

3. Any evidence on the impact of the introduction of TDOC on other HAL commercial revenue streams (such as car parks and public transport modes) compared to forecasts made at H7.

Data demonstrates that Heathrow has not benefitted from mode share growth in other revenue generating streams following the introduction of TDOC. Car parking, Heathrow Express and Piccadilly Line, the non-TDOC revenue drivers for Heathrow, have all witnessed important decline in mode share and number of transactions between 2019 and 2024 (see Table 1 below).

This is chiefly due to the modal shift brought by the introduction of the Elizabeth Line, which has attracted and continues to attract a growing number of passengers travelling to and from Heathrow. Differently to what happens in relation to the Picadilly Line, Heathrow has no revenue share or concession agreement in place with the Elizabeth Line. Therefore, the modal shift to the Elizabeth Line does not benefit Heathrow commercially, and instead generates losses due to reduction in passengers using other modes.[5]

4. Any other comments or information that you wish to submit in relation to any of the issues covered by this letter or the regulation of HAL's TDOC charges more generally.

No additional comments.

[5] Heathrow has a track access agreement where it receives income from the Elizabeth Line for running on Heathrow's track and it also receives a non-material amount related to platform ticket sales (RDG mechanism).

Table 1. Mode share evolution 2019-2024

Mode share		2019	2020	2021	2022	2023	2024		24 vs 19
Car parking									
CAA forecast									
	Park & fly	7.0%	6.5%	8.0%	7.6%	7.3%	7.2%		3.0%
Profiler mode share									
	Park & fly	7.1%	6.6%	5.0%	6.0%	6.2%	5.9%		**(16.3%)**
Heathrow Express									
CAA forecast									
	Heathrow Express	8.5%	6.6%	5.7%	7.3%	6.6%	6.8%		(20.9%)
	Heathrow Connect	0.9%	1.0%	1.1%	1.1%	0.2%	0.0%		(99.0%)
	HEx + Connect	**9.5%**	**7.6%**	**6.8%**	**8.4%**	**6.8%**	**6.8%**		**(28.7%)**
Profiler mode share									
	Heathrow Express	8.6%	6.6%	7.1%	8.4%	6.7%	5.0%		**(42.1%)**
Piccadilly Line									
CAA forecast									
	Piccadilly Line	19.8%	18.3%	16.0%	18.4%	17.7%	17.9%		(9.6%)
Profiler mode share									
	Piccadilly Line	19.9%	18.3%	15.1%	15.3%	15.3%	13.8%		**(30.8%)**
Elizabeth Line									
CAA forecast									
	Elizabeth Line	-	-	-	1.2%	8.2%	9.8%		na
Profiler mode share									
	Elizabeth Line	0.9%	1.0%	1.3%	3.8%	10.4%	13.1%		**1,363.7%**

Appendix B

Please refer to Towerhouse LLP legal opinion submitted together with this letter.