

Group Director's Office

24 March 2015



Dear Stakeholder,

Re: Notice in relation to a modification of Condition C1 of Heathrow Airport Limited's Licence made under section 22(6) of the Civil Aviation Act 2012

The CAA has today modified Heathrow Airport Limited's (HAL) licence granted under the Civil Aviation Act 2012 (the Licence). The reason for, and effect of, this modification is to correct an error in Table C.3 of Condition C1 of the Licence which would, if uncorrected, lead to an over-estimate of the inflation adjustment to the development capital expenditure (capex).

The CAA published a notice to propose a modification to correct this error on 18 February 2015. The CAA received two representations in support of the modification, and has decided to modify Condition C1 as in its proposal.

I enclose a notice setting out the details of the modification. The modification shall take effect on 5 May 2015.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Iain Osborne', written over a faint, illegible printed name.

Iain Osborne
Group Director, Regulatory Policy

Civil Aviation Authority

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Notice in relation to a modification of Condition C1 of Heathrow Airport Limited's Licence made under section 22(6) of the Civil Aviation Act 2012

1. On 13 February 2014, the Civil Aviation Authority (CAA) granted a licence to Heathrow Airport Limited (HAL) pursuant to section 15 of the Civil Aviation Act 2012 (CAA12) (the Licence).¹
2. Condition C1 of the Licence relates to the price control formulae and contains the methodology for inflation adjustment to the development capital expenditure (capex) in Table C.3 (the Methodology).
3. HAL considered that the Methodology over-estimates the inflation adjustment because it uses the incorrect index. In the light of this, HAL requested that the CAA consider whether any modifications to Table C.3 were necessary.
4. Pursuant to section 22(1) (a) CAA12, the CAA may modify a licence condition.
5. In accordance with section 22(2) CAA12, the CAA consulted on proposed changes to Condition C1 on 18 February 2015. The consultation closed on 1 March 2015. There were representations in support of the modification from HAL and from the Heathrow airline community. There were no other representations.
6. The CAA has carefully considered HAL's views and those of other consultees and has decided to modify Condition C1 by substituting the current Table C.3 with a new Table C.3 as set out below.

The new Table C.3 Development capex adjustment

		Year t =				
		9mo. 2014	2015	2016	2017	2018
Additional revenue requirement for projects in	2014	$0.5 \times d_{2014}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2014}$	$\frac{P_{t-1}}{P_{t-5}} \times d_{2014}$
	2015	0	$0.5 \times d_{2015}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2015}$	$\frac{P_{t-1}}{P_{t-4}} \times d_{2015}$
	2016	0	0	$0.5 \times d_{2016}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2016}$	$\frac{P_{t-1}}{P_{t-3}} \times d_{2016}$
	2017	0	0	0	$0.5 \times d_{2017}$	$\frac{P_{t-1}}{P_{t-2}} \times d_{2017}$
	2018	0	0	0	0	$0.5 \times d_{2018}$
		Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$	Sum Rows $\times W$

where:

- W is the Weighted Average Cost of Capital which shall have a value of 5.35%;
- d_t is the annual development capex adjustment in Regulatory Period or Regulatory Year t defined in condition C1.10; and

¹ See <http://www.caa.co.uk/application.aspx?catid=33&pagetype=65&appid=11&mode=detail&id=6072> for further information.

- P_{t-1} is the value of the ONS CHAW Retail Price Index in April in Regulatory Period or Regulatory Year $t - 1$.

Reasons for and effect of the proposed modification

7. The CAA is making this modification because the current Table C.3 over-estimates the inflation adjustment by using the wrong index in the calculation. The current table multiplies d_t by a factor equal to $\frac{P_{t-1}}{222.8}$, where P_{t-1} is the ONS CHAW RPI in April of period $t - 1$ (where t is the period for which charges are being set) and 222.80 is the ONS CHAW RPI in April 2010. Referring back to April 2010 over inflates the revenue requirement.²
8. Table C.3 is intended to inflate the annual development capex adjustment (d_t) in each year of the settlement into nominal terms when setting airport charges, using the Retail Price Index (RPI) in the year in which a project migrated from development to core as the basis for the inflation calculation.
9. The effect of the modification is to allow for correct inflation adjustment to development capex, using RPI in the year in which capex migrates from development to core as the basis for the inflation calculation rather than using the April 2010 RPI. This may result in either higher or lower adjustments each year depending on the RPI in the relevant migration year.

Effective Date

10. The modification shall take effect on 5 May 2015.



Iain Osborne
Group Director, Regulatory Policy
24 March 2015

² For example, when setting charges in 2015, the annual development capex adjustment for core projects in 2014 (d_{2014}) is calculated in 2013 prices through condition C1.10. When calculating charges in 2015, this value should be converted into 2014 prices by applying one year of inflation through Table C.3. However, the current table would multiply d_{2014} by the RPI in April 2014 (255.7) divided by the RPI in April 2010 (222.8) to give $(255.7 / 222.8 = 1.148)$. This is equivalent to 3 years of inflation. The correct multiple should be RPI in April 2014 (255.7) divided by the RPI in April 2013 (249.5) to give $(255.7 / 249.5 = 1.025)$. Similar over inflation occurs for the calculation of charges in other years. To correct for this error, the figure 222.8 in the current Table C.3 should be replaced with a relative price term based on the necessary inflation adjustment in each year.