

Towerhouse LLP for Heathrow

Risk sharing under the Terminal drop-off charge

A. Executive summary and conclusions

1. Heathrow Airport Limited has instructed Towerhouse LLP to provide a view on the CAA's position in respect of risk sharing in relation to the terminal drop-off charge ("TDOC"). The question arises because the CAA's position varies from Heathrow's interpretation of the relevant conditions.
2. The TDOC contributes to Heathrow's commercial revenue and to its single till under the regulatory price control. Because TDOC revenue is subject to high levels of uncertainty, the CAA decided it should be subject to risk sharing and created a new "TDOC factor" in the price control condition in Heathrow Airport Ltd's licence (the "Licence")¹.
3. The TDOC factor establishes a risk sharing mechanism under which Heathrow is exposed to 35% of the variation in TDOC revenue vs the CAA's forecast for H7 and the airlines 65%. The TDOC factor adjusts Heathrow's maximum revenue yield per passenger up or down accordingly. If outturn revenue falls short of forecast, 65% of that difference is recovered for Heathrow from the price control, leaving Heathrow exposed to 35% of the shortfall, and if outturn exceeds forecast, the price control is reduced to pass 65% of the difference to Heathrow's customers.
4. The formula for the TDOC factor in the Licence is plainly symmetric, with no suggestion of a difference between the treatment of a higher or lower outturn compared to forecast. By contrast the traffic risk sharing mechanism is set out in such a way that while essentially symmetric in principle, to the extent that there are differences in calculation depending on the percentage difference between the outturn and the forecast these are clearly set out.
5. In any case it would be perverse and contrary to the principle of regulatory consistency for a mechanism constantly referred to by the CAA as "risk sharing" to leave all of the downside risk with the regulated entity but only 35% of the upside risk. Had the TDOC factor been intended to operate to the upside only the Licence, the consultations and the FD and, most importantly, the condition itself would have said so.

¹ Heathrow Airport Ltd licence, granted under s.15 of the Civil Aviation Act 2012 ("CAA12"), in effect from 1 September 2024

6. The CAA now says (in its H7 final issues decision) that it "*consider[s] that the approach set out in the Final 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. This is not correct. As the Licence clearly sets out and the accompanying formula also clearly establishes, this is a risk sharing mechanism, not an upside share or profit share. This is not subject to any ambiguity. The CAA's newer view is also inconsistent with the CAA's statements in its H7 initial proposals ("IPs"), final proposals ("FPs") and final decision ("FD").
7. The law makes clear how rules are to be made by the CAA and there is no power for it to make rules outside of that. Although the Civil Aviation Act 2012 provides for the CAA to exercise certain powers, in line with its statutory duties in economic regulation, it does not grant the CAA a "Humpty Dumpty" power under which it may change the meaning of words.³ If the CAA wants to change the rules the only available route is a proper licence modification.
8. The CAA also says "*the licence drafting ... only applies from 2024 and does not address differences between forecasts and outturns in 2022 and 2023*"⁴. This is a misrepresentation. The charge controls in 2022 and 2023 were expressly subject to true-up or true-down to the level of the price control for the full H7 period. This applies to all of the components of the price control.⁵
9. There was no suggestion in any of the CAA's H7 consultation materials, or in the FD, that the TDOC would exist without its risk sharing adjustment factor and the TDOC factor appears as early as the draft licence modifications under the IPs⁶. It seems unlikely that the TDOC factor's application to 2022 and 2023 would be up for debate had TDOC revenue exceeded the CAA's forecast.

B. Definition of the terminal drop-off charge factor

10. The Licence defines a TDOC factor⁷ which is taken into account in the calculation of the price control (i.e. in calculating the regulated maximum revenue yield per passenger) under Licence Conditions C1.4 and C1.5.
11. The terminal drop-off charge factor is defined as follows:

"TDO_t is the Terminal Drop-off charge factor that:

(a) implements risk sharing; and

(b) provides protection to the Licensee from the risk that a change to legislation that substantially alters the basis upon which the CAA makes its forecasts on revenue from Terminal drop-off charges in Regulatory Year t.

² CAA CAP3001: Final Issues Decision, 11 July 2024, para 7.30

³ Lewis Carroll: *Through the Looking-Glass* (1872) ch. 6: "*When I use a word, it means just what I choose it to mean—neither more nor less*"

⁴ CAA CAP3001: Final Issues Decision, 11 July 2024, para 7.22

⁵ 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

⁶ CAA CAP2275: IPs – draft licence modifications, 23 November 2021, New C1.12 and C1.13 (page 27)

⁷ Licence Condition C1.4(i), Licence Condition C1.5(i) (c1.4(i) for t = 2024)

TDO_t shall be calculated in accordance with Table C.5 below.

Table C.5: Calculation of the Terminal drop-off charge

If $w_t = 0$	If $w_t = 1$
$-0.65 \times (OTDO_t - FTDO_t)$	$-1.00 \times (OTDO_t - FTDO_t)$

where:

$w_t = 1$ if a change to legislation comes into force in Regulatory Year t that prevents the Licensee from recovering the full amount of the Forecast, and

$w_t = 0$ otherwise;

$OTDO_t$ is the outturn revenue collected by the Licensee from Terminal Drop-off charges in Regulatory Year t ;

$FTDO_t$ is CAA's forecast of the revenue that the Licensee is expected to collect from Terminal drop-off charges in Regulatory Year t and is set out in the CAA's final decision setting the price control applicable to the Licensee for H7.⁸

12. Consequently, in the continuing absence of the referred to legislative change (i.e. while $w_t = 0$):

$$TDO_t = -0.65 \times (OTDO_t - FTDO_t)$$
13. The TDOC factor is applied to the price cap on a per passenger basis⁹. In this formula, $OTDO_t$ may be greater than, equal to or less than $FTDO_t$ and hence the result, TDO_t - the TDOC factor, may be positive, zero or negative. Indeed, in the parallel formula for the case in which $w_t = 1$, $OTDO_t$ will typically be smaller than $FTDO_t$ and TDO_t positive, so adjusting the price control in Heathrow's favour is clearly intended.
14. The effect of the TDOC factor is to adjust the maximum revenue yield per passenger for 65% of the difference between the forecast and outturn revenue from the TDOC, whether positive or negative. In other words, if outturn revenue falls short of forecast, 65% of that difference is recovered for Heathrow from the price control and if outturn exceeds forecast, the price control is reduced to pass 65% of the difference to customers.
15. This puts into effect a 35/65 symmetric risk sharing arrangement with Heathrow taking 35% of the down- or up-side versus forecast and the airlines 65%.
16. Overall the operation of the mechanism in this way is consistent with:
 - a. The original intention of the adjustment which, according to the IPs, was to be a "risk sharing mechanism under which HAL would bear 35% of any differences between actual and forecast drop-off charge revenues in H7"¹⁰ (emphasis added);

⁸ Licence Conditions C1.18 and C1.19

⁹ Licence Conditions C1.4 and C1.5

¹⁰ CAA CAP2265B: IPs – Section 1: Overall approach and building blocks, 19 October 2021, para 5.46

- b. The description of the adjustment, in the H7 FD as *“a new adjustment term to allow for uncertainty over the terminal drop-off charges”*¹¹; and
- c. The operation of the similar, broadly symmetric mechanism that derives the traffic risk sharing adjustment¹². Note that under the traffic risk sharing adjustment, to the extent there are differences in the calculation between situations where the outturn is larger than forecast and those where it is smaller, these are spelled out in the Condition, which is not the case for the TDOC factor so again clearly establishing that the TDOC operates symmetrically.

C. TDOC risk sharing is symmetrical

- 17. There is no suggestion in the licence terms that define the TDOC factor that it is asymmetric, e.g. that it applies only to one of the upside or downside. On the contrary, it is plain from the formula that it applies in the same way in both directions. There is no language that sets out that it should apply only in one direction or, were it to, which direction that would be. In the absence of any such language the meaning is plain, that this is a symmetric mechanism along the same lines as the traffic risk sharing adjustment.
- 18. Comments in the H7 interim and FPs, and the FD make clear that this was the intention all along, i.e. that the mechanism was always seen as being symmetric.
- 19. In the FD the CAA says that the TDOC factor is intended to be *“a new adjustment term to allow for uncertainty over the terminal drop-off charges”*¹³. It does not say that the uncertainty being addressed is peculiar to one or other of Heathrow or the airlines, it is plain that it is referring to uncertainty in general, to both sides.
- 20. Similarly, in the H7 FPs the CAA says: *“While HAL has some control over TDOC revenues, these revenues are subject to very high levels of uncertainty”*¹⁴. Here it is recognised that HAL has only some control over TDOC revenues and it is this level of uncertainty that justifies a risk sharing mechanism. It would be absurdly unfair for the mechanism to then require Heathrow to bear all of the downside risk while handing back 65% of any upside. This would also plainly not meet the requirement for regulatory consistency.
- 21. In addition the TDOC factor is referred to throughout as being for the purpose of risk sharing. Were it intended to operate in one direction only then another term would have been chosen. In the Licence it is referred to as a factor that *“implements risk sharing”*¹⁵.

¹¹ CAA CAP2524D H7 FD – Section 3: Financial issues and implementation, 8 March 2023, para 14.4

¹² Licence Condition C1.21 (Table C.7)

¹³ CAA CAP2365D: H7 FPs – Section 3: Financial issues and implementation, 28 June 2022, para 14.4

¹⁴ CAA CAP2265B: H7 FPs – Section 2: Building Blocks, 28 June 2022, fn 44

¹⁵ Licence Condition C1.18(a)

The same wording appears in the draft licence amendments under the FPs¹⁶ and the IPs¹⁷. The symmetric formulae for implementing the TDOC factor were also the same in each.¹⁸

22. In the IPs the CAA said that the TDOC factor would be:

“a risk sharing mechanism under which HAL would bear 35% of any differences between actual and forecast drop-off charge revenues in H7, so if the revenue is greater than forecast, airport charges would reduce by approximately two thirds of this difference”¹⁹

23. Again this says that this is to be a risk sharing mechanism, not limited to sharing risk merely to the upside, and that Heathrow would bear 35% of any differences between the outturn and forecast revenues, again not merely to the upside. The second half of the sentence gives an example of how this would work, the example applying where the outturn exceeds the forecast, but this does not preclude sharing in the other direction as well, quite the contrary. Similar language was used in the FPs.²⁰
24. Consequently it is a symmetric risk sharing mechanism that is codified in the Licence (and so is binding), as anticipated from the IPs onward through the H7 decision making process.

D. TDOC risk sharing applies across H7

25. The TDOC factor has been expected to be part of the H7 regime since at least the IPs in November 2021 and so has been an indispensable component of the TDOC throughout its existence. As such it is subject to the same true-up or true-down process as the rest of the price control.

26. On introducing its interim price controls for 2022 and 2023 the CMA said:

“it remains important for us to protect the interests of consumers by setting a holding price cap for 2022. This is needed even though we intend to true-up (or true-down) the charges in 2022 to the level of the price control for the full H7 period”;²¹

“we have committed to a true-up (or true-down) of 2022 revenues against the main H7 price control so a lower cap in the first part of 2022 would mean higher charges in the future”;²²

and

¹⁶ CAA CAP2365E2: H7 FPs – Appendix C Notice of Proposed Licence Modifications, 28 June 2022, new Condition C1.15(a) (page 20)

¹⁷ CAA CAP2275: H7 IPs – draft licence modifications, 23 November 2021, New Conditions C1.12(a) (page 27)

¹⁸ CAA CAP2275: H7 IPs – draft licence modifications, 23 November 2021, New Conditions C1.12 and C1.13 (page 27); CAA CAP2365E2: H7 FPs – Appendix C Notice of Proposed Licence Modifications, 28 June 2022, new Conditions C1.15 and C1.16 (page 20)

¹⁹ CAA CAP2265B: H7 IPs – Section 1: Overall approach and building blocks, 19 October 2021, para 5.46

²⁰ CAA CAP2365C: H7 FPs – Section 2: Building Blocks, 28 June 2022, para 5.16

²¹ CAA CAP2305 - Notice of licence modifications (interim), 22 December 2021, para 1.25

²² CAA CAP2305 - Notice of licence modifications (interim), 22 December 2021, para 1.47

“we also said we would true up or down the price cap we decide on as part of our Final Decision on the H7 price control to adjust for any differences between that Final Decision and the 2022 and 2023 holding price caps”.²³

27. Hence since the TDOC, and its accompanying TDOC factor, were components of the main H7 price control they are subject to true-up or true-down in the terms under which the 2022 and 2023 interim price controls were implemented. It would be perverse and plainly not the intention of the CAA to suggest (after the event) that the TDOC could be in place in H7 without the TDOC factor.
28. In addition, there is the precedent of the CMA’s decision as part of the H7 appeal regarding the AK factor. The CMA said:

“we have determined that the CAA was not wrong to have considered that some adjustment through the application of an AK factor should apply. Such an adjustment is a standard part of the regulatory settlement and all parties could have foreseen the possibility of HAL over-recovering some revenue and the need for some correction”.²⁴

29. It would be inconsistent with this precedent if the CAA attempted to be selective about which standard part of the regulatory settlement it applies across all of H7 and which from an essentially arbitrary date. The TDOC factor should be applied from the point that the TDOC was first levied and no later.

E. Modification of licence conditions

30. The CAA may not change the effect of Heathrow’s licence by adopting an interpretation that contradicts the text set out in the Conditions. Changing Licence Conditions C1.18 and C1.19 to mean sharing to the upside only, rather than symmetric risk sharing as they currently state, would require a licence modification and so would be subject to the procedure set out in s.22 of the Civil Aviation Act 2012 (“CAA12”).
31. This would require the CAA to follow a formal process including by publishing a notice following the minimum formalities set out in s.22(4), conducting a consultation and giving due consideration to any representations that it received, none of which it has done.
32. Should the CAA decide to modify the Licence then that decision would be subject to an appeal to the Competition and Markets Authority under s.25 CAA12. Effecting a change in a licence through some kind of reinterpretation after the event would deny Heathrow its use of this statutory appeal right.
33. The CAA is correct when it says: *“this is a matter that the CAA did not consult on as part of the March 2024 Consultation and, therefore, no changes to Condition C1 can be made at this stage”.²⁵* Were a change to the Licence to be considered this would need a new consultation process to be followed.

Towerhouse LLP
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²³ CAA CAP2515 - Notice of licence modifications (interim), 1 February 2023, Summary para 9

²⁴ CMA H7 Appeal Final Determinations, 17 October 2023, para 10.63

²⁵ CAA CAP3001: Final Issues Decision, 11 July 2024, para 7.27