Economic regulation of Heathrow Airport Limited: Notice of licence modifications

CAP2305

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About this document

This document gives notice under section 22(6) of the Civil Aviation Act 2012 of the CAA's decision to modify the Licence granted to Heathrow Airport Limited under section 15 CAA12 on 13 February 2014. The modifications that the CAA has decided to make are to:

- replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes a "holding price cap" for the Regulatory Year 2022;
- modify paragraph 4 in Schedule 1 to the Licence (Statement of Standards, Rebates and Bonuses) to ensure that rebates and bonuses can continue to be accrued in relation to performance against the targets set in Tables 1a to 10 in that Schedule;
- remove the definition of "Regulatory Period" in Condition A3 (Definitions) at Condition A3.1(f) and all subsequent references to that term throughout the Licence;
- amend the definition of "Regulatory Year" in Condition A3 (Definitions) at Condition A3.1(g) to remove references to specific years so that it refers only to the twelve-month period from 1 January to 31 December in any year; and
- include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6.

The decision on these licence modifications follows on from the Notice issued by the CAA under section 22(2) of CAA12 in October 2021 as part of the October 2021 Initial Proposals for the H7 price control.[1]

The licence modfications will take effect on 2 February 2022.

If you would like to discuss any aspect of this document, please contact Abigail Grenfell (abigail.grenfell@caa.co.uk).

1 For references to where these materials can be found, see page 6.

Summary

Introduction

1. This document gives notice under section 22(6) of the Civil Aviation Act 2012 ("CAA12") that the CAA has decided to modify the licence granted to Heathrow Airport Limited ("HAL") under section 15 CAA12 ("the Licence").[2] The modifications that the CAA has decided to make are to:

   - replace the whole of Condition C1 (Price Control) with a new Condition C1 (Price Control), which includes the "holding price cap" for the Regulatory Year 2022;[3]
   - modify paragraph 4 in Schedule 1 to the Licence (Statement of Standards, Rebates and Bonuses) to ensure that rebates and bonuses can continue to be accrued in relation to performance against the targets set in Tables 1a to 10 in that Schedule;
   - remove the definition of "Regulatory Period" in Condition A3 (Definitions) at Condition A3.1(f) and all subsequent references to that term throughout the Licence;
   - amend the definition of "Regulatory Year" in Condition A3 (Definitions) at Condition A3.1(g) to remove references to specific years so that it refers only to the twelve-month period from 1 January to 31 December in any year; and
   - include a reference to the Regulatory Year 2022 in Condition C2 (Charges for other services) at Conditions C2.5 and C2.6.

2. The modifications are specified in Appendix B. The licence modfications will take effect on 2 February 2022.

3. The CAA has made the decision to make these licence modifications after considering the responses we received from stakeholders to the notice issued by the CAA under section 22(2) of CAA12 in October 2021 ("the October 2021 Notice").[4, 5]

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2 Licence granted to HAL on 13 February 2014 under section 15(5) CAA12 at www.caa.co.uk/HAL_licence.

3 In this Notice, we refer to the "interim" or "holding" price control to apply to HAL in the first part of 2022 which will be replaced by the full price control for the "H7" period (2022 to 2026) as the "holding price cap".

4 The October 2021 Notice was published alongside, and as part of, our Initial Proposals for the H7 price control to apply to HAL for the period 2022 to 2026. See: Economic regulation of Heathrow Airport Limited: H7 Initial Proposals October 2021 (CAP2265) www.caa.co.uk/Commercial-industry/Airports/Economic-regulation/H7/Consultations-and-policy-documents. ("the October 2021 Initial Proposals").

5 Appendix C of the October 2021 Initial Proposals set out the October 2021 Notice as a notice under section 22(2) CAA12 proposing licence modifications to set a holding price cap for HAL for 2022, see: www.caa.co.uk/CAP2265E. Reasons for the proposals contained in the October 2021 Notice were set out at chapter 15 of the October 2021 Initial Proposals, see: www.caa.co.uk/CAP2265D.

Background

4. HAL's current price control ends on 31 December 2021. In the October 2021 Initial Proposals, we noted that the final decision on the licence modifications to put in place a new five year control period for H7 will not be made until summer 2022. In this context, it is 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 the early part of 2022 to the level of the price control for the full H7 period that we intend to put in place during 2022. If we were not to do this, prices might be too high in 2022 and this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period.

5. To deal with these issues, we consulted on a holding price cap of £29.50 (in 2020 prices) in the October 2021 Initial Proposals and received responses from a range of stakeholders including HAL, airlines, airline representatives and others. HAL and airlines made a wide range of comments, which included important representations on the overall level of the holding price cap:

- HAL said that we had made errors in our approach (including that the allowances we had made for its operating costs were too low and estimates of its commercial revenues too high) and that the holding price cap should be significantly higher. It also said we had not properly considered its financeability; and
- airlines and their representatives said that airport charges at Heathrow were already the highest in the world and that we had also made errors in our approach (including that we had under-estimated the number of passengers likely to use Heathrow airport over the period of the H7 price control and that the allowances we made for operating costs were too high and estimates of HAL's commercial revenues were too low). Airlines said that these issues meant that the holding price cap should be significantly lower.

Our assessment

6. We have reviewed the additional information provided by HAL and airlines and consider that:

- in the light of the developments associated with the Omicron variant of covid-19,[6] it would be premature at this time to adopt the significantly higher forecasts of passenger numbers put forward by airlines;

[6] We refer to this as "Omicron" in the remainder of this Notice.

- in relation to the forecasts of operating costs and commercial revenues, we remain of the view that, at this stage of our process (when HAL has not had the opportunity to respond to the detail of our consultants' work),[7] it is appropriate to take account of the evidence provided by both the information in HAL's business plan and the work of our consultants in making projections of operating costs and commercial revenues; and
- we note HAL's concerns about its financeability, but observe (i) that credit markets and credit rating agencies did not react adversely to our consultations in October 2021 on the Initial Proposals and holding price cap, and (ii) the increasingly strong outlook in our forecasts of HAL's key credit metrics over the H7 period.

7. We have also noted the likely pressures on the affordability of air travel for consumers in 2022, including in relation requirements for covid-19 testing and also reflected on airline suggestions that we should give more weight to the detriment to consumers caused by the relatively high level of airport charges at Heathrow.

8. There would undoubtedly be benefits to passengers in seeing lower airport charges as we expect that this would be reflected in lower fares and through airlines having an extra incentive to bring back additional services in 2022. Nonetheless:
   - these benefits would be limited, as 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;
   - while we are confident that a £29.50 holding price cap for HAL would be consistent with efficient financing for HAL, we would have less confidence with respect to financeability if we were to set the holding price cap at a significantly lower level and, in particular, the £19.39 suggested by airlines;
   - we also note that, in adopting our proposed holding price cap of £29.50 (in 2020 prices), we have already ensured that consumers already benefit from the profiling of charges in 2022. Had we not done this, taking 2022 in isolation, the unprofiled range for charges was £38.44 to £51.02 (CPI-real 2020 prices) with a mid-point of £44.73, compared to the holding price cap we proposed for 2022 that benefitted from smoothing of £29.50; and
   - a substantial change to our proposals for the holding price cap would trigger the need for additional consultation to support the associated licence modifications and lead to a greater period of time at the start of 2022 when HAL would not have a price control condition in place restricting the amount it could charge airlines.

9. Bearing the above in mind as well as the advantages of retaining the assumptions in the October 2021 Initial Proposals on passenger forecasts, operating expenditure, commercial revenues and the cost of capital, at least

[7] HAL's response to the October 2021 Initial Proposals was received on 17 December 2021 and, therefore, was not available to the CAA at the time it made its decision on the holding price cap. We will consider this evidence alongside that provided by other stakeholders in developing our Final Proposals.

during the current period of heightened uncertainty about the impact of the Omicron variant, the balance of evidence supports retaining £29.50 (in 2020 prices) as the holding price cap. Further details of our assessment are set out in chapter 1 of this Notice.

10. We need to translate the £29.50 from 2020 prices to 2022 prices so that we can include them in HAL's Licence and remove any ambiguity about adjustments for price indexation. Consistent with the method currently set out in HAL's Licence, we adopted price indices in April to calculate the applicable inflation uplift. The increase in the consumer price index was 0.8% in April 2020 and 1.5% in April 2021, giving a compound increase of 2.32%. Applying this to £29.50 gives a holding price cap of £30.19. We have used the CPI as it is now a properly recognised measure of inflation and is preferred to the RPI.

11. In formulating Final Proposals for the five year price control for H7 in early 2022, we will look to set suitably stretching targets for HAL, such that the path of its charges delivers value for money for consumers in the medium and longer-term. Given the present level of uncertainty, we will also need to reconsider the forecasts of passenger numbers, and there should be no presumption that the H7 price control will be at the same level as the holding price cap. We will formulate the Final Proposals for the five year H7 price control in a way consistent with our statutory duties, ensuring that consumers' interests are appropriately protected, while also having regard to the matters required by those duties, including HAL's financeability and the financing of essential new investment at Heathrow airport.

Next Steps

12. The modifications to the Licence set out in Appendix B will take effect on 2 February 2022, and subject to any appeals and subsequent decisions of the Competition and Markets Authority under the provisions of CAA12.[8]

Our duties

13. In taking this decision, the CAA had full regard to our statutory duties under CAA12. These are set out more fully in Appendix A.

Structure of this document

14. The structure of this document is as follows:

- Chapter 1 explains our reasons for making the modifications to put in place price control arrangements for 2022, including:

[8] The price control condition that the CAA has decided to put in place for 2022 to implement the holding price cap has the effect of requiring HAL to set its prices so as not to exceed the maximum revenue yield per passenger in respect of the Regulatory Year 2022. As noted in paragraph 2.3, on 17 December 2021 (pursuant to its obligations under the ACR2011), HAL issued its decision to set airport charges consistent with the holding cap of £30.19.

  - how we have taken account of the representations made in response to the October 2021 Notice, and
  - the reasons for any differences between the modifications and those set out in the October 2021 Notice.
- Chapter 2 sets out our reasons for, and the effects of, the drafting of the modifications to put in place price control arrangements for 2022 and other modifications to remove redundant terms and update relevant dates, including:
  - how we have taken account of the representations made in response to the October 2021 Notice, and
  - the reasons for any differences between the modifications and those set out in the October 2021 Notice.
- Appendix A summarises our statutory duties.
- Appendix B sets out the modifications to existing licence conditions and the new licence conditions.

Chapter 1

The holding price cap for 2022

Introduction

1.1 This chapter:

- explains the background to our proposal to implement an holding price cap on HAL's airport charges for 2022;
- summarises the responses we received from stakeholders on this issue;
- discusses our views of the responses; and
- sets out and explains our decision.

The October 2021 Notice

1.2 The October 2021 Initial Proposals noted that:

- the impacts of the covid-19 pandemic had adversely affected the timetable for the H7 price control review. In particular, HAL's RBP and updated RBP were delayed to ensure they were based on more up-to-date information and traffic projections. In addition, we needed to take extra time and resources to consult stakeholders on the important issues raised by HAL's request for a covid-19 related RAB adjustment. These developments meant that the Initial Proposals were issued in October 2021 rather than summer 2021 as we had intended at the time of our April 2020 timetable update;
- HAL's current price control ends on 31 December 2021. This means that, without further action by the CAA, there would be no price cap applicable to HAL from 1 January 2022 until the summer of 2022, when we expect the licence modifications for the five year H7 price control to take effect;
- the absence of a price cap in the intervening period risks exposing consumers to charges that could be unduly high in 2022 and could also create or exacerbate a conflict between the interests of "present consumers" travelling during the first part of 2022 and "future consumers" travelling later in the H7 period. Present consumers could experience materially higher charges than necessary because of the absence of a price control in early 2022, while future consumers could experience somewhat lower charges than they otherwise would have done because of the impact of any truing-up arrangements;
- at the end of August 2021, HAL issued its consultation on airport charges for 2022, which it considered was in accordance with the requirements of the ACR2011. HAL's consultation assumed charges at a level that is designed to deliver a yield of £37.64 per passenger (nominal prices). It developed this approach from the assumptions included in its updated RBP; and

- we have been considering this issue with HAL and airlines since our April 2021 Way Forward Document.[9] We have encouraged both sides to engage on the level of the charge for 2022 to see if they could agree a holding price cap which would be trued-up (or trued-down) with the CAA's final decision to ensure that each of HAL and consumers would be "held harmless" for any difference between the holding price cap and the eventual price cap that the CAA sets for H7. Unfortunately, agreement between HAL and airlines has not been forthcoming.

1.3 To address these difficulties (and as part of the publication that also contained our Initial Proposals) we issued the October 2021 Notice as a formal consultation on, and notice of, licence modifications which proposed to put in place a licence condition to regulate HAL's prices in 2022 based on an holding price cap of £29.50 per passenger (2020 prices).[10] We also said we would use a correction factor in the price control licence condition that we intend to include in our final decision for H7 to provide an automatic mechanism that will true-up (or true-down) any under- or over recovery of revenue between the holding price cap and the final level of the H7 price control.

1.4 On 27 October 2021, HAL wrote to the airlines to delay the publication of its final 2022 airport tariff list and associated Conditions of Use to better understand the implications of the October 2021 Initial Proposals and the impact of them on the 2022 airport charges. On 16 December 2021, we wrote to HAL, British Airways, Virgin Atlantic Airways and the Heathrow AOC (and put the letter on our website)[11] stating that we had decided to make the modifications as proposed in the October 2021 Notice, and that we would be confirming our decision in this Notice before Christmas. In response to the 16 December 2021 letter, HAL published its final decision on its charges for 2022 under the ACR2011 on 17 December 2021, based on a holding price cap of £30.19.

Stakeholder views

1.5 We received 19 responses to our consultation on the holding price cap set out at chapter 15 of the October 2021 Initial Proposals and in the October 2021 Notice. These were from HAL, airlines, airline representative bodies, one consulting firm and one member of the public. The key issues are summarised below.

HAL

1.6 HAL said that the holding price cap proposed by the CAA is too low and would significantly undermine its financial resilience. HAL also stated that airport charges represent a modest proportion of airfares. It argued that the interests of consumers would be furthered by the CAA prioritising a charge that allows for and incentivises investment and resilience, including protecting HAL's access to capital markets. It said that this would enable it to obtain sufficient liquidity and efficient financing to remain financially resilient. In HAL's view, the CAA's

9 See www.caa.co.uk/CAP2139.

10 As noted above, the October 2021 Notice of the proposed modifications to the Licence to implement this holding price cap under section 22(2) CAA12 was given at Appendix C of the October 2021 Initial Proposals See footnotes 5 and 6 above.

11 See https://www.caa.co.uk/CAP2307

proposed charge failed to do this and creates risk of a credit rating "downgrade" that would restrict its access to finance and increase its costs. It said this would not be in the interests of consumers.

1.7 HAL also:

- disputed the CAA's method for calculating the WACC on the grounds that it assumes the covid-19 pandemic has had no impact, ignores evidence from other airports and the method followed by the CAA's consultants is flawed;
- identified an error in the CAA's financeability analysis relating to HAL's opening gearing and another error in respect of opex that reduces the projections of the funds from operations ("FFO") financing metrics; and
- stated that the CMA had set clear thresholds for what FFO should be to support an investment grade credit rating, and the CAA's approach put this at risk.

1.8 Noting the need for caution over passenger forecasts, HAL said that its existing forecasts for 2022 remained reasonable central forecasts, especially given the uncertainty from rising covid-19 cases in Europe. HAL also argued that the CAA's passenger forecast for later years of H7 was wrong as it did not take account of the annual cap of 480,000 aircraft movements at Heathrow.

1.9 It also said there were serious errors in the estimates made by the CAA's consultants (CEPA/Taylor Airey) for opex and commercial revenues in 2021/22 such that these projections are neither realistic nor credible.

1.10 In HAL's view, the CAA had erred in its judgement in relation to financeability, opex, commercial revenues, passenger numbers and the WACC so that the estimates for these were below what is required to operate a safe and resilient airport. HAL stated that the CAA's range for charges set out in the October 2021 Initial Proposals is too low and fundamentally compromised.

1.11 HAL argued that the consequence of the CAA's price cap being set at the level it proposed would be a loss for HAL before tax of over £300 million based on a notionally financed company. HAL considered that it is unprecedented for a regulator to set a price cap that would lead to such a degree of loss. It also said the CAA's process had led to a timeline that is inconsistent with the requirements on HAL to consult on its charges for 2022 under ACR2011.

1.12 HAL's proposed solution was for the CAA to set the cap at the top of its range and at the level that HAL had consulted on under the ACR2011 (£37.64 in 2022 prices).

1.13 It also said that it was provisionally accepting the notion of a holding price cap for 2022 provided that, if the final H7 determination were to be for a higher level of revenue for 2022, it could recover any shortfall. It reserved its rights to make further representations (including in relation to opex and financeability) and to fully evaluate the CAA's H7 final decision.

Airlines and other stakeholders

1.14 Airlines' positions were broadly aligned in suggesting that the October 2021 Initial Proposals were not in line with the CAA's duties because they did not further the interests of consumers, promote economy and efficiency and were not proportionate. They said that an appropriate assessment of the price control building block assumptions would lead to a significantly lower cap and that a holding price cap set at £29.50 would be inconsistent with the CAA's statutory duties.

1.15 They noted that Heathrow is already one of the most expensive airports in the world, yet the CAA's approach to the holding price cap would lead to an increase in charges of over 50%, significantly above the costs airlines see elsewhere and disproportionately compensating HAL. They considered that the proposed cap for 2022 would be around £10 per passenger too high, would damage Heathrow as a hub airport and was not in the interests of consumers.

1.16 Airlines said that the CAA's analysis was based on out-of-date passenger forecasts and said that these should be updated for recent trends, particularly the removal of travel restrictions. Airlines noted that passenger numbers at Heathrow had historically bounced back more rapidly than the rest of the UK after previous downturns. Among other points, they noted that there is strong evidence that passenger numbers will be at 90% of 2019 levels in 2022. Airlines have requested that HAL's forecasting model is either independently assured or that airlines be allowed timely access to it prior to the CAA issuing its Final Proposals for H7.

1.17 In relation to the forecasts of opex and commercial revenues, airlines said that the CAA should adopt the projections made by CEPA/Taylor Airey rather than use these to help define a range for these forecasts. Airlines said that HAL's projections were based on high level arguments with little or no supporting evidence and they should not be given the same weighting or be disregarded. They claimed it was inexplicable and unlawful for the CAA to rely so heavily on HAL's updated RBP compared to independent analysis and also noted that:

- the CAA had not given reasons why it has given equal weighting to HAL's and CEPA/Taylor Airey's analysis; and
- as HAL's updated RBP did not comply with the CAA's business plan guidance, it was inappropriate for the CAA to rely on HAL's numbers.

1.18 Airlines said that adjusting for these factors and adopting a higher passenger forecast would lead to a more realistic and defensible mid point for 2022 of £19.39 which should be used for the price cap. Airlines stated that a cap at this level would not impact the financeability of the notional company, as it would be substantially the same as the current (2021) price cap which they considered to be demonstrably financeable. Further, airlines noted that HAL has declared its financial strength in its investor reports.

1.19 They said that the WACC range is too high and that airlines are being asked to shoulder too much of HAL's pension deficit repair costs. They did not, however, propose changes for the holding price cap in relation to these matters. Rather, they propose to provide detailed arguments on these issues for the development of the CAA's Final Proposals for H7.

1.20 Airlines also said that the "correction factor" ("k") that is normally used to true-up (or true-down) imbalances between charges set in individual years should not be used to true-up (or true-down) any differences between the holding price cap and the final price control for H7. They considered that this would lead to price volatility in 2024. Rather, any adjustments should be reflected either "within year" in 2022, or spread across the whole of H7.

1.21 Individual airlines also raised additional issues including that:

- the proposed holding price cap did not have regard to/was not commensurate to the risk that HAL may engage in conduct that amounts to an abuse of market power;
- the CAA's financeability analysis should take account of HAL's use of interest rate swaps which reduced its interest repayments for 2022 to near zero; and
- the focus of the CAA's consultation was too narrow and should also have considered the structure of HAL's charges, including issues such as the charge per aircraft movement.

1.22 Other respondents generally emphasised the points being made by airlines, including that the CAA had erred with its judgements and should set the holding price cap at a lower level.

Our views

1.23 In the October 2021 Initial Proposals, we said that, given the impact of the covid-19 pandemic on Heathrow and the wider aviation sector, it is not straightforward to calibrate a price control that protects consumers with respect to prices while also allowing for the funding of necessary investment (including in relation to safety, security and resilience) at Heathrow airport.

1.24 Since the close of our consultation period on the October 2021 Notice on 17 November 2021, new information about the emergence of Omicron has emerged, and continues to emerge. As a result, there is now a greater level of uncertainty about the likely level of passenger volumes over 2022 than there was both at the time when we published the October 2021 Notice and when that consultation closed. This is not just due to the immediate responses by Governments to the emergence of Omicron, but also the indication it provides about how Governments may respond to future variants of concern.

1.25 Nonetheless, 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. If we were not to do this, prices might be too high in 2022 and this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period.[12]

1.26 In setting the holding price cap for 2022 it is appropriate that we take account of a broad range of information, have appropriate regard for the wider process for

[12] As such, setting a holding price cap is necessary or expedient having regard to the risk that HAL might engage in conduct that amounted to an abuse of substantial market power in the way its sets its charges and is, in any event, necessary in the interests of consumers for the reasons set out in this chapter.

setting the main H7 price control and act in a proportionate and focused way. In particular:

- we have reviewed the additional information provided by HAL and airlines on projections of passenger numbers and consider that, in the light of the developments associated with Omicron and other available evidence, it would be premature to adopt the significantly higher forecasts of passenger numbers put forward by airlines;
- in relation to the forecasts of operating costs and commercial revenues, we remain of the view that, at this stage of our process (when HAL has not had the opportunity to respond to the detail of our consultants' work),[13] it is appropriate to consider both the information in HAL's business plan and the work of our consultants in determining a range with respect to these costs and revenues. Bearing this in mind, we do not accept the views of airlines that we should focus solely on the projections made by our consultants. We are also not persuaded by HAL's arguments that because our projections of costs are lower than those in its business plan they must be flawed, particularly given the weaknesses in HAL's business plan information highlighted in the October 2021 Initial Proposals. As such, it is not appropriate for us to discount either source of evidence at this stage; and
- we note HAL's concerns about its financeability, but observe that credit markets and credit rating agencies did not react adversely to our consultations on the October 2021 Initial Proposals or the holding price cap. Bearing this in mind, and the increasingly strong outlook in our forecasts of its key credit metrics over the H7 period, we consider the suggestion by HAL that the holding price cap could jeopardise its financeability to be unduly pessimistic and not properly supported by evidence.

1.27 These matters are discussed in more detail below.

Passenger forecasting

1.28 We have carefully considered all of the responses that been put to us including by discussing the key issues with HAL and airline stakeholders. We have also updated our own analysis of passenger volumes and financial modelling of the price cap. Some of this work was undertaken in the period prior to the emergence of Omicron, which has led the UK Government to reintroduce some travel restrictions, including PCR testing. Revised passenger forecasts are set out in Figure 1.1 below together with our forecasts from the October 2021 Initial Proposals and the most recent forecasts provided by HAL and airlines.

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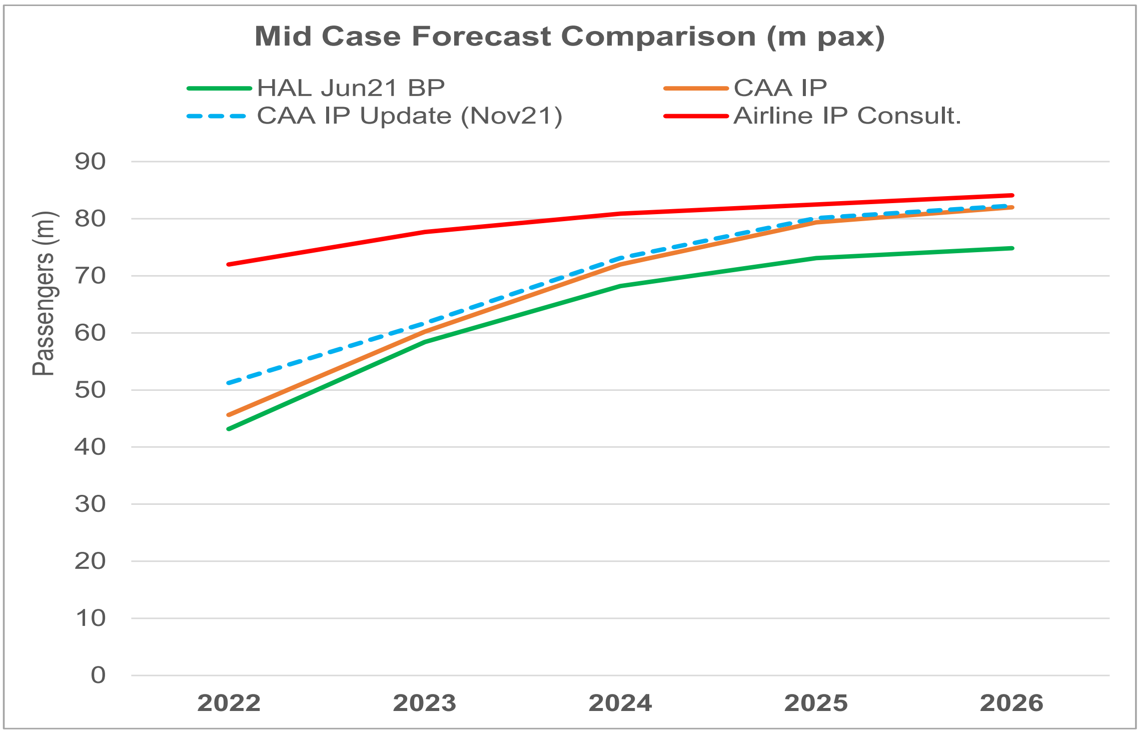
[13] See footnote 7 above.

Figure 1.1: comparison of passenger forecasts



Source: CAA, HAL and airlines

1.29 Our updated forecasts were based on the removal of travel restrictions and are somewhat higher than those we set out in the October 2021 Initial Proposals, particularly in the earlier years of H7. Over the five year period of H7, our latest projections are 3% higher than those we used for the October 2021 Initial Proposals. Using this updated projection to calculate airport charges would imply a slightly lower holding price cap of £28.40, calculated in the same manner as used for the holding price cap we consulted on in the October 2021 Notice. These updated forecasts were completed before the news on Omicron started to fully emerge.

1.30 The airline projections for passenger numbers are considerably more optimistic than the forecasts prepared by either the CAA or HAL, and were also provided to the CAA before the emergence of Omicron.

1.31 Having reviewed the information provided by HAL and airlines on projections of passenger numbers and the latest developments associated with Omicron, we consider it would be premature at this stage of the price control review process to adopt the significantly higher forecasts of passenger numbers put forward by airlines. It would also be premature to update our projections for the removal of travel restrictions or to assume that Omicron will not have an adverse impact on passenger traffic in 2022. Bearing this in mind, there is a relatively strong case for retaining the forecast of passenger demand used in the October 2021 Initial Proposals, but we acknowledge projections of passenger number remain subject to significant uncertainty.

Opex and commercial revenues

1.32 Noting the ongoing degree of uncertainty created by the impact of the continuing covid-19 pandemic, we identified a range in the October 2021 Initial Proposals for both opex and commercial revenues. HAL's updated RBP projections (scaled to CAA passenger forecasts) defined one end of the range and CEPA/Taylor Airey's mid case the other. We then used the upper and lower quartile of this range to inform our range for the price cap.

1.33 As noted above, Airlines have said that we should use the CEPA/Taylor Airey projections of opex and commercial revenues and not put any weight on HAL's business plan, which they say was supported by little or no evidence. We note that the October 2021 Initial Proposals stated that:

> "*we consider that HAL has provided a reasonable level of detail on opex in its updated RBP and this has been an improvement from the level of information included in the RBP and earlier IBP*."[14]

1.34 The October 2021 Initial Proposals also explained some of the limitations of the CEPA/Taylor Airey work. For instance, in relation to commercial revenues, we noted CEPA/Taylor Airey assumed that HAL can increase average revenues per passenger through the H7 period by applying a 2% per year "management stretch" challenge to estimates of relevant revenues for H7. While HAL's assumptions may lack sufficient stretch,we also note the significant challenge created by the stretch assumption made by CEPA/Taylor Airey over the H7 period. So, we remain of the view that it will be important to consider the representations HAL and other stakeholders make in response to the October 2021 Initial Proposals before deciding on what level of stretch is appropriate.

1.35 Bearing this context in mind, it does not appear appropriate at this stage of the process to focus exclusively on the work of CEPA/Taylor Airey and to disregard the information contained in HAL's business plan.

1.36 In contrast to airlines, HAL argued that the lower levels of costs identified by CEPA/Taylor Airey contained errors and produced estimates of costs significantly below the levels that HAL expects to incur. HAL also said these levels of costs would not be consistent with the safe and resilient operation of the airport. As we have explained above, we have not assumed that HAL can meet the targets suggested by our consultants. Instead, we have used a range of alternative estimates in formulating the October 2021 Initial Proposals and the holding price cap.

1.37 Given that there are weaknesses in the business plan information that HAL has provided (as we noted in the October 2021 Initial Proposals), we remain of the view that taking a range between HAL's business plan and the views of our consultants is appropriate at this stage of the price control review process. The use of lower and upper quartiles was a pragmatic decision that reflected limited maturity of our analysis at the time of making the Initial Proposals and that stakeholders had not yet been provided with full information on which to comment. We will reconsider these issues as part of our work on Final Proposals. Similarly, our proposal that the holding price cap should be set at a level consistent with the middle of this range was a pragmatic exercise of judgement reflecting the maturity of the evidence and analysis at the time when we made the Initial Proposals. Having considered them carefully, we do not

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14 See www.caa.co.uk/CAP2139

consider that the representations we have received on opex and commercial revenue are sufficiently persuasive as to warrant a change in our approach at this stage of our process.

1.38 Our work on preparing Final Proposals will include commissioning an update of the CEPA/Tailor Airey report so that it reflects the latest information.

Cost of capital and financeability

1.39 HAL and airlines have set out very different views on the cost of capital and associated issues such as financeability. The most pressing matter is taking appropriate steps to ensure that our approach to the holding price cap has regard to the need to ensure that HAL can finance its activities. In formulating the October 2021 Initial Proposals, our focus was on the financing of an efficient or notionally financed licensee with gearing in the range 60% to 70%. This approach remains valid but we also have new information from debt markets that it is appropriate for us to consider.

1.40 While we note HAL’s concerns about its financeability, we observe that credit markets and credit rating agencies did not react adversely to our consultations on the October 2021 Initial Proposals or holding price cap in the October 2021 Notice. These observations relate both to Heathrow Funding Limited and Heathrow Financing Limited, with the latter having a significantly higher level of gearing than the notionally financed company. As noted above, bearing this in mind and the increasingly strong outlook in our forecasts of HAL’s key credit metrics over the H7 period, we consider the suggestion by HAL that the holding price cap could jeopardise its financeability to be unduly pessimistic and not properly supported by evidence.

1.41 In response to the October 2021 Initial Proposals, HAL also highlighted an error in our financial modelling that meant we had underestimated the gearing of the notional company by around 5%. We will correct this error for Final Proposals for H7. That said, we note that the broad conclusions of the analysis in the October 2021 Initial Proposals remain valid in that there should be an increasingly strong outlook in HAL’s credit metrics over the H7 period and that it should also be in a position to restart the payment of dividends to its shareholders (but perhaps a little later than we had previously assumed).

1.42 As noted above, stakeholders also expressed a wide range of views about the appropriate level of HAL’s cost of capital. We will consider these matters further in formulating the Final Proposals for H7.

Other issues

1.43 HAL has suggested that the CAA has the option to not implement a holding price cap and instead rely on the provisions of ACR2011 to protect consumers. For the reasons set out above, we do not consider that this is an option that provides an appropriate level of protection to the interests of consumers in 2022, since, if we were not to implement a holding price cap:

- prices might be too high in 2022; and

- this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period.

1.44 In addition, we do not consider that the provisions in the ACR2011 provide an adequate level of protection for consumers as those regulations focus on transparency, consultation processes and preventing discrimination, rather than giving protection on/regulation of the overall level of airport charges.

1.45 We note the comments of airlines on the use of the correction factor to true-up (or true-down) the difference between the holding price cap and the final level of charges. We intend to keep this issue under review and will consider alternative approaches such as smoothing any difference over the full H7 period if circumstances suggest such an approach would be in the consumer interest (for example to avoid a spike in prices in any given year).

Our decision

1.46 It is looking increasingly likely that the affordability of air travel for consumers in 2022 will be put under greater pressure by the costs of new travel requirements such as additional covid-19 testing. We have also reflected on airline suggestions that we should give more weight to the detriment to consumers caused by the relatively high level of airport charges at Heathrow.

1.47 There would undoubtedly be benefits to passengers in seeing lower airport charges, as we expect that this would be reflected in lower fares and through airlines having an extra incentive to bring back additional services in 2022. Nonetheless:

- these benefits would be limited as 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;
- while, as discussed above, we are confident that a £29.50 holding price cap would be consistent with efficient financing for HAL, we would have less confidence with respect to financeability if we were to set the holding price cap at a significantly lower level and, in particular, the £19.39 suggested by airlines. We observe that the news around Omicron caused a widening of the spreads on HAL's investment grade bonds and that an unexpected and significant tightening of the holding price cap could exacerbate these issues;
- we also note that our proposed holding price cap of £29.50 would ensure that consumers significantly benefit from the profiling of charges in 2022. In developing the range we set out in the October 2021 Initial Proposals (£24.50 to £34.50), we smoothed the level of charges over the five years of the H7 price control. Had we not done this, taking 2022 in isolation, the unprofiled range for charges was £38.44 to £51.02 (CPI-real 2020 prices) with a mid-point of £44.73, compared to the holding price cap we have proposed for 2022 of £29.50; and

- a substantial change to our proposals for the holding price cap would trigger the need for additional consultation to support the associated licence modification and lead to a greater period of time at the start of 2022 when HAL would not have price control condition in place restricting the amount it could charge airlines.

1.48 Bearing the above in mind and the advantages of retaining the assumptions in the October 2021 Initial Proposals on passenger forecasts, opex, commercial revenues and the cost of capital, at least during the current period of heightened uncertainty about the impact of Omicron, the balance of evidence suggests retaining £29.50 (in 2020 prices) as the basis of the holding price cap.

1.49 In formulating our Final Proposals for the main five year price control for H7, we will consider the points made by HAL and airlines on issues such as passenger forecasts, operating costs, commercial revenues, cost of capital and financeability. Our Final Proposals for H7 may be different from our decision on the holding price cap as it will benefit from the further evidence and analysis that we are conducting prior to making our final decision for the full the H7 price control. Nonetheless, the approach set out in the October 2021 Initial Proposals to calibrating the holding price cap remains valid for this stage of our process as an accurate reflection of the evidence we have overall, especially in the context of the present levels of uncertainty.

1.50 We are conscious of the challenges that the level of the holding price cap will create in the short term for consumers and, in the context above, the airlines that serve them, but we are also of the firm view that the holding price cap needs to be established in a way that is consistent with HAL continuing to be able to finance necessary investment in security, safety and resilience. These issues are vital to the interests of consumers and, given the greater uncertainty that has been created by Omicron, now would not be an appropriate time to bring forward a significant tightening of the holding price cap.

1.51 In formulating Final Proposals for the five year price control for H7, we will look to set suitably stretching targets for HAL, such that the path of its charges delivers value for money for consumers in the medium and longer-term. By retaining our approach to the holding price cap but also looking again at the underlying assumptions and efficiency targets for the five year price control, we should ensure that consumers' interests are appropriately protected while also having regard to HAL's financeability and the financing of new investment.

1.52 We need to translate the £29.50 from 2020 prices to 2022 prices so that we can include in HAL's Licence and remove any ambiguity about adjustments for price indexation. Consistent with the method set out in HAL's Licence, we adopted price indices in April to calculate the applicable inflation uplift. The increase in the consumer price index was 0.8% in April 2020 and 1.5% in April 2021 giving a compound increase of 2.32%. Applying this to £29.50 gives a cap of £30.19. This will be the cap used in the final licence modification. We have used the CPI as it is now a properly recognised measure of inflation and is preferred to the RPI.

Chapter 2

Other modifications

Introduction

2.1 This chapter sets out the reasons for and effects of the licence modifications that we are making. It should be read in conjunction with the reasons set out in chapter 1 on:

- why we are setting a holding price cap for HAL for 2022; and
- the level of the holding price cap;

and the reasons set out in that chapter therefore form part of the reasons for, and explanation of, the effect of the modifications.

The October 2021 Notice

2.2 The October 2021 Notice proposed modifications to the Licence to:

- delete the whole of the existing Condition C1 Price Control and replace it with a new Condition C1 Price control condition;
- make consequential modifications to the schedule of the Licence to remove links to Condition C1 that were not required for the new Condition C1 Price control condition;
- remove redundant terms in Condition A3 relating to the beginning of the 2014 to 2021 price control, together with the required consequential modifications throughout the Licence for clarification; and
- update Condition C2 to add the year 2022 to the reporting requirements.

Stakeholder views

2.3 HAL was the only respondent to make specific comments on the drafting proposed by the CAA in the October 2021 Notice. Its more general comments may be summarised as follows:

- A licence modification at this stage creates uncertainty and may cause further delay if it is appealed. HAL noted that it had offered to make a legally binding commitment on the maximum charge for 2022 in place of a licence modification, but that airlines had not engaged meaningfully with that offer;
- It was not clear how the proposed “simple price cap” would allow for accounting and recovery of key parts of the price control, such as capital expenditure and service quality bonuses, arguing that removing the formulae currently in the Licence would create uncertainty;

- HAL questioned the use of CPI rather than RPI as the appropriate adjustment factor for the price control.

2.4 On the specific drafting set out in the October 2021 Notice, HAL proposed:

- new drafting in Condition C1.1 to address a concern that the drafting consulted on provided no clarity on how, and in what format, any applicable correction factors will be re-inserted into the Licence;
- amendments to Condition C1.2 which it considered added clarity to the drafting;
- amendments to Condition C1.3 so that HAL would be under an obligation to continue to use reasonable endeavours to comply with the governance arrangements in the Q6 Capital Investment Triggers Handbook, rather than simply “maintain” those arrangements as the CAA’s drafting proposed. HAL considered that the flexibility its proposed approach offered would be more appropriate given the uncertainty regarding the interim period prior to the introduction of the price control for the full H7 price control period; and
- amendments to Condition C1.4 to insert a definition of “H7 Price Control” to support its proposed drafting amendments for Condition C1.1.

Our Decisions

The need for and level of a holding price cap condition

2.5 We have decided to modify the Licence to protect the interests of consumers in 2022, for the reasons set out in chapter 1 of this Notice. We note there was engagement between HAL and airlines on the possibility of a legally binding commitment, but that no progress was made on agreeing the level of the cap that would be subject to such a commitment. It has, therefore, become necessary for us to decide the level of the holding price cap to be put in place and to implement that decision through modifying the Licence. Chapter 1 sets out our reasons for choosing the level of the holding price cap to be put in place through the licence modifications and for retaining it in light of the representations made to the October 2021 Notice. As a result, we do not accept HAL’s arguments that a holding price cap would create uncertainty. Rather, we consider that it creates certainty. We do not consider that the possibility that one or more stakeholder(s) may choose to exercise the rights of appeal against a licence modification are a valid reason not to proceed with the modification.

2.6 The October 2021 Initial Proposals for H7 and the proposed licence drafting to implement those proposals set out in “Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – draft licence modifications” (“the H7 drafting consultation”)[15] make our intention clear that we will (subject to the outcome of our ongoing consultation processes) re-insert updated versions of the adjustment terms (including formulae, definitions and tables) that allow HAL to account for and recover elements such as capex, the security factor, business rates and service quality bonuses in modifcations we adopt to implement the final decision

[15] See: www.caa.co.uk/CAP2275

for H7. As the final decision for H7 will be made, and the licence modifications will take effect, during 2022, this approach will have the effect of ensuring that these adjustments will have effect in sufficient time to facilitate the relevant accounting processes at the end of the year.

2.7 The changes we have proposed to schedule 1 of the Licence remove the link to Condition C1 Price Control that forms the basis of the price control bonus adjustment factor, as this will not be needed for the interim period prior to the introduction of the price control for the full H7 price control period. As noted above, the H7 drafting consultation makes our intention clear that we will reinstate this link for H7. In the meantime, the mechanism remaining in schedule 1 in this interim period will allow HAL to continue to log up bonuses in 2022 for recovery in 2024.

2.8 As a result, we consider that our overall approach makes clear that HAL can continue to accrue capital expenditure and service quality bonuses because these issues will be addressed within the final decisions we take for the H7 price control.

2.9 As noted in chapter 1, the October 2021 Notice specified the holding price cap in 2020 prices. We have decided to translate it from 2020 prices to 2022 prices in the licence modifications to remove any ambiguity about adjustments for price indexation. Consistent with the method set out in the Licence at Condition C1 (Price Control) in force immediately preceding this modification (and which we are removing through this Notice) we have adopted price indices in April in each of the previous two years to calculate the applicable inflation uplift. The increase in the consumer price index was 0.8% in April 2020 and 1.5% in April 2021 giving a compound increase of 2.32%. Applying this to £29.50 gives a cap of £30.19. This is the figure used in the holding price cap in the new Condition C1.1 that will be given effect by this Notice. We have used the CPI as it is now a properly recognised measure of inflation and preferred to the RPI.

Specific drafting changes suggested by HAL

2.10 We have considered HAL’s suggestions for changes to the licence modifications proposed in the October 2021 Notice and have decided that it is not necessary for us to implement any of them in our decision to implement the holding price cap for 2022 for the following reasons:

- Drafting in condition C1.1 re-inserting correction factors: It is the CAA’s clear policy that we will true-up (or true-down) the holding price cap for 2022 against the full price control set for H7, if the maximum yield specified for H7 is higher or lower than that set for the 2022 holding price cap. However, we have decided that the changes that HAL has proposed would not be appropriate because they sought to make an adjustment to the price control, rather than replace and re-state it with the full price control for H7 which will be the CAA’s approach. As such, the proposed change is not needed as (i) the true-up (or true-down) mechanism will be made clear in the final H7 price control decision and (ii) the price control condition in Condition C1.1 will be replaced and re-stated for H7 so that any such drafting would not survive into the H7 price control and, thus, could not deliver the effect HAL intends.

- Amendments to promote clarity in Condition C1.2: It is not clear that the proposed amendments do achieve additional clarity. As such, they do not appear preferable to the drafting consulted on and so we have decided not to implement them.
- Amendments to Condition C1.3 to create a "reasonable endeavours" obligation to comply with capex governance: The drafting proposed by HAL appears to create a new obligation to comply with the governance arrangements in the Q6 Capital Investments Triggers Handbook, rather than more simply to "maintain" the current arrangements. At present, the Q6 Capital Investment Triggers Handbook is used as a point of reference for the calculation of the T_t trigger factor, rather than being the subject matter of a direct obligation in the Licence. As such, we do not consider it appropriate at this time to increase the intensity of the obligation on HAL in relation to that Handbook as HAL's suggested amendment would do. However, stakeholders should note that it is the CAA's intention to reintroduce material in relation to capital investment as part of the H7 final decision. Drafting in relation to this is set out for consultation in the H7 drafting consultation at Condition C1.8 and Part F of the draft licence conditions. In the meantime, we have decided that the drafting we proposed to accompany the holding price cap is more appropriate to reflect the present position.
- Amendment to Condition C1.4 to insert a definition of the H7 Price Control: Given that, as discussed above, we do not consider that the change proffered by HAL to condition C1 is needed, we have decided that this additional definition is not required.

2.11 In this light, we have decided not to implement any of the changes to the drafting of the licence conditions to implement the holding price cap suggested by HAL.

The Modifications which the CAA has decided to implement

2.12 We have considered the representations we received on the October 2021 Notice and, for the reasons set out above and in chapter 1, we have decided to modify the Licence in the way set out in the October 2021 Notice with no changes, other than to uplift the holding price cap from 2020 prices to 2022 prices. The modifications to the relevant licence conditions are specified in full in Appendix B and are summarised below.

Condition C1 Price control

2.13 The reasons why action by the CAA is needed to set an holding price cap are set out in detail in chapter 1 of this Notice. In summary, we:

- have decided that it remains important for us to protect the interests of consumers by setting a holding price cap for 2022, 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 that we intend to put in place during 2022. If we were not to do this, prices might be too high in 2022 and this could damage the interests of consumers in a way that would not be appropriately compensated for even if charges were lower during the remainder of the H7 period;

- do not consider that the provisions in the ACR2011 provide an adequate level of protection for consumers as their focus is on transparency, consultation processes and preventing discrimination rather than giving protection to/regulation of the overall level of airport charges; and
- consider that the interests of consumers will be served by having clarity on the level of airport charges at Heathrow in 2022 as soon as possible.

2.14 Therefore, we have decided that a licence condition is needed because the absence of a price cap in the intervening period risks exposing consumers to charges that could be unduly high in 2022 and could also create or exacerbate a conflict between the interests of "present consumers" travelling during the first part of 2022 and "future consumers" travelling later in the H7 period. Present consumers could experience materially higher charges than necessary because of the absence of a price control in early 2022, while future consumers could experience somewhat lower charges than they otherwise would have done because of the impact of any "truing up" arrangements.

2.15 So, given the importance of charges in 2022 to consumers, any such licence modification needs to:

- set the holding price cap; and
- be accompanied by a provision that requires HAL to price to the level of the holding price cap in 2022 and consult under the ACR2011 to that effect if necessary.

2.16 If the modifications were not to do this, HAL might seek to introduce the charging arrangements it had proposed in its consultation on its charging proposals in August 2021 and rely on the operation of the truing up of charges and/or the correction factor mechanism with the price control licence condition to address the difference. If HAL took this approach, the benefits to consumers of addressing the issues set out above would not be realised.

The structure of the price control condition

2.17 The licence modification made by this Notice:

- removes the current price control condition in its entirety (save for relevant definitions in Condition C1.16, which are restated as Condition C1.4); and
- replaces it with the new condition setting a single holding price cap.

2.18 For the reasons set out above, the new condition does not include:

- any adjustment arrangements for corrections for any over recovery against the maximum yield in 2020, or bonuses under the service quality rebates and bonuses scheme in Schedule 1 of the Licence. We will replace these adjustment factors into Condition C1 (Price Control) and will take these factors into account in the truing up of the holding price cap put in place by these modifications against the price control we put in place following our final decision for H7; or

- the adjustment factors for additional security measures, the transition of capital projects from "development" to "core" status, capital project tiggers, business rate revaluations or expansion. These are generally adjustments to the price control in the year after the expenditure is incurred and, as we are intending to reinstate most of them in the H7 settlement,[16] it is not necessary to include them here.

2.19 Given our preference and that of stakeholders for a five year price control period for H7, the holding price cap will be trued-up (or trued-down) against the price control we put in place following our final decision for H7, as discussed in chapter 1. Our current view is that:

- the final decision for H7 would simply remove the holding price cap from the Licence; and
- the correction factor in a new price control condition that we intend to insert in the licence modifications for our final decision for H7 would automatically adjust revenue in the later years of the price control for any under or over recovery of revenue against the level specified for 2022 in our final decision for H7.

We intend to keep this issue under review and will consider alternative approaches such as smoothing any difference over the full H7 period if circumstances suggest such an approach would be in the consumer interest (for example to avoid a spike in prices in any given year).

2.20 This approach provides a simple holding price cap for a short period until the licence modifications to implement the H7 price control come into effect later in 2022. We consider that this approach will provide clarity for HAL and the airlines on airport charges in 2022 but, through the truing up of the holding price cap against the price control we put in place following our final decision for H7, will allow for the current uncertainty over the level of the cap to be corrected through the H7 settlement. This will ensure:

- protection for present consumers in 2022 through the operation of the holding price cap; and
- protection for future consumers through the operation of the H7 price control.

As such, this approach will manage the conflict between the interests of present and future consumers.

The level of the maximum allowable yield

2.21 Chapter 1 discusses the uncertainty that remains about the appropriate level of charges for the H7 period and the overall range for charges set out in the October 2021 Initial Proposals, particularly in the light of the emergence of Omicron since our consultation on the October 2021 Notice closed. Chapter 1 also discusses the significantly differing views from HAL and the airlines on the calculation of the holding price cap, including our proposals on Opex and the

16 As discussed in the October 2021 Initial Proposals consultation.

WACC, and notes that these are still subject to consultation and the ongoing processes for determining the H7 price control.

2.22 For the reasons set out in chapter 1, we have decided to retain the level of the holding price cap that we proposed in the October 2021 Notice. On this basis, the holding price cap included in this Notice remains at £29.50 per passenger (2020 prices), as proposed in the October 2021 Notice. We have made one change to the text of the modification that was proposed in the October 2021 Notice. The effect of this is to implement the required uplift to the holding price cap from 2020 prices to 2022 prices using the CPI, as explained in paragraph 2.7 above. The licence modification is now clear that the holding price cap is £30.19 in 2022 prices.

Requiring a new consultation on the airport charges

2.23 On 17 December 2021 (pursuant to its obligations under the ACR2011), HAL issued its decision to set airport charges consistent with the holding cap of £30.19. We will review the detail of this decision in due course.

2.24 We have decided to implement the obligation on HAL to carry out a new consultation on its airport charges under the ACR2011 within one month of the modifications set out in this Notice taking effect if it has set its prices on a maximum yield that was more than £30.19 per passenger (2022 prices). We have done this as a backstop protection for consumers. Nonetheless, bearing in mind the decision HAL has just issued, we are not expecting HAL to need to reconsult on charges in the near future.

Arrangements for capital investment

2.25 Although we have not included the adjustment factors for capital investment, we are retaining the existing capital governance arrangements and triggers, so that discussions on these important elements can continue as normal. As compliance with these arrangements will not be an element of the formulae for the price control, to effect this, we have decided to include a simple requirement on HAL to “maintain” the existing capital governance arrangements and capital investment triggers handbook. As noted above, we do not consider it is necessary to include additional obligations on HAL for its capital development processes as part of the holding price cap.

Schedule 1 (Statement of Standards, Rebates and Bonuses)

2.26 We have decided to modify the Bonus term in paragraph 4 of the Schedule 1 to the Licence (Statement of Standards, Rebates and Bonuses) to make consequential changes that:

- remove cross references to Condition C1 (Price Control); and
- to remove information relating to past years from Table 9 and insert information relating to 2022 into it.

2.27 This modification is required because the new Condition C1 (Price Control) does not use the bonus factor. As noted above, we intend to replace the relevant terms and tables in the H7 licence modifications later in 2022 so that the bonus arrangements will remain in place for the whole of H7.

2.28 These modifications will ensure that HAL can still earn bonuses in 2022 under Schedule 1 for recovery in 2024, in line with the current arrangements. Bonuses accrued in years up to and including 2021 shall be dealt with in truing up the price control for 2022 in line with our final decision for H7.

2.29 We have also decided to delete redundant material in the Schedule relating to the early years of Q6 to avoid confusion.

Condition A3 (Definitions)

2.30 We are changing the definition of Regulatory Year in Condition A3 (Definitions) to remove the references to specific years, so that the definition now simply specifies the start and end dates of a Regulatory Year. This is because some of the licence conditions which use the term should not be time limited and should continue to have effect from one control period to the next, unless modified either under section 22 CAA12 or under provisions of the Licence. Making this change will achieve this effect.[17] Where a specific licence condition needs to be time limited, this will be made clear in the condition itself.

2.31 In addition to this change, we are making some consequential changes throughout the Licence to change references to “each” and/or “subsequent [number]” Regulatory Years to become references to “any” Regulatory Year. In Condition C2 (Charges for other services) we are also changing references to a “year” to refer to a “Regulatory Year”. These changes will provide greater clarity in the Licence but will have no effect on the obligations themselves.

2.32 We are also removing the definition of “Regulatory Period” from Condition A3 (Definitions) and deleting all uses of the term throughout the Licence. This term was required solely for the period from 1 April 2014 to 31 December 2014 when HAL changed its financial and reporting year to match the calendar year. As this term is now redundant, it is good practice to remove it from the Licence: its removal will have no effect on HAL’s ongoing obligations in the Licence.

Condition C2 (Charges for other services)

2.33 We have decided to modify this condition to add the year 2022 to the reporting requirements for these “Other Regulated Charges” or (“ORCs”). In the Q6 settlement, we included a forecast for ORCs and required HAL to report on the reasons for any differences between actual revenues and those included in the forecast. We did not include forecasts for the extended years of the price control period (2019 to 2021), but instead required HAL to report on differences between actual revenues in each year with actual revenues in the previous year. HAL has committed to continue with this practice in 2022. Nonetheless, we have decided to modify the Licence to implement this change for clarity and completeness. This effect of this modification will, therefore, be to ensure the current arrangements continue uninterrupted within the licence framework.

[17] Relevant conditions are (C2 Charges for other services, C4 Cargo, E1 Regulatory accounting requirements, E2 Financial Resilience and Schedule 1, Statement of Standards, Rebates and Bonuses).

Appendix A

Our duties

A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services (“AOS”), including capacity expansion, are set out in the CAA12.

A2 CAA12 gives the CAA a general (“primary”) duty, to carry out its functions under CAA12 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 AOS.

A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of “consumers”.

A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.

A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:

- the need to secure that each licensee is able to finance its licensed activities;
- the need to secure that all reasonable demands for AOS are met;
- the need to promote economy and efficiency on the part of licensees in the provision of AOS;
- the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
- any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
- the Better Regulation principles.

A6 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.

A7 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

Appendix B

Modifications to the Licence

Key

Text marked in red indicates where new text has been added to an existing condition

Text marked in ~~striked out red~~ indicates where existing text has been removed from an existing condition.

Where a condition has been removed in its entirety and replaced with a new condition (specifically Condition C1 Price Control) only the new condition is shown.

Changes to the modifications proposed in the October 2021 Notice are shown in underlined green or ~~struck out in out green~~

Relevant Condition	Summary of the Modification	Details of changes to the condition	Explanation of the reasons and effects of the modification can be found at:
A3.1(f) and C2.5, C4.1, E1.3, E1.5(a)&(b), E2.2, E3.5, Schedule 1: 2.1(e),(f) &(j), 2.28(a)&(b), 3.2, 3.4, 3.4(a)&(b), 3.5, 3.7, 3.11, 3.13, 3.15, 4.2, 4.4, 4.5, 5.2(b) 6.2, 6.3(c).	Delete the definition of Regulatory Period and replace with “NOT USED” and all delete all references to the term throughout the Licence in text and formulae.	~~(the Regulatory Period means the period of nine months between 1 April 2014 and 31 December 2014 and this period shall also be considered to be the Licensee’s financial year for the purposes of this Licence~~ (f) **NOT USED**	Chapter 2, paragraph 2.32

A3.1(g) and C2.1, C2.2, C2.3, C3.7, C4.1, E1.3, E3.1, Schedule 1: 2.4, 3.4(a), 3.5, 3.11, 6.6.	Modify the definition of Regulatory Year, Change references to "each" and/or "subsequent [number]" Regulatory Years to "any" Regulatory Year.	(g) the Regulatory Year means ~~for each of the seven years from 2015 to 2021,~~ the twelve month period beginning on 1 January and ending on 31 December. ~~These years shall also be considered to be the Licensee's financial year for the purposes of this Licence.~~	Chapter 2, paragraphs 2.30 and 2.31.
C1	Delete the whole of the current Condition C1 Price Control and replace with new Conditions C1.1 and C1.2.	New condition - C1 Price Control C1.1 When the Licensee fixes the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022, it shall fix those charges at the levels best calculated to secure that, in that Regulatory Year, the total revenue at the Airport from such charges divided by the total number of passengers using the Airport does not exceed the maximum revenue yield per passenger, which shall be £~~29.50~~30.19 (~~2020~~2022 prices).	The whole of chapter 1 and chapter 2 paragraphs 2.1 to 2.22.

		C1.2 If the Licensee has fixed the amounts to be levied by it by way of airport charges in respect of relevant air transport services in the Regulatory Year 2022 at levels that exceed the maximum yield per passenger set out in Condition C1.1, the Licensee shall, within 1 month of Condition C1 Price Control coming into effect in relation to the Regulatory Year 2022, consult airlines under the Airport Charges Regulations 2011 (2011 No. 2491) to reset its prices to a level calculated to secure compliance with Condition C1.1.	Chapter 2 paragraphs 2.23 to 2.24
C1	Insert a new Condition C1.3 to require HAL to maintain the existing capex governance arrangements.	C1.3 The Licensee shall maintain the governance arrangements and the Q6 Capital Investments Triggers Handbook in relation it is core capex projects and development capex projects.	Chapter 2 pararaph 2.25.
C1	Retain relevant existing definitions from Condition C1.16 and restate them as Condition C1.4.	***Definitions*** C.1.4 In this Condition C.1: (a) **core capex project** is any project that has passed Gateway 3, being taken forward for implementation in accordance with the governance arrangements; (b) **development capex project** is any project under development that has not passed Gateway 3 in accordance with the governance arrangements, but for which an allowance has been included in the development capex allowance; (c) **Gateway 3** has the meaning set out in the governance arrangements; (d) **the governance arrangements** means the arrangements set out in the Q6 Capital Efficiency Handbook published by the Licensee by 1 October 2014 as agreed by the CAA, and updated in April 2015;	These definitions are required to support the operation of Conditions C1.1 to C1.3 above and are restated from condition C1.16 in the Licence in the form it is in as at 1 October 2021. Insertion of this condition,

		(e) **passenger using the Airport** means a terminal passenger joining or leaving an aircraft at the Airport. A passenger who changes from one aircraft to another, carrying the same flight number is treated as a terminal passenger, as is an interlining passenger; (f) **the Q6 Capital Investment Triggers Handbook** means the handbook in existence when this Licence comes into force, having been agreed by the Licensee and the airlines. This handbook contains details of the triggers, milestone months and monthly trigger payments for core capex projects and details of how future changes to those elements can be made with the agreement of the Licensee and the airlines; and (g) **relevant air transport services** means air transport services carrying passengers that join or leave an aircraft at the Airport, including air transport services operated for the purpose of business or general aviation.	therefore, supports the effective operation of those conditions.
C2	In Condition C2.5 and C2.6, remove references to "2019, 2020 and 2021" and replace with "2022"	C2.5 Where in respect of any relevant ~~Regulatory Period or~~ Regulatory Year (apart from the ~~2019, 2020 and 2021~~ Regulatory Year~~s~~ 2022) actual revenue for any of the Specified Facilities differs from that forecast for the purposes of the price control review for the period 1 April 2014 to 31 December 2018 (as specified by the CAA), the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences. C2.6 Where in respect of the ~~2019, 2020 and 2021~~ Regulatory Year 2022~~s~~ actual revenue from any of the Specified Facilities differs from actual revenue in the preceding Regulatory Year, the Licensee shall provide to the CAA and to users of the Specified Facilities or their representatives detailed reasons for the differences.	Chapter 2 paragraph 2.33.

Schedule 1 Statement of Standards, Rebates and Bonuses.	modify paragraphs 4.1, 4.2,4.3,4.4,4.5 and 4.6. (Bonuses)	**(a) Payment** 4.1 The Licensee may recover bonuses from Relevant Parties. Bonus payments shall be included in the calculation of the ~~Airport Charges~~ maximum revenue yield per passenger in respect of relevant air transport services in ~~Condition C1~~Relevant Year 2024. **4(b) Calculation** 4.2 $B_{\cancel{t}2022}$, the bonus factor ~~as specified in Condition C1~~, is based on performance achieved in respect of specified elements k in the relevant ~~Regulatory Period or~~ Regulatory Year $\cancel{t}2022$ as set out in Table 8 of this Schedule. 4.3 ~~For the purposes of calculating M_t as specified in Condition C1, t~~The corresponding periods for which bonuses are recoverable by the Licensee ~~to be included in the calculation of M_t~~ are set out in Table 9 of this Schedule. 4.4 Not used. ~~For the purposes of calculating M_t for the Regulatory Period, $B_{t-2} = B_{2012/13}$ is set to zero; for the purposes of calculating M_t for the Regulatory Year t starting on 1 January 2015, $B_{t-2} = B_{2013/14}$ is set to zero. This is because bonuses earned in 2012/13 and 2013/14 should have been recovered through the K factor as specified in Condition C1.~~ 4.5 Not used. ~~B_t for the Regulatory Period, i.e. B_{2014}, shall be calculated as follows:~~ $$\cancel{B_t = \sum_{j=April}^{j=December} \sum_{k} \mathrm{Max}\left[0, \mathrm{Min}\left[BNS(T2)_{kj}, BNS(T3)_{kj}, BNS(T4)_{kj}, BNS(T5)_{kj}\right]\right]}$$ ~~For each month j and specified element k;~~	Chapter 2 paragraphs 2.26 to 2.29

$$\cancel{\mathrm{BNS(T2)}_{kj} = \frac{1}{9} \times \mathrm{MB}_k \frac{\mathrm{Min}\left[\mathrm{UPL}_k, \mathrm{MP(T2)}_{kj}\right] - \mathrm{LPL}_k}{\mathrm{UPL}_k - \mathrm{LPL}_k}}$$

$$\cancel{\mathrm{BNS(T3)}_{kj} = \frac{1}{9} \times \mathrm{MB}_k \frac{\mathrm{Min}\left[\mathrm{UPL}_k, \mathrm{MP(T3)}_{kj}\right] - \mathrm{LPL}_k}{\mathrm{UPL}_k - \mathrm{LPL}_k}}$$

$$\cancel{\mathrm{BNS(T4)}_{kj} = \frac{1}{9} \times \mathrm{MB}_k \frac{\mathrm{Min}\left[\mathrm{UPL}_k, \mathrm{MP(T4)}_{kj}\right] - \mathrm{LPL}_k}{\mathrm{UPL}_k - \mathrm{LPL}_k}}$$

$$\cancel{\mathrm{BNS(T5)}_{kj} = \frac{1}{9} \times \mathrm{MB}_k \frac{\mathrm{Min}\left[\mathrm{UPL}_k, \mathrm{MP(T5)}_{kj}\right] - \mathrm{LPL}_k}{\mathrm{UPL}_k - \mathrm{LPL}_k}}$$

~~where:~~

~~MB_k, LPL_k and UPL_k are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and~~

~~$\mathrm{MP(T2)}_{kj}$, $\mathrm{MP(T3)}_{kj}$, $\mathrm{MP(T4)}_{kj}$ and $\mathrm{MP(T5)}_{kj}$ are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.~~

4.6 $\mathrm{B}_{\cancel{t}2022}$ for ~~any subsequent relevant~~ the Regulatory Year2022 ~~t~~ shall be calculated as follows:

$$\mathrm{B}_{\cancel{t}2022} = \sum_{j=\mathrm{January}}^{j=\mathrm{December}} \sum_{k} \mathrm{Max}\left[0, \mathrm{Min}\left[\mathrm{BNS(T2)}_{kj}, \mathrm{BNS(T3)}_{kj}, \mathrm{BNS(T4)}_{kj}, \mathrm{BNS(T5)}_{kj}\right]\right]$$

For each month j and specified element k;

		$$BNS(T2)_{kj} = \frac{1}{12} \times MB_k \frac{Min[UPL_k, MP(T1)_{kj}] - LPL_k}{UPL_k - LPL_k}$$ $$BNS(T4)_{kj} = \frac{1}{12} \times MB_k \frac{Min[UPL_k, MP(T4)_{kj}] - LPL_k}{UPL_k - LPL_k}$$ $$BNS(T4)_{kj} = \frac{1}{12} \times MB_k \frac{Min[UPL_k, MP(T4)_{kj}] - LPL_k}{UPL_k - LPL_k}$$ where: MB_k, LPL_k and UPL_k are defined in paragraphs 2.1(j), 2.1(k) and 2.1(l) respectively; and $MP(T2)_{kj}$, $MP(T3)_{kj}$, $MP(T4)_{kj}$ and $MP(T5)_{kj}$ are the moving annual average monthly performance for specified element k in month j weighted by monthly passengers numbers in Terminal 2, Terminal 3, Terminal 4 and Terminal 5, respectively. It is calculated using the formulae set out in paragraph 2.3.	

Modify Table 9 to remove redundant information relating to the Regulatory Period 2014 and Regulatory Years 2015 -2021 and insert relevant information for 2022.

Table 9: Periods of bonuses earned to be taken into account ~~when setting~~ ~~M_{t2022} as specified in Condition C1~~[11]

To set the maximum revenue yield per passenger $M_{\cancel{t}2024}$	**$M_{\cancel{t}2024}$ representing the period**	**Take account bonuses earned in $B_{\cancel{t-2}2022}$**	**$B_{\cancel{t-2}2022}$ representing the period**
$\cancel{M_{2014}}$	~~April 2014 – December 2014~~	$\cancel{B_{2012/13}}$	~~April 2012 – March 2013~~
$\cancel{M_{2015}}$	~~January 2015 – December 2015~~	$\cancel{B_{2013/14}}$	~~April 2013 – March 2014~~
$\cancel{M_{2016}}$	~~January 2016 – December 2016~~	$\cancel{B_{2014}}$	~~April 2014 – December 2014~~
$\cancel{M_{2017}}$	~~January 2017 – December 2017~~	$\cancel{B_{2015}}$	~~January 2015 – December 2015~~
$\cancel{M_{2018}}$	~~January 2018 – December 2018~~	$\cancel{B_{2016}}$	~~January 2016 – December 2016~~
$\cancel{M_{2019}}$	~~January 2019 – December 2019~~	$\cancel{B_{2017}}$	~~January 2017 – December 2017~~
$\cancel{M_{2020}}$	~~January 2020 – December 2020~~	$\cancel{B_{2018}}$	~~January 2018 – December 2018~~
$\cancel{M_{2021}}$	~~January 2021 – December 2021~~	$\cancel{B_{2019}}$	~~January 2019 – December 2019~~
M_{2024}	Regulatory Year 2024	B_{2022}	Regulatory Year 2022

11 ~~In Table 9, for the purposes of calculating M_{2014}, $B_{2012/13}$ is set to zero; for the purposes of calculating M_{2015}, $B_{2013/14}$ is set to zero.~~