Economic regulation of Heathrow Airport: H7 Final Proposals – Summary

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Summary

Introduction and overview

Introduction

1. This document sets out the CAA's Final Proposals ("Final Proposals") for the price control and associated regulatory framework that will apply to Heathrow Airport Limited ("HAL") for the five-year ("H7") period starting in January 2022 and ending in December 2026. These arrangements will replace the holding price cap that came into effect on 1 January 2022 and which will run until 31 December 2022.

2. This summary has four main parts:
   - this introduction and overview;
   - the context and the process we have followed to reach our Final Proposals;
   - a summary of the main components of our Final Proposals and approach to developing the key elements of the regulatory framework for HAL; and
   - an overview of our statutory duties that are key to our work on this price control review and the remaining steps of the process necessary to finalise the arrangements for the new price control, quality of service arrangements and regulatory framework for the H7 period.

3. Setting price controls for HAL is how the CAA fulfils one of its core functions under the Civil Aviation Act 2012 ("CAA12"). Our primary duty is to further the interest of users[1] (collectively referred to as "consumers") of air transport services regarding the range, availability, continuity, cost, and quality of airport operation services ("AOS"). [2]

4. We have formulated these Final Proposals on the basis of a "single till" whereby we make projections of (i) HAL's total efficient costs and (ii) projections of its "single till" revenues (commercial revenues such as from car parking and retail outlets, other regulated charges and revenue from cargo flights). We net these off against one another as described below to help ensure that airport charges are no higher than is necessary.

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[1] "Users" include present and future users and are defined in CAA12 as passengers and those with "a right in property" (cargo) carried by air transport services.

[2] Airport operation services ("AOS") are defined in section 68 CAA12.

5. These projections of efficient costs are based on estimates of operating expenditure, regulatory depreciation of and return on the Regulated Asset Base ("RAB").[3] The RAB changes as new investment is added and regulatory depreciation is removed (allowing investment to be financed over its expected life, rather than in the year it is incurred). The price control is then calculated by dividing the overall projections of costs less the projections of single till revenues by our forecast of passenger numbers (over the period of the price control) to give an allowed level of price control revenue per passenger that HAL can collect from airport charges.

6. HAL and airline stakeholders have put forward diametrically opposed positions on the key issues discussed in our Initial Proposals, such as passenger forecasts and the cost of capital. These positions are consistent with their commercial interests, with HAL suggesting airport charges should increase significantly and airlines saying they should be significantly lower. We have given all stakeholders extensive opportunities to make their views and concerns known to the CAA and have responded to these challenges with a consistent focus on developing an appropriate and evidence-based view of the various elements of the price control in the interests of consumers as required by CAA12.

7. We are also setting out alongside this document our Final Proposals for incentives, continuous improvements in service levels and improved governance arrangements that encourage HAL and airlines to work together to further the interest of consumers. These Final Proposals will be implemented by modifying HAL's licence: a Notice under section 22 CAA12 specifying the necessary modifications accompanies this document.[4]

Overview

8. These Final Proposals follow on from the Initial Proposals we published in October 2021. Noting the uncertainties and difficulties that the covid-19 pandemic had created, those Initial Proposals were based on a range of estimates of airport charges. Since then, we have assessed the responses to that consultation, updated the evidence base, and updated our own analysis to support the Final Proposals set out here.

9. The impact of the covid-19 pandemic on the aviation sector has been severe, with passenger numbers at Heathrow airport in 2020 and 2021 around 75% lower than their pre-pandemic levels in 2019. The beginning of 2022 was also

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3 The RAB is a regulatory construct used for setting the price control and is a notional sum representing the value of the investments made by HAL. Broadly, additions to the RAB are determined by reference to HAL's capital spend, after the application of any capital incentives under the licence.

4 See Appendix C.

affected by travel restrictions introduced following the emergence of the Omicron variant, but the Spring has seen sharp increases in demand.

10. To help deal with the passenger forecast uncertainty over H7, we have developed further the Traffic Risk Sharing ("TRS") mechanism set out in the Initial Proposals. This mechanism will mean that, if passenger numbers are lower than expected, then HAL will have some protection against lower revenues. This should help secure that HAL can finance investment in a cost effective way and avoid any undue upward pressure on airport charges. Consumers will also benefit through lower prices if volumes are higher than expected. We explain how this mechanism works in more detail below and in chapter 2 (Regulatory framework).

11. Where appropriate, we are building on the advantages of the existing regulatory framework, including by retaining the approach based on the Regulatory Asset Base ("RAB") described above and setting a five-year price control. This should provide airlines and consumers with significant certainty about the level of airport charges and HAL with a stable framework that will allow it to continue to finance the investment necessary to provide a safe, secure and resilient airport.

12. Over the last two years, Heathrow and many businesses across the aviation sector supply chain have seen many staff leaving the industry. It is important that, through the recovery from the pandemic, HAL can bring new staff on board to provide a good service to passengers. The operational challenges across the aviation sector in recent months have further emphasised the importance of all parts of the sector having the people and other resources to provide an appropriate quality of service to consumers.

13. Since the Initial Proposals, we have increased our estimate of HAL's operating expenditure to £5.9 billion (2020 CPI prices) over the five years. While this is about £330 million less than HAL's proposals (consistent with promoting economy and efficiency), it should support the recruitment of new staff and allow HAL to provide a good quality service. We have also updated our projections of commercial revenues, which are closer to HAL's proposals, but which will nonetheless provide HAL with the challenge of driving real increases in the level of its commercial revenues across the H7 period.

14. There are some very important investments that HAL intends to make in the coming years that should further improve not only the passenger experience, but also the safety, security and resilience of the airport. Our Final Proposals are based on investment of £3.6 billion over the five years of H7 compared to HAL's estimate of £4.5 billion. Our estimate of the investment HAL will make includes next generation security scanners and a new baggage system in Terminal 2, which are collectively expected to cost about £1.3 billion. "Net Zero" and making aviation more environmentally sustainable is a strategic challenge and priority for the sector (all 2020 CPI prices). HAL has proposed expenditure to help address

these issues and, while further work is required on the detail of these projects, including with airlines, we welcome the focus that HAL is placing on these issues.

15. Inevitably, there is always uncertainty about the most appropriate investments over a five-year period and, particularly, in the later years of the period where detailed planning for projects has not yet commenced. Where we have not included specific projects in our estimate, it will be for HAL to work with airlines under the governance framework that will be strengthened and made more flexible by these Final Proposals. HAL can bring forward proposals for higher levels of spending, but will need to show that such spending would be efficient and improve consumer outcomes. Therefore, our estimate of capital spending is not an absolute cap.

16. We have also developed new incentives for HAL to deliver capital spending efficiently and in the interests of consumers, with the intention that these will lead to a more efficient airport and better value for money from airport charges in the future.

17. The return that HAL earns on its asset base (its "cost of capital") forms a very significant component of the price cap calculation. Since the Initial Proposals, we have considered the extensive evidence presented by stakeholders, but also taken account of wider developments. As a result, we have made two main changes since the Initial Proposals to our estimate of HAL's cost of capital:

- the increase in inflation and expected inflation reduces the real cost of much of HAL's existing debt, which feeds through to a lower real cost of capital; and
- we have reduced our assessment of the cost of equity to account for the material reduction in risk as a result of introducing TRS arrangements.

18. HAL has continued to request that the CAA make an adjustment to its RAB that would have the effect of allowing HAL to recover a significant proportion of the losses it experienced during the covid-19 pandemic. In April 2021, we decided to make a targeted and focused adjustment to HAL's RAB of £300 million (2018 RPI prices) to support it in maintaining a high quality of customer service and re-open terminal capacity in a timely manner in 2021. We have considered whether a further RAB adjustment is appropriate, including the £2.5 billion (2018 RPI prices) suggested by HAL and have concluded that such an adjustment would not further the interest of consumers or be necessary to support the efficient financing of HAL. Therefore, we have retained the £300 million adjustment made in Initial Proposals and not made any further RAB adjustment. This is consistent with the basis on which we set the previous "Q6" price control, which provided for HAL to manage the risks associated with changes in passenger volumes.

19. Our Final Proposals are based on retaining the "holding price cap" which we set in December 2021 to cover 2022. This is £27.39[5] in 2020 prices and £30.19 in 2022 prices. Implementation of these Final Proposals will see the price cap reducing over the H7 period to £21.75 in 2026 in 2020 prices. The higher charges at the start of the H7 period support HAL's financeability with lower airport charges in real terms as the period progresses, consistent with furthering the interests of consumers. Compared to the mid-point of the range that we used for the Initial Proposals of £29.50 in 2020 prices, our Final Proposals are an average price cap of £24.50 in 2020 prices over the H7 period. This is about £2 per passenger more than during Q6, which largely reflects the lower predicted passenger volumes we expect during the recovery period from the covid-19 pandemic, rather than an increase in HAL's costs. The reduction compared to the mid-point of the Initial Proposals reflects a number of factors, in particular, the increase in the passenger forecast and the reduction in the cost of capital.

20. In setting airport charges, HAL will also be able to take account of the impacts of inflation up to 2023 and beyond. Given our current forecast of inflation we expect the allowed airport charge for 2023 will be £29.68 (nominal prices). Based on current forecasts of inflation this charge would fall to £26.31 in 2026.

21. Given the challenges of the covid-19 pandemic, it is particularly important that we consider whether our proposals are consistent with our statutory duty to have regard to the need to secure that HAL is able to finance its activities at Heathrow. We consider that this level and profile of airport charges reasonably supports the financeability of an efficiently financed regulated business carrying out the activities of HAL.

22. Since the Initial Proposals, we have introduced price profiling that means higher airport charges in the early years of H7 and lower charges later, and revised our approach to the TRS mechanism, which should support HAL's financeability. Nonetheless, it will be for HAL's shareholders and management to address any issues that arise as a result of its actual financial structure differing from the assumptions we make in setting price controls and, in particular, the higher levels of debt finance that HAL uses to support the regulated business and its wider group of companies.

Forecasts of passenger numbers

23. The recovery in passenger traffic in 2022 is expected to continue with growing bookings and a significant ramp up in capacity both at Heathrow airport and by airlines. The number of passengers using Heathrow was about 74% of 2019 levels in April, 79% of 2019 levels in May, and HAL has re-opened Terminal 4 in June. We expect the ramp up in demand in 2022 to set the scene for a sustained

[5] This figure represents the "Holding price cap" in nominal terms deflated using updated inflation forecasts.

recovery into 2023 and beyond, with passenger numbers at Heathrow airport expected to broadly return to 2019 levels by 2025.

24. While this more optimistic outlook of demand is encouraging, there remains a greater than usual level of uncertainty about passenger forecasts, with potential upsides given the recent surges in passenger numbers and potential downsides associated with macroeconomic headwinds, the possibility of further difficulties associated with covid-19 and the difficulties airports and airlines have faced with recruitment and resourcing.

25. It is possible that evidence will emerge during the period of consultation on these Final Proposals and during our work to make our Final Decisions on the price control that would mean the passenger forecast used in these Final Proposals should be reviewed. We explain in the final section below the steps we would take if such circumstances arise.

Summary: context and process

Approach

26. Despite the impact of the covid-19 pandemic discussed above, Heathrow airport retains its unique position for passengers and freight owners as the UK's only hub airport and the largest airport in terms of both passenger numbers and the value of the cargo it handles.

27. HAL's airport charges are among the highest in the world, and left unconstrained, its market power has the potential to damage the interests of consumers, for example through:

- even higher prices;
- lower quality services and facilities; and
- inefficiencies, such as in overrunning capital projects, both in costs and time, and higher than necessary operating expenditures.

28. To further the interests of consumers, we have sought to ensure that HAL's future charges will be "affordable" in the sense of representing appropriate value for money. We do so by basing our projections on efficient costs and creating incentives on HAL both to provide an appropriate quality of service and to seek out further efficiencies in the future.

29. Our process has generated a significant volume of evidence and submissions from stakeholders on the full range of issues covered by these Final Proposals. In this context, we note that:

- HAL's submissions suggested that consumers and airlines should fund significant levels of support for its financeability, together with maintaining high levels of customer service, all financed by significantly higher airport charges; and
- airlines' submissions have focused on the importance of the H7 review supporting the recovery of passenger volumes at Heathrow by the introduction of stretching efficiency targets for HAL and significantly lower airport charges.

Our Process

The Q6 price control

30. After CAA12 came into force, the CAA determined that HAL was the operator of a "dominant airport" and granted it a licence under CAA12 in 2014. The CAA's market power assessment was based on HAL's position as the operator of the UK's only hub airport, airline network effects available at Heathrow which limit the ability of airlines to switch capacity and to constrain HAL's charges, Heathrow's good surface access options and the attractiveness of the London market to airlines.

31. The licence included a price control originally covering the years 2014 to 2018 ("Q6"). The Q6 price control was set using a RAB and a 'single till' approach.

32. After the Government's announcement that Heathrow was its preferred location for the development of a new runway in the south east of England (known as "expansion") in 2016, an extensive period of regulatory development work was undertaken by the CAA to determine how the regulatory framework could accommodate expansion. During this period, the Q6 price control was extended by the CAA successively to cover 2019 and then 2020 to 2021. These extensions were intended to align the start of the H7 period with the period during which it was anticipated that the construction work for the third runway would take place.

33. Following the Court of Appeal's judgment that the Airports National Policy Statement had not been lawfully prepared, HAL paused work on expansion. Although the Supreme Court subsequently overturned this judgment, expansion remains paused following the outbreak of the covid-19 pandemic. As a result, we focused on setting a price control for the H7 period consistent with the operation of a two-runway airport.

34. In July 2020, HAL sent the CAA a request that it should reopen the Q6 price control by making an adjustment to its regulatory asset base ("RAB") to address the shortfall in the revenue it expected to recover in 2020 and 2021 due to the severe impact of the covid-19 pandemic. HAL made a series of subsequent representations in support of its request.

35. Having consulted on HAL's request in October 2020 and February 2021, we issued a decision in April 2021 that set out our response to HAL's request and its further representations. This set out our decision on the regulatory intervention package which we intended to apply ahead of making these Final Proposals.

36. In order to further the interests of consumers, we decided to make a targeted and focused regulatory intervention ahead of the H7 price review. This was not on the scale of the intervention that HAL had proposed (£800 million RAB adjustment in 2021, with a total RAB adjustment of around £2.5 billion). The intervention that the CAA decided to make was a RAB adjustment of £300 million (in 2018 prices), as a transparent and proportionate intervention that was needed to further the interests of consumers. This intervention was targeted, among other things, at maintaining service quality across a full range of demand scenarios and providing necessary capacity during 2021.

The H7 price control review and holding price cap for 2022

37. In the light of the impact of the covid-19 pandemic, HAL issued a revised financial forecast and accompanying narrative in July 2020 which it referred to as a "building block update" ("BBU"). After HAL issued the BBU, a period of Constructive Engagement ("CE") with airlines started, which ran between August 2020 and October 2020. CE is a process for engagement between HAL and its airline customers to enable them to discuss and review HAL's plans and to provide a forum for airlines to set out their preferences on issues such as charges, costs, investment and service quality.

38. Following CE, HAL issued a revised business plan ("RBP") in December 2020. HAL's RBP "base case" implied a very significant increase in airport charges compared to the iH7 price control period. HAL's base case for H7 assumed an average charge of £30 per passenger (2018 prices) compared to an average of around £22 (nominal prices) for 2020.

39. The April 2021 Way Forward Document provided an update on our overall approach to the price control review, our initial assessment of HAL's RBP, our latest thinking in key policy areas and our proposed approach to developing projections for each of the key price control building blocks.

40. HAL then provided an updated business plan ("updated RBP") at the end of June 2021. The updated RBP stated that the lower passenger numbers expected over the H7 period meant that airport charges would need to rise beyond the level set out in the RBP. The updated RBP included two scenarios, one implying average charges over H7 of £32 per passenger, and the other implying charges of £43 per passenger (in 2018 prices).

41. Following the April 2021 Way Forward Document on the H7 price review, we issued our Initial Proposals consultation for the H7 price control for consultation in October 2021. This summarised our assessment of the responses to the April

2021 Way Forward Document, set out our assessment of HAL's RBP and set a range for the new price control and described associated incentive arrangements and other aspects of the regulatory framework for consultation.

42. Given the uncertain circumstances prevailing at that time of the Initial Proposals, we based our Initial Proposals on a relatively wide range of airport charges for the period from 2022 to 2026 (£24.50 to £34.40 per passenger in 2020 prices) representing an increase of between 15% and 60% on the charge in 2020.

43. Given that the uncertainty associated with the covid-19 pandemic had led to an extended price control review process and that we did not expect to make Final Proposals until mid-2022, we also decided it would be appropriate to put in place an interim, or "holding price cap", for 2022. We did so at the mid-point of the range set out in our Initial Proposals (£29.50 per passenger in 2020 prices or £30.19 per passenger in nominal prices) and made clear that this holding price cap would be "trued up" or "trued down" in the light of our Final Proposals.

44. We received detailed responses to the Initial Proposals, including from HAL and airlines. HAL and airline stakeholders also met with CAA Board members in January 2022 and May 2022, to explain their views on key issues. The CAA has also engaged regularly with HAL and airlines, both at senior and working level, on the matters covered by the Initial Proposals.

45. In preparing these Final Proposals, we have carefully considered the respective stakeholders' positions, assessed new evidence that was provided, undertaken our own additional analysis, and commissioned further independent expert advice, where appropriate, in order to develop Final Proposals that further the interests of consumers as required by CAA12.

Summary: the key elements of our Final Proposals

46. We set out below further details of our Final Proposals, starting first with our assessment of the key price control building blocks and how these come together to support our Final Proposals for the new price control. This includes a summary of our approach to financeability issues and our Final Proposals in relation to HAL's request for a covid-19 related RAB adjustment. We then go on to summarise the regulatory mechanisms we have developed to help deal with uncertainty on issues such as the level of passenger traffic and we then summarise the other important elements of the regulatory framework for the H7 period.

Our Final Proposals for the price control on airport charges

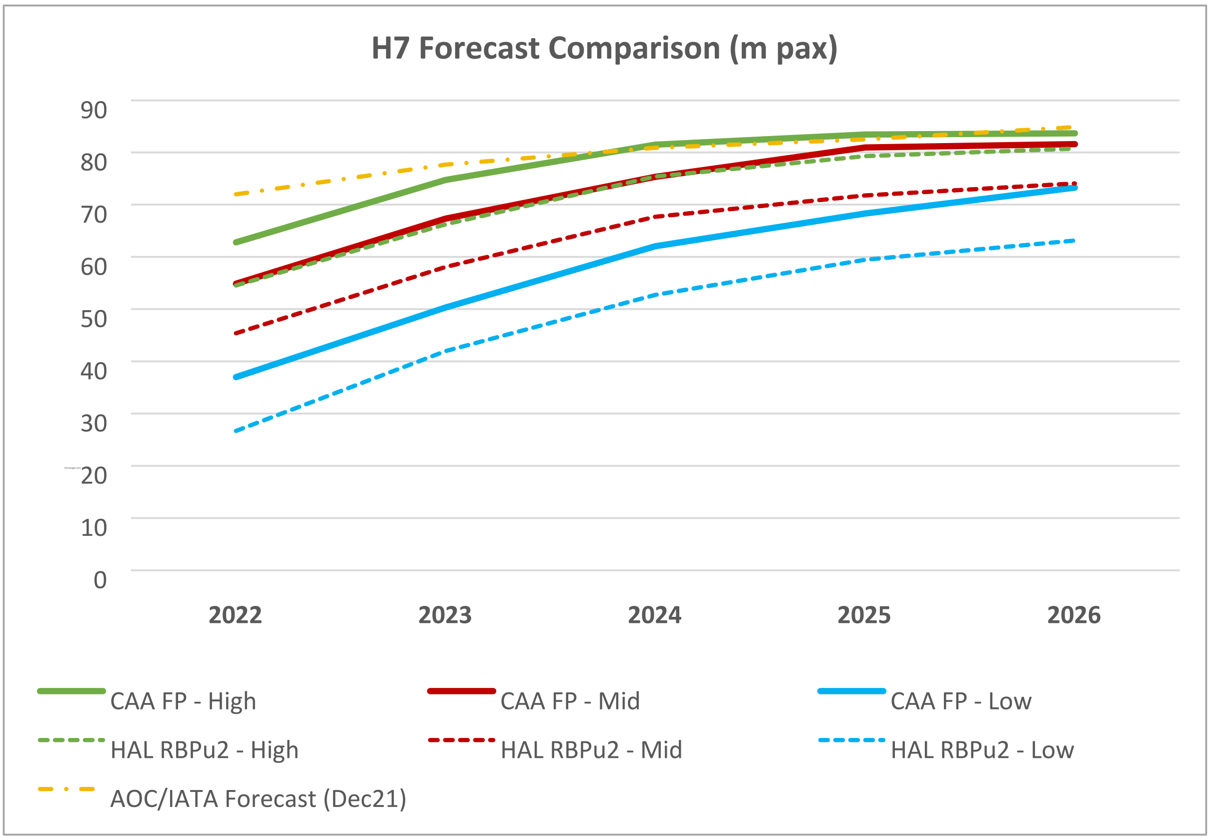
Passenger numbers

47. To produce our passenger forecast for Initial Proposals, we used HAL's traffic model and made adjustments based on our judgement around the input assumptions used. We have adopted a broader approach at Final Proposals that

uses both HAL's model and a wider range of independent forecasts. In doing so, we are drawing on a wider and deeper evidence base to enhance our method, taking into account a wide range of industry views on recovery, including HAL's forecasting model and approach.

48. Our Final Proposal forecast scenarios for H7 are presented in Figure 1 and Table 1 below.

Figure 1: CAA Final Proposals passenger forecasts compared with HAL RBPu2 and AOC/LACC forecasts, H7



Source: CAA

Table 1: CAA Final Proposals passenger forecasts compared with HAL & AOC/LACC forecasts, H7

	2022	2023	2024	2025	2026	H7 Total
AOC/LACC	72.0	77.7	80.9	82.5	84.9	**398.0**
HAL High	54.5	66.2	75.4	79.3	80.7	**356.2**
HAL Mid	45.4	58.1	67.7	71.8	74.1	**316.9**
HAL Low	26.7	42.0	52.7	59.5	63.2	**244.1**
CAA High	**62.8**	**74.8**	**81.5**	**83.4**	**83.7**	**386.2**
CAA Mid	**54.9**	**67.3**	**75.4**	**81.0**	**81.6**	**360.2**
CAA Low	**37.0**	**50.3**	**62.0**	**68.3**	**73.3**	**291.0**

Source: CAA

49. Our resulting “Mid Case” is around 7% higher than the forecasts used in our Initial Proposals. See chapter 1 (Passenger forecasts) for further information on our passenger forecast. As further explained below, we will also review the passenger forecast again in the light of responses to these Final Proposals to ensure our Final Decision incorporates an appropriate passenger forecast.

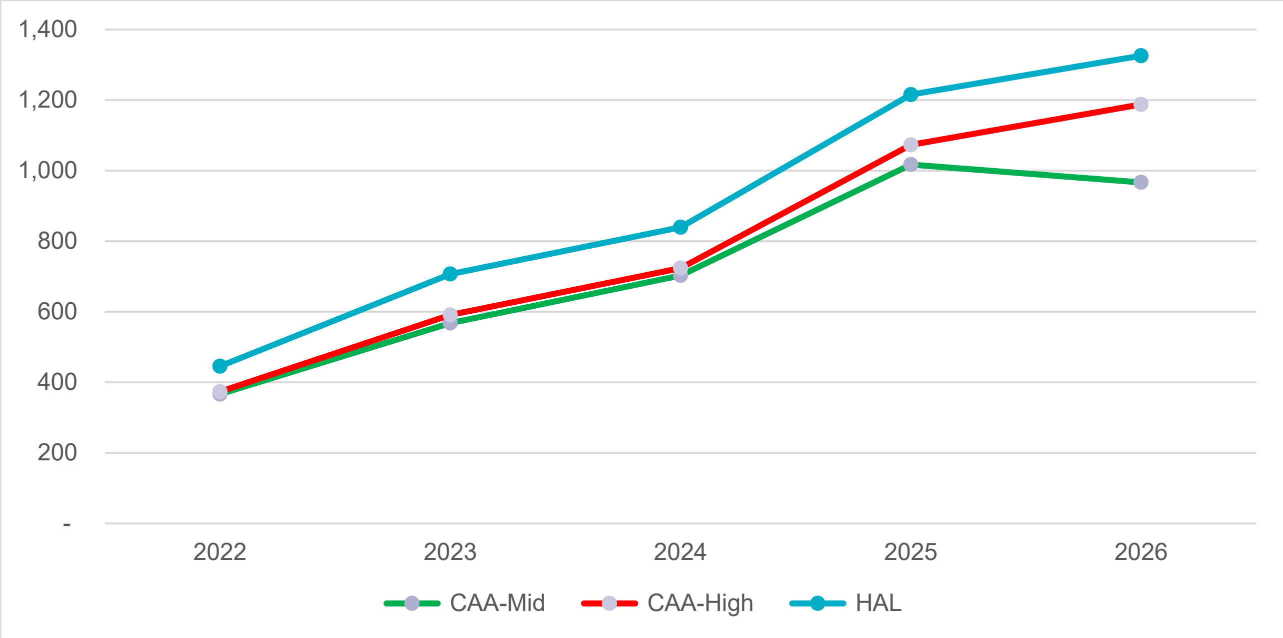
Capex

50. Setting the price control in a way that supports efficient investment in capital furthers the interests of consumers by allowing HAL to continue to invest in a safe, secure and resilient airport.

51. In our Initial Proposals, we developed estimates of efficient capex on the basis of evidence from HAL, feedback from airlines and advice from our expert advisors (Arcadis). We recognised the challenges faced by HAL as a result of the impact of the covid-19 pandemic but concluded that both the quality and depth of evidence supplied by HAL in its updated RBP on capex estimates to be generally poor for that stage in the price control process. We used the CAA “Mid Case” in establishing our range for HAL’s price control which assumed a total capex plan of £2.4 billion (2020 CPI prices) over H7.

52. Our approach for Final Proposals builds on our previous work and we have developed a structured needs assessment combined with an efficiency assessment by our technical advisors Arcadis. Applying our approach produces a Mid Case of £3.6billion (£0.9billion or 20% below HAL) (2020 CPI prices). Our Final Proposal forecast scenarios for H7 are presented in Figure 2 below.

Figure 2: CAA and HAL capex estimates, H7 (£m 2020 CPI)



Source: CAA analysis including using HAL data.

53. We have also retained our proposals for flexibility mechanisms, broadly consistent with the approach set out in Initial Proposals. So, HAL will be able to use the governance processes during H7 to bring forward further projects, but these will need to be strongly supported by evidence and in the interests of consumers.

Opex and commercial revenues

54. Our estimates of operating costs (“opex”) and commercial revenues (that are deducted from HAL’s revenue requirement under the “single till” used to set the price control) are two of the most significant contributors to the overall airport charge. Setting robust estimates for opex and commercial revenues protects consumers’ interests by incentivising efficiency, while allowing HAL sufficient revenue to operate to an appropriate standard.

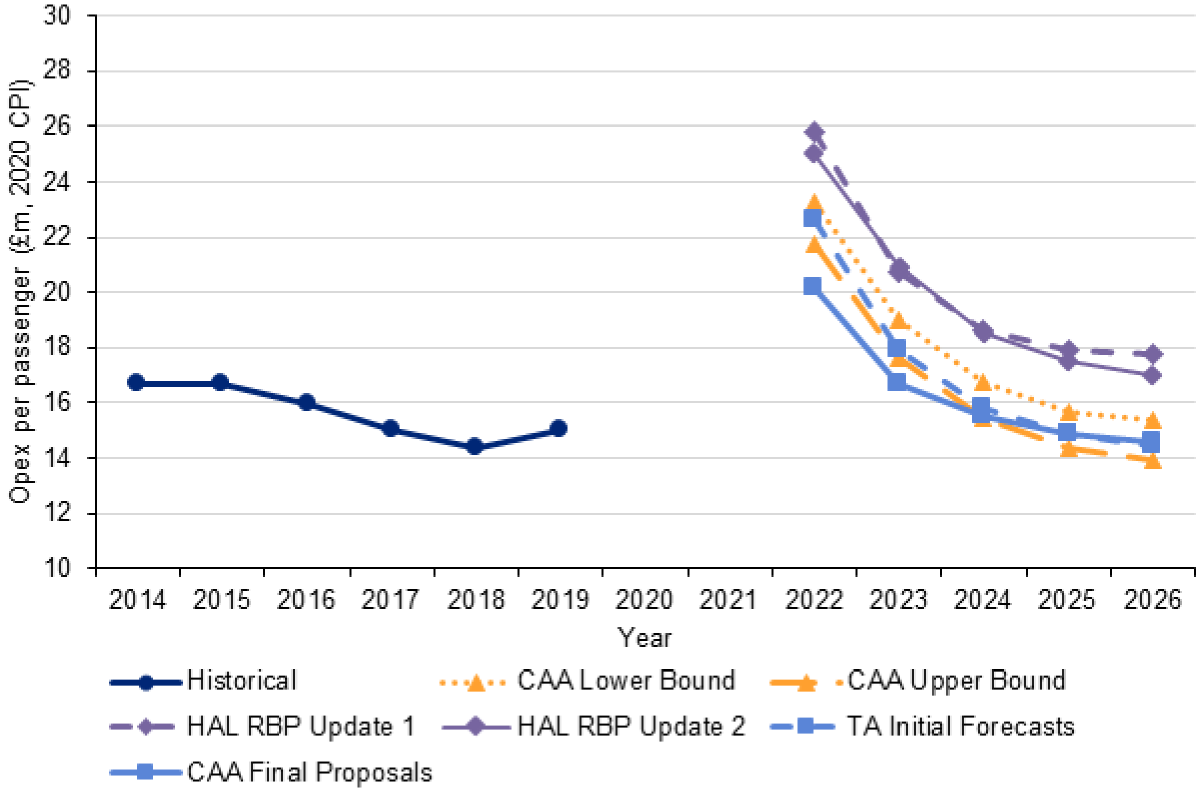
55. In our Initial Proposals, we presented detailed estimates for opex and commercial revenues, broken down by element, supported by a report from CEPA/Taylor Airey (“CTA”). HAL argued that our estimates of opex were too low and that our estimates of commercial revenues did not properly take account of current and future market conditions, and that additional commercial revenue per passenger can only be generated with additional capex. Airlines said that it is inappropriate to place weight on HAL’s forecasts, and that we should rely solely on the estimates provided by CTA.

56. We have continued to work closely with CTA and have increased our estimates of opex to allow for higher staff numbers to support quality of service and higher estimates of wage inflation. For commercial revenues, we have reduced our

estimates in the light of new evidence presented by HAL in relation to the scope for increasing retail and surface access revenues.

57. For Final Proposals, we are projecting commercial revenues of £4,205million, 17% higher than HAL's estimate and opex of £5,800million, 6% lower than HAL's estimate (figures are 2020 CPI prices). See Figures 3 and 4

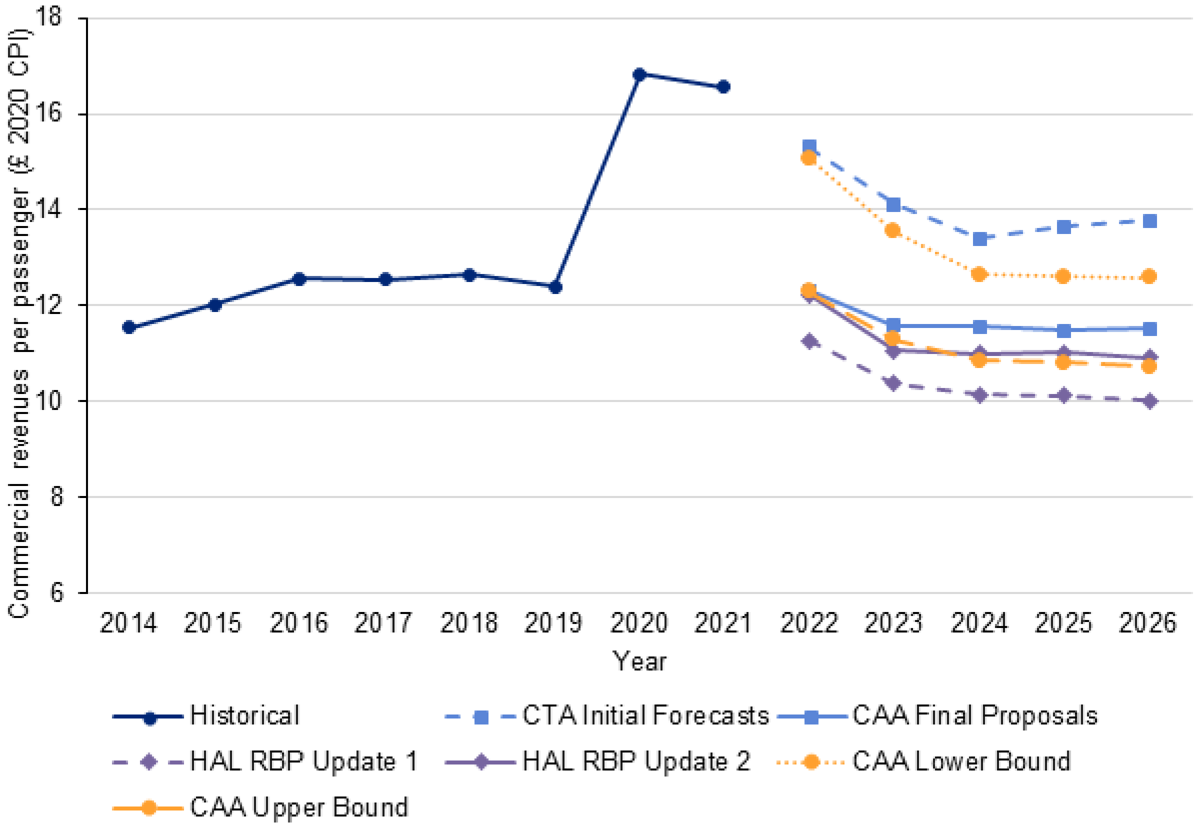
Figure 3: Opex per passenger: CAA, HAL and TA estimates and historical costs*



* 2020 = £43/passenger, 2021 = £43/passenger

Source: CTA/CAA

Figure 4: CAA Final Proposals for Commercial revenues per passenger excluding cargo: CTA, CAA and HAL (£, 2020 CPI prices)



Source: CAA/CTA

The cost of capital

58. The weighted average cost capital ("WACC") is a key building block used in calculating HAL's price control. It represents a return on the RAB and acts as a payment to investors and creditors for the risk they incur by committing capital to the business. Setting an appropriate WACC furthers the interests of consumers by helping to secure that:

- HAL is able to finance the investment it needs to carry out its activities and meet the reasonable demands of consumers for airport operation services; and
- efficient financing costs are reflected in the price control.

59. At Initial Proposals, we presented a detailed, bottom-up estimate of a range for the (RPI-real) Vanilla WACC of 3.6%- 5.6%, supported by a report from our expert advisors, Flint Global.

60. Stakeholders submitted extensive feedback on our WACC estimate used in Initial Proposals. Among other things, HAL said that we had underestimated the impact of the pandemic on the WACC. It also disputed that any downward adjustment was needed in respect of the TRS, arguing that any impact is

accounted for in our base estimates. HAL also said we had underestimated its efficient debt financing costs.

61. Airlines said that we had overestimated both the level of risk faced by HAL prior to the pandemic and the impact of the pandemic. They also said we had not sufficiently accounted for the impact of the TRS and that we had overestimated HAL’s efficient debt financing costs.

62. For Final Proposals, we have carried out significant further work on our WACC assessment, including commissioning a further expert report on the “asset beta” from Flint Global as well as carrying out further analysis of HAL's existing debt costs, supported by our strategic financial advisors, Centrus.

63. Overall, our analysis suggests that a lower WACC than our Initial Proposals range is appropriate. This is mainly driven by:

- the application of a higher downward adjustment to the asset beta to take account of TRS arrangements; and
- the impact of higher forecast inflation in H7 than we forecast at Initial Proposals, which serves to reduce the real cost of HAL's existing fixed-rate debt.

64. In making our estimate of the WACC for H7 in these Final proposals, we have assumed gearing of 60%, a real post-tax cost of equity of 7.5% (which means we are allowing equity returns 20% higher than the market average) and a real cost of debt of 0.43%, to give a real WACC of 3.26%. Further information on our approach is set out in chapter 9 (Weighted average cost of capital).

The level of charges

65. As we explained in the Introduction above, we allow for capex through estimates of regulatory depreciation and returns (which include a component to reflect the WACC and a corporation tax allowance) calculated on the basis of HAL’s RAB. This means capex is not funded in the year that it is incurred but is financed over the assumed useful life of the asset. We calculate price control revenue by adding these estimates of regulatory depreciation and returns to our estimates of opex and subtracting other single till revenues (commercial revenues, ORCs and cargo revenue). We then divide this total by the passenger forecast to give a price control revenue allowance per passenger.

66. In making these Final Proposals, we have assumed that the holding price cap for 2022 of £29.50 in 2020 prices remains in place and adjusted revenues in the subsequent four years such that HAL is expected to recover the present value of the assumptions used for the building blocks of the price control. We have also assumed that prices decrease steadily after 2022 (consistent with protecting the interests of consumers) to ensure that price levels move down as demand rises and costs can be spread over a greater number of passengers, while also

supporting HAL's financeability as discussed further below. Our Final Proposals are summarised in Table 2 below.

Table 2: Summary of our final proposals for airport charges

Final proposals						
£m 2020, CPI-real	**2022**	**2023**	**2024**	**2025**	**2026**	**Total[6]**
Operating costs*	1,127	1,143	1,192	1,227	1,210	5,899
Regulatory depreciation	841	879	918	970	1,022	4,629
Allowance for asymmetric risk	-	6	18	28	27	79
Allowed return (incl. tax)	644	658	663	663	667	3,295
Service quality bonus [7]	-	4	-	-	-	-
Gross revenue requirement	**2,611**	**2,690**	**2,791**	**2,888**	**2,925**	**13,905**
Commercial revenues (incl. ORCs)	(852)	(955)	(1,052)	(1,115)	(1,122)	(5,096)
Cargo revenues	(45)	(28)	(18)	(11)	(11)	(114)
Net revenue requirement	1,714	1,707	1,721	1,762	1,792	8,696
Passengers (m)	55	67	75	81	82	360
Unprofiled yield per pax (£)	31.22[8]	25.37	22.82	21.75	21.96	24.14

* Including pension deficit repair costs

Source: CAA

[6] The figures in the 'total' column for unprofiled yield per pax is a weighted average rather than a total.

[7] Represents service quality bonuses earned in 2020 and 2021. Bonuses earned thereafter are recovered through airport charges as set out in the licence.

[8] This figure is different to the £30.19 (nominal) charge that applies for 2022. The figure shown here reflects the sum of the building block calculation for 2022. The difference between this figure and the £30.19 (nominal) is spread over the remaining years of the H7 period such that the total allowances for H7, taking account of the £30.19 (nominal) charge for 2022, match the total of the building block calculations.

Table 3: Price cap profile

Final proposals						
	2022	**2023**	**2024**	**2025**	**2026**	**Average[9]**
Profiled yield per pax (£ 2020, CPI-real)	27.39	25.88	24.42	23.04	21.75	24.50
Profiled yield per pax (£ nominal)	30.19	29.68	28.43	27.33	26.31	28.39
CPI inflation forecast	7.4%	4.0%	1.5%	1.9%	2.0%	3.4%

Source: CAA

Financeability

67. We have assessed the financeability of our Final Proposals in respect of both debt and equity. Debt financeability focuses on the notional company (which we assume has a reasonably efficient financing structure and gearing of about 60% over the H7 price control period) being able to access the debt finance it needs at a reasonable cost.

68. HAL has stressed the importance of the notional company targeting at least a BBB+ investment grade credit rating. The notional financial structure has a number of similarities to HAL's existing Class A debt, which is also currently rated BBB+ by Standard & Poor's (S&P).

69. Since our Initial Proposals (on 24 February 2022) S&P has placed HAL's Class A debt on "CreditWatch negative" and highlighted concerns about:

- the key credit metric funds from operations ("FFO", which is a measure of cash flow) to debt falling below an average of 7% for the period 2022 to 2024;
- our Initial Proposals for TRS; and
- the vulnerability of HAL's credit metrics if passenger demand were to recover only slowly.

70. The financial modelling that supports these Final Proposal shows FFO/debt at an average of 9% for 2022 to 2024 and 10% for 2022 to 2026. We have also made changes to our proposals for the TRS to bring forward the recovery of cash and note the robust recovery in passenger numbers during the spring of 2022. Bearing all of this in mind, we consider the Final Proposals reasonably support debt financeability.

71. Nonetheless, S&P and other rating agencies will take their own views on the creditworthiness of HAL and its various classes of debt finance. On 8 June 2022 S&P published a further note on its views of the prospects for European aviation

[9] The average shown in this table is a straight average over the H7 period

and the recovery in passenger traffic. This provided a range for the recovery in passenger traffic for 2022 to 2024 and noted that airports that depend more on long-haul traffic “are likely to be at the lower end of these ranges”. In our view the lower end of the ranges suggested by S&P are unduly pessimistic for Heathrow airport and our forecasts of passenger traffic are broadly consistent with the top half of the S&P ranges. Combined with our Final Proposals for airport charges traffic levels at the low end of the S&P ranges would put significant pressure on HAL’s credit metrics, which could result in a downgrade of its Class A debt.

72. We note the group of companies of which HAL is a part has a much higher level of indebtedness than the notional company and the debt of Heathrow Financing is rated as sub-investment grade. We also note that, if HAL’s Class A debt were to be downgraded 2 “notches”, it would be rated BBB- and, at this rating, UK debt markets are more expensive and have significantly reduced liquidity. If the notional company were to be in this position, it would likely need to rely more on equity finance to ensure that it could finance investment and reduce gearing, until it was able to regain a stronger investment grade rating. We note that during the pandemic, Heathrow airport’s shareholders have not supported the group with additional equity finance, in contrast to the shareholders of many aviation businesses.

73. We have assessed equity financeability using a range of metrics including the Internal Rate of Return (“IRR”) and dividend yield. Our base case financial modelling shows a return to dividends in 2022 for the notional company, these dividends rising over time and returns on equity consistent with our assumptions on the cost of capital.

RAB adjustment

74. Our April 2021 RAB Adjustment Decision set out the targeted RAB adjustment of £300 million (in 2018 prices) that we considered was appropriate to further the interests of consumers, particularly to support HAL’s financeability, the timely re-opening of airport capacity and the quality of service it provides during 2021, ahead of the new H7 price control period starting in 2022.

75. While the Initial Proposals acknowledged that the impact of the covid-19 pandemic is likely to have in heightening investor perceptions of risk in HAL, and that this could persist for a significant period, we noted that we were taking the following steps to address these matters:

- introducing a TRS mechanism, which reduces HAL's exposure to future shocks;
- providing an allowance for asymmetric risk; and

- determining a higher "asset beta", and hence allowed cost of capital, in recognition of the likelihood of heightened risk perceptions by investors, even after taking into account the above two regulatory mechanisms.

76. Bearing these steps in mind, we were not persuaded by HAL's arguments that we should make a further RAB adjustment, as the approach to setting the H7 price control would provide an appropriate risk and reward package for investors without any further adjustment, and a further RAB increase would increase airport charges to the detriment of consumers.

77. We note that airlines have continued to object to the £300 million RAB adjustment set out in our April 2021 RAB Adjustment Decision, including because, in their view, HAL has delayed the reopening of Terminal 4. However, we note that the RAB adjustment was made in relation to investment and service levels in 2021 and not in relation to HAL's performance in 2022.

78. In May 2022, HAL submitted a further report in support of its claim for a RAB adjustment in relation to its covid-19 losses. As was the case with the Initial Proposals, these Final Proposals provide for HAL to be reasonably financeable without further adjustment. Bearing this in mind, we consider that no further RAB adjustment is needed to support the interests of consumers nor would a RAB adjustment be necessary to support HAL's financeability.

79. In the light of all of the above, we do not propose any further RAB adjustment for H7 beyond the £300m RAB adjustment to which we have already committed in the April 2021 RAB Adjustment Decision.

The regulatory framework – dealing with uncertainty

Traffic Risk Sharing

80. The Initial Proposals explained our intention to introduce a TRS mechanism for HAL in H7. We consider this to be in consumers' interests as a TRS mechanism will reduce the risk of significant gains or losses for HAL that could otherwise arise from changes in passenger numbers over which it has only limited control. TRS should also avoid unnecessary upward pressure on HAL's cost of capital, facilitate the certainty and advantages of a five-year price control for the H7 period, and help to clarify the risks that HAL is expected to bear during that period.

81. In calibrating the TRS mechanism, we have taken account of, among other things, the impact of traffic changes on opex and commercial revenues, and the extent of traffic risk that HAL has experienced in the past. We are also seeking to preserve incentives for HAL to grow passenger volumes, which can reduce charges to the benefit of consumers.

82. We are now proposing a TRS mechanism similar to that set out in the Initial Proposals, with moderate risk sharing in a central band and stronger risk sharing in an outer band. However, rather than implementing the entire adjustment through HAL's RAB at the H8 price control review, we are now allowing the adjustment to charges to start in H7, two years in arrears. This short delay is common to most TRS mechanisms and reflects the practicalities of setting airport charges. The full adjustment will be spread over ten years, with the adjustments to charges in H8 and beyond implemented through HAL's RAB (but with the amortisation period consistent with the full recovery of revenue over ten years as noted above).

83. These changes should support HAL's financeability while spreading the TRS adjustment over ten years reduces the increase in charges that could occur after (or even during) a sharp downturn in traffic and should make the mechanism robust to a wide range of circumstances. Further details of our proposed approach to these matters are set out in chapter 2 (Regulatory framework), with our guidance on the circumstances we would consider re-opening the price control provided in Appendix J (Policy on Reopeners).

Allowances for asymmetric risk

84. We have established an approach for dealing with future "pandemic risks" through a stand-alone revenue allowance for these low probability but significant events. This has been calibrated by estimating the losses that HAL might incur if another pandemic were to occur, evaluating the potential frequency of such an event and weighting the estimated losses by the probability of such an event occurring during the period.

85. While airlines have criticised the asymmetric risk allowance as unnecessary and duplicative, we remain of the view that this approach appropriately compensates HAL's investors for risk, when combined with our approach to the cost of capital and the shock factor adjustment to the passenger forecast. Further details of our proposed approach are set out in chapter 11 (Allowance for asymmetric risk).

Flexibility in relation to capital expenditure

86. In developing the approach to capital expenditure efficiency incentives discussed below, we are retaining the flexibility that is associated with the existing "core and development" approach and propose to introduce arrangements for the enhanced oversight of any major changes to HAL's capex programme. This means that the capex programme can be updated to take account of the projects that are appropriate in the circumstances later in the price control period. These arrangements are described further in chapter 7 (Capex incentives).

Encouraging efficiency and delivering for consumers

Outcome Based Regulation ("OBR")

87. Placing service quality regulation at the heart of our H7 proposals delivers a core part of the CAA's duty to promote the interests of consumers under the CAA12.

88. Transitioning to OBR from the current Service Quality Rebates and Bonuses ("SQRB") arrangements strengthens the link between economic regulation and what consumers want by expanding our regulation of HAL to cover aspects of service quality that are valued by consumers and that are jointly delivered by HAL and other parties.

89. Since our Initial Proposals, we have undertaken extensive stakeholder engagement with HAL and airlines in finalising our proposals for OBR. This has culminated in a package of Final Proposals which is broadly consistent with the approach that we set out in our Initial Proposals. In summary, the key features of the OBR arrangements we propose are:

   - six consumer outcomes that reflect the most important aspects of airport operation services that consumers value and as proposed by HAL;
   - thirty-seven measures with reputational and financial incentives which include most SQRB metrics and wider measures reflecting services provided by HAL and other parties that consumers value. These include security queue time, wi-fi performance and helpfulness of staff. We intend that this package better reflects consumers overall experience of using the airport;
   - targets that, for the most part, maintain existing SQRB targets but with three areas of additional "stretch" above both HAL's proposed targets and the corresponding SQRB targets;
   - broadly consistent with the SQRB arrangements, incentive envelopes of 7% downside and 1.44% upside of airport charges allocated across financially incentivised measures; and
   - a stakeholder-led continuous improvement mechanism and a CAA-led mid term review within the H7 period.

90. We also confirm that the implementation of OBR will start when the licence modifications take effect. Further details of our proposed approach are set out in chapter 3 (Outcome Based Regulation).

Capex incentives

91. The Initial Proposals set out details of our proposed approach to improving capital efficiency incentives. We consider that stronger incentives are needed to protect the interests of consumers from the increased costs that they would otherwise face were HAL to make inefficient capex investments. The current

arrangements have tended to be effective in the selection of projects by Heathrow and airlines, but we consider there is scope to sharpen the delivery and efficiency incentives, including by focusing on forward looking incentives that encourage HAL to deliver projects, and spend in line with, outcomes and budgets that are agreed in advance.

92. In responding to the Initial Proposals, HAL made several criticisms of our approach and said we had not provided sufficient evidence to justify these changes. Airlines, on the other hand, broadly supported the development of improved incentives.

93. Our Final Proposals for the H7 capex incentive framework build on the approach set out in Initial Proposals as follows:

- we confirm a move to a forward-looking incentive framework. This will apply to the majority of HAL's capex portfolio, except for Q6 projects, which will remain on the previous backward-looking framework and HAL's contribution to the costs of Crossrail, which is already committed;
- we have updated our proposals on "triggers" and timing incentives as well as the implementation of delivery obligations following stakeholder feedback;
- HAL's performance will be measured against a baseline set at project Gateway 3[10] ("G3") for each project, with appropriate project delivery obligations. Delivery Obligations will be agreed by HAL and airlines through the airport/airline governance arrangements with the possibility of escalating disputes to the CAA;
- the same symmetrical incentive rate of 25% will apply to any over- or under-spending compared to the baselines set at G3; and
- we have retained the "core and development" approach to capex, with enhanced airport/airline governance arrangements to reflect changes to the incentives framework and improved oversight and accountability around any significant changes to HAL's overall capex programme.

94. Further details of our proposed approach are set out in chapter 7 (Capex incentives).

Other Regulated Charges

95. Other Regulated Charges ("ORCs") are charges for specified services and facilities that are collected separately from the general airport charge. They are, in general, levied on a "user pays" principle. The costs of providing these

[10] Gateway 3 is the point in the governance process around capital expenditure where the requirement, scope and budget is agreed jointly with airlines and HAL. G3 is the point in the development of a project where it moves from being a "development" to a "core" project.

services form part of HAL's overall cost base and the revenue associated with them is included in the single till calculations used to set the price control.

96. Our Final Proposals for ORCs are broadly similar to our Initial Proposals. There are advantages to consumers in the greater transparency and simplicity of an approach to ORC pricing that reflects marginal costs and this approach has broad support from stakeholders. We also propose to strengthen the associated governance arrangements for ORCs.

Statutory framework and next steps

97. The Civil Aviation Authority ("CAA") is a public corporation established[11] to act as the UK's independent aviation regulator, with all civil aviation regulatory functions (economic regulation, airspace policy, safety regulation, consumer protection and aviation security regulation) being integrated within a single specialist body. The CAA's ministerial "sponsor" is the Secretary of State for Transport.

98. The CAA's work in regulating HAL is conducted under CAA12. CAA12 replaced the previous statutory economic regulatory regime with a new approach under which only the operators of "dominant" airports[12] are subject to economic regulation. Currently only Heathrow and Gatwick are economically regulated through licences as a result of market power determinations made by the CAA in 2014. The parties (HAL and affected airlines) who are eligible to request that the CAA conduct a further market power determination for Heathrow airport have not chosen to do so. For the reasons set out above, the CAA considers that it continues to be appropriate to regulate prices and service quality at Heathrow.

Our duties as economic regulator of HAL

99. As noted above, our work as economic regulator of HAL is conducted under CAA12. Setting price controls for HAL is one of our core functions under CAA12. In doing so, our primary duty in carrying out its functions under CAA12 is to:

> *"further the interests of [present and future] users[13] of air transport services regarding the range, availability, continuity, cost and quality of airport operation services"* ("AOS")[14]

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[11] See the Civil Aviation Act 1982, section 2: https://www.legislation.gov.uk/ukpga/1982/16/section/2

[12] Operators of "dominant airports" are those that the CAA has determined have met the "market power test" set out in CAA12: see sections 5 to 7 CAA12. See: https://www.legislation.gov.uk/ukpga/2012/19/part/1

[13] Users are defined in section 69 CAA12 as passengers and those with "a right in property" carried by air transport services and are referred to collectively by the CAA as "consumers".

[14] See section 1(1), CAA12. Section 1(2) CAA12 makes clear that the CAA must, "where appropriate", carry out its functions in a manner which it considers will promote competition in the provision of airport operation services. The CAA considers that, while important, this duty is less relevant to its work in setting price controls.

100. In discharging its duty under section 1(1), the CAA has "secondary duties" to "have regard to" (that is, consider) the following:[15]

- The need to secure that HAL is able to finance its provision of AOS at Heathrow airport (which we refer to as "financeability"): in considering HAL's ability to finance its licensed activities, the CAA has been clear throughout the H7 process that the correct approach is to focus on a "notional company" and that the responsibility for the actual financing choices made is for HAL's directors and shareholders. This approach reflects that taken by other regulators, as well as the Explanatory notes published alongside CAA12 when it came into force.[16] The CAA has sought to ensure that the approach taken allows for HAL to be financed on a reasonably prudent basis, but this does not involve the CAA regulating on the basis of HAL's actual financing structure as this would transfer the risk of the financing choices HAL makes to consumers. We have considered the impact of our proposals on the likely credit rating of the notional company as part of ensuring our proposals are financeable.
- The need to secure that all reasonable demands for AOS are met: we have considered issues such as how best to support the recovery in passenger numbers and services at Heathrow airport. This has included making estimates of capital and operating costs that are consistent with an appropriate approach to developing, maintaining and operating the airport and that charges are no higher than necessary to support that investment. We have also developed a flexibility mechanism that will allow additional capital expenditure later in the period if it is needed and properly justified.
- The need to promote economy and efficiency on the part of HAL: this has been of particular relevance in considering our approach to:
    - (i) assessing the efficiency of past investments made by HAL;
    - (ii) setting an allowance for capital investments based on appropriate evidence (allowing funding for efficient expenditure); and
    - (iii) how HAL should be incentivised to make capital investments efficiently in the future (putting forward looking efficiency incentives in place).

[15] See section 1(3) CAA12.

[16] See: https://www.legislation.gov.uk/ukpga/2012/19/notes/division/4/1/1/1/1

- The need to secure that HAL is able to take reasonable measures to address the environmental effects of the airport: our approach to capex (including the flexibility mechanism) should secure the licensee's ability to mitigate environmental effects by promoting targeted, efficient and effective investment. This should enable HAL to take appropriate steps in moving its operations towards "net zero".
- The "Better Regulation Principles":[17] our actions are transparent and accountable through our consultation processes (including the informal engagement with HAL and airlines) and the appeal rights to which our decisions are subject. We consider a range of potential options/approaches to ensure our approach is proportionate to furthering consumers' interests.

101. If there is a conflict between:

- the different interests of consumers, such as between cost and quality; or
- between the interests of present and future consumers

section 1(5) CAA12 provides that we must further such of those interests as it thinks best. This requires the CAA to consider in the course of our decisions the necessary trade-offs (such as those between lower prices and higher quality services and between consumers' short-term interests and their long-term interests) that can arise in setting the price control and requires that we use our discretion to address these trade-offs.

102. Although they have the right to appeal our final price control decision,[18] we do not have a duty to consider the interests of airlines under CAA12. So, it would not be appropriate for us to consider the interests of the airlines' businesses as a standalone factor. However, airlines' views, and the evidence that they have provided in the lengthy consultation process supporting the development of these Final Proposals, are important in helping us to determine the interests of consumers and there are areas, such as in relation to the operation of the airport, where they may have very significant insight into the operational impact of our proposals.

103. There can often be aspects relevant to the setting of the price control and service quality incentives where the interests of consumers and airlines will be very closely aligned, for example secure and timely security processes that allow passenger boarding to facilitate on time departure. But there may be other aspects where consumers may have a stronger interest than airlines, such as parts of the arrivals process once the customer has disembarked the flight. We

[17] These are the principles set out in section 1(4) CAA12.

[18] This is the final decision to modify HAL's licence set out in a notice under section 22(6) CAA12.

are mindful of the importance of considering the customer interest, but using the airlines' views to inform that assessment where appropriate.

Putting these Final Proposals into effect

104. The arrangements set out in these Final Proposals will replace the holding price cap that came into effect on 1 January 2022 and which will run until 31 December 2022 (and will leave prices unchanged in 2022, these Final Proposals take account of the arrangements for the holding cap and set a new level for maximum allowed airport charges for the period 2023 to 2026).

105. These Final Proposals include (at Appendix C) the statutory notice of the CAA's intention to modify HAL's licence to implement these proposals as required by section 22(2) CAA12. The statutory procedure for modifying a condition in a licence, including a price control condition, is set out in section 22 CAA12, and in brief, provides that the CAA must:

- publish a notice setting out the proposed modification and the reasons for it (see Appendix C);
- consult on the proposed modification for a "reasonable period" (in the present case, six weeks); and
- after the consultation period and considering any representations received from stakeholders, publish a further notice under section 22(6) specifying the modification to be made. We refer to this notice in these Final Proposals as the "Final Decision".

Dealing with uncertainty on the passenger forecast

106. The position in relation to covid-19 and the recovery from the pandemic has changed and evolved over the last two years and there remains significant uncertainty as to what will happen over the coming months. We also recognise that certain new information on the strength of the recovery in passenger numbers at Heathrow has only emerged very recently. We are conscious of the importance of the passenger forecast in terms of calibrating the overall level of price control on airport charges and so to our discharge of our primary duty to further the interests of consumers, and its importance to our secondary duty to have regard to HAL's financeability.

107. These Final Proposals are based on the "Mid" case passenger forecast set out in chapter 1 (Passenger forecasts). This is intended to be a forecast of the average expected number of passengers and so takes into account both the potential for upside but also the potential for downside (relating to both the macroeconomic difficulties noted earlier or the emergence of further variants of covid-19). The TRS arrangements discussed in chapter 2 (Regulatory framework) also provide a degree of protection from traffic variations for HAL, airlines and consumers.

108. Nonetheless, if strong evidence were to emerge during the period of consultation on these Final Proposals that indicated our “Mid” case was no longer an appropriate average forecast for 2022 and beyond, and that retaining this forecast would create significant bias, then we would consider adopting a new passenger forecast and revising our proposals for the H7 price control on this basis.

109. Our approach to dealing with these matters will include the following steps:

- we will consider new information (including representations we receive in response to our consultation on these Final Proposals) to determine whether we should adopt a revised passenger forecast;
- only if the information we receive strongly suggests that a significantly different passenger forecast is warranted would we consider changes to these Final Proposals. In considering the need for any such changes, we will take into account the working of the TRS mechanism set out in chapter 2 (Regulatory framework) of these Final Proposals;
- if we were to adopt a revised passenger forecast, we would make consequential changes in the levels of operating cost and commercial revenues used in our price control calculations; and
- we would also seek to ensure that the position on financeability as set out in chapter 13 (Calculating the price cap and financeability) and, in particular, the position on key credit metrics is consistent with the analysis supporting these Final Proposals.

110. We are not currently aware of any credible information that suggests it would be appropriate to adopt a forecast above our high case forecast summarised in chapter 1 (Passenger forecasts) and, if a new and more dangerous variant of covid-19 were to emerge in the next few months, it might be appropriate to reduce our mid-case forecast.

111. The effect of section 22(7) CAA12 is to require us to re-consult before making a licence modification if the modification “differs significantly” from that proposed in these Final Proposals. We welcome representations on how we should interpret “differs significantly” in the context of the H7 price control review and will consider these matters carefully in formulating our Final Decisions. We would also take into account the relatively focused nature of the changes we have in mind in deciding on whether further consultation on a revised licence modification would be appropriate.

112. Further, as any such consultation would likely reflect the limited scope of changes noted above, it is likely that the time for consultation could be reasonably shortened and be of the order of two weeks. We note that such a

period was used for the final consultation on the final price control modifications we undertook to put the Q6 price control in place.

Next steps

113. As noted above, we are consulting on our Notice of proposed licence modifications under section 22(2) of CAA12 set out in Appendix C and explanatory text which summarises our reasoning and rationale for the licence modifications proposed. We will also consider any representations we receive on whether the passenger forecast that supports these Final Proposals is an appropriate forecast to support our Final Decisions. The consultation period will run for 6 weeks. Please e-mail responses to economicregulation@caa.co.uk by no later than Tuesday 9 August 2022.

114. We note that we have previously granted requests for extensions to the consultation period. Given the importance of the Final Proposals and the need to prepare and publish the Final Decision in a timely way, we will not be accepting any submissions after Tuesday 9 August 2022.

115. We expect to publish the responses we receive on our website as soon as practicable after the period for representations expires. Any material that is regarded as confidential should be clearly marked as such and included in a separate annex. Please note that we have powers and duties with respect to information under section 59 CAA12 and the Freedom of Information Act 2000.

116. We also expect that HAL will begin to consult on its airport charges for 2023 in approximately August 2022, in line with expectations set out in the Airport Charges Regulations 2011 (ACR11). These Final Proposals should provide the basis for HAL’s consultation on the overall level of airport charges for 2023.

117. After considering the responses we receive to the Final Proposals, we will publish our Final Decision on the modifications we make to HAL’s licence. We currently intend to publish that Final Decision in the Autumn of 2022.

118. HAL, as the licence holder, and any provider of air transport services whose interests are materially affected by the final decision (typically airlines operating from Heathrow), may apply to the CMA for permission to appeal a decision to modify a licence condition under section 25 CAA12. An appeal may be brought on the grounds that (i) the decision was based on an error of fact, (ii) the decision was wrong in law, or (iii) an error was made in the exercise of a discretion (see section 26, CAA12). Such an application must be made within six weeks of the day on which the Final Decision is published (see paragraph 1(1), Schedule 2, CAA12).

Structure of our Final Proposals document

119. The structure of these Final Proposals is set out below.

120. Section 1 sets out details of the passenger forecast, overall framework and proposals for outcomes based regulation:

- Chapter 1 - Passenger forecasts;
- Chapter 2 - Regulatory framework; and
- Chapter 3 - Outcome based regulation.

121. Section 2 sets out details of our Final Proposals for the main cost and revenue building blocks:

- Chapter 4 - Operating expenditure;
- Chapter 5 - Commercial revenues;
- Chapter 6 - Assessment of capital expenditure;
- Chapter 7 - Capex incentives; and
- Chapter 8 - Other regulated charges.

122. Section 3 sets out details of our Final Proposals for financial building blocks, key price cap issues and implementation:

- Chapter 9 - Weighted average cost of capital;
- Chapter 10 - The H7 Regulatory Asset Base and HAL's request for a RAB adjustment;
- Chapter 11 - Allowance for asymmetric risk;
- Chapter 12 - Financial framework;
- Chapter 13 - Calculating the price cap and financeability; and
- Chapter 14 - Implementing through the Licence.

123. Of the appendices:

- Appendix A sets out a summary of our duties and Appendix B provides a glossary of terms used in these Final Proposals;
- Appendix C sets out the notice of the modifications we propose to make to HAL's licence to implement these Final Proposals; and
- Appendices D to K provide further information on the main issues set out in these Final Proposals.