

# Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023

Notice of Licence Modifications under section 22(6) of the Civil Aviation Act  
2012

CAP 2515

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# Summary

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## Introduction

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1. This document gives notice under section 22(6) of the Civil Aviation Act 2012 (“CAA12”) of the CAA’s decision to modify the licence granted to Heathrow Airport Limited (“HAL”) under section 15 CAA12 on 13 February 2014 (the “Licence”). The modifications that the CAA has decided to make are to:
  - amend condition C1 (Price Control) so that the maximum yield per passenger does not exceed £31.57 in the Regulatory Year 2023; and
  - amend paragraphs 2.7, 2.10, 3.9 and 5.1 and Tables 2a, 3a, 4a, 5a, 8 and 10a of Schedule 1 (Statement of Standards, Rebates and Bonuses) of the Licence to implement a small number of specific changes to the Statement of Standards, Rebates and Bonuses.
2. The decision on these licence modifications follows on from the notice issued by CAA under section 22(2) of the CAA12 on 8 December 2022 in which the CAA consulted stakeholders on the need for, and level of, interim (“holding”) price control arrangements for 2023.<sup>1</sup>
3. The CAA has made the decision set out in this notice having carefully considered the responses we received from stakeholders and confirms that these arrangements will follow on from the price control arrangements that covered the period 1 January 2022 to 31 December 2022. They replace the text of those earlier arrangements in the Licence.
4. This document addresses:
  - the background to the amendments to the Licence we have decided to make, including the interaction with HAL’s timetable for consulting on airport charges under the Airport Charges Regulations 2011 (“ACR2011”) and the CAA’s wider H7 price control timetable;
  - a summary of stakeholders’ responses to our proposals to amend HAL’s licence as set out in the notice we published on 8 December 2022;
  - having considered stakeholder responses to the proposed modifications set out in the notice we published on 8 December 2022, our decision to implement a holding price cap for HAL for 2023;

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<sup>1</sup> Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023 (CAP2888) . See [www.caa.co.uk/CAP2488](http://www.caa.co.uk/CAP2488)

- our decision to implement a small number of specific changes to Schedule 1 (Statement of Standards, Rebates and Bonuses) of HAL's licence; and
  - next steps and the process for implementation.
5. In this context, it should be noted that neither this notice, nor any further consultation on the issues identified above that we might conduct, constitutes a notice under section 22(5) CAA12 that the CAA has decided not to implement the modifications set out in the notice under section 22(2) CAA12 that we published as part of Final Proposals.<sup>2</sup> We are continuing to consider the position in relation to our decision on the modifications set out in that notice in the light of stakeholders' responses and developments since the Final Proposals were published.
6. The licence modifications set out in this notice will take effect six weeks after the publication of this document.

## Background

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7. The notice we published on 18 December 2022 contains a detailed background to this issue. In summary:
- in December 2021, we modified HAL's licence to set a holding price cap of £27.39 (in 2020 prices) for the regulatory year 2022.<sup>3</sup> Our Final Proposals for the main H7 price control (published in June 2022)<sup>4</sup> were based on retaining that "holding price cap" for 2022 with the price cap for subsequent years reducing each year over the H7 period to £21.75 in 2026 in 2020 prices;<sup>5</sup> and
  - we noted in our Final Proposals for the main H7 price control<sup>6</sup> that new data received by the CAA in response to that consultation might indicate that the passenger forecast we had used may be out of date before we make our Final Decision to implement the price control for the H7 period.
8. Since Final Proposals, we have seen a larger increase in passenger numbers at Heathrow than we had anticipated. Separately, developments in the wider economy since we published Final Proposals have given rise to a degree of

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<sup>2</sup> CAP2365E2 at Appendix C. See:

<https://publicapps.caa.co.uk/docs/33/CAP2365%20H7%20Final%20Proposals%20Appendix%20C.pdf>

<sup>3</sup> Economic regulation of Heathrow Airport Limited: Notice of licence modifications, CAP2305. See: <http://publicapps.caa.co.uk/docs/33/CAP2305.pdf>

<sup>4</sup> Economic regulation of Heathrow Airport: H7 Final Proposals, CAP2365. See <https://www.caa.co.uk/commercial-industry/airports/economic-regulation/h7/consultations/final-and-initial-proposals-for-h7-price-control/>

<sup>5</sup> See the Final Proposals Summary, CAP2365A at Table 3.


<sup>6</sup> See Final Proposals Summary, CAP2365A at paragraphs 108ff.

volatility in forecasts of inflation and interest rates. We are currently formulating our Final Decision on the main H7 price control.

## **The notice we published on 8 December 2022 on a holding price cap for 2023**

9. As we have yet to make a Final Decision on the main H7 price control, we consulted on a new holding price cap of £31.57 (nominal prices) for the Regulatory Year 2023. This is based on our Final Proposals for the main H7 price control, and we also said we would true up or down the price cap we decide on as part of our Final Decision on the H7 price control to adjust for any differences between that Final Decision and the 2022 and 2023 holding price caps.

## **Responses to the notice we published on 8 December 2022**

10. We received responses from HAL, the Airline Community (AOC/LACC), American Airlines, British Airways, and a joint response from Virgin Airlines/Delta Airways. All respondents supported our proposals to implement a holding price cap for 2023. However, they also expressed reservations around the level of the proposed holding price cap and disappointment on the general delay to the process for the CAA making its Final Decision on the H7 price control. Furthermore, respondents suggested that the subsequent truing up/down adjustments should take place immediately after the CAA's Final Decision on H7 rather than taking effect from January 2024.
11. HAL said that:
- we had not properly taken account of its financeability and should adopt a different approach for our Final Decisions on the main H7 price control<sup>7</sup>; and also introduce a true-up in 2023 to its price control arrangements to adjust for these issues
  - it was unacceptable to have no clear timeline for the H7 process; and
  - changes in external circumstances meant that assumptions in the CAA's Final Proposals were now out of date.
12. It claimed that the proposed holding price cap did not take into account the costs of delivering HAL's latest business plan for H7 or the higher agreed service levels at the airport. HAL said the proposed charge was too low, as based on the notional balance sheet (with only 30% of debt index linked) it results in a ratio of Funds from Operations ("FFO")/debt  below the minimum 7% level required

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<sup>7</sup> HAL pointed to its December 2022 Business Plan which set out an average cap of £40.08 (CPI 2020 prices) for the H7 period.

by Standard & Poor's ("S&P"). HAL added that when compared to 70% of debt index linked to be consistent with its balance sheet, the notional company FFO/debt would be only  $\frac{1}{3}$ . HAL stated that this creates significant risk to the financeability of the notional company and the ability to deliver the capital programme assumed in the Final Proposals. HAL said that, if it is not financeable, this could jeopardise investment and would have undesirable impacts for current and future consumers.

13. The AOC/LACC and airlines said that the 2023 holding price cap of £31.57 (nominal prices) should be lower, pointing to higher than expected passenger numbers and that the holding cap should be adjusted to reflect the most up to date information before the CAA. Virgin/Delta in particular claimed that the cap should be £31.11 (nominal prices)

## Our Assessment

14. We explained in the notice we published on 8 December 2022 that it was necessary, and in the interest of consumers, for us to take more time to assess the latest information on passenger numbers and changes in macroeconomic factors such as inflation and interest rates. The complexity of, and interrelation between, the H7 building blocks meant that it was not possible simply to adopt new passenger forecast numbers without assessing the impact of other inputs on the holding price cap, the traffic risk sharing mechanism, important building blocks such as opex allowances, commercial revenues and the financeability of the notional company.
15. In respect of HAL's comments on financeability, we note that credit rating agencies tend to focus on the average of credit metrics over a number of years and the trends in metrics, rather than the performance in an individual year. In our Final Decision on the main H7 price control, we will set out our assessment of financeability over the 5 year period of the H7 price control and the evidence that supports our view that the notional company should be able to retain access to cost effective investment grade financing.
16. Bearing the above in mind, we continue to be of the view that basing the holding price cap for 2023 on our Final Proposals is the most appropriate approach, as the Final Proposals represent the most up-to-date figure that benefits from a full analysis, albeit undertaken earlier in 2022 on the evidence available at that time. We also consider that, for the reasons set out in them, the Final Proposals struck an appropriate balance between the interests of consumers and the other considerations that we are required to take into account under CAA12 (including HAL's financeability).
17. We note stakeholders' representations that the truing up or down exercise be implemented sooner than 2024, but consider that, as long as the overall profile of charges in our Final Decision on the H7 price control is consistent with HAL's



financeability, then there is no reason to bring forward and/or create the complexity of a separate truing up/down exercise. We also note that HAL has already set its airport charges for 2023 and within year changes in airport charges may not necessarily be passed on to passengers. As a result, it is not clear that effecting an immediate reconciliation would be in the interests of consumers.

18. As for the true up between the yield set out in the holding cap for 2022 and the actual yield achieved by HAL during 2022, we intend to deal with this through the existing correction factor in the price control formula, such that this difference will be reflected in the airport charges for 2024. Similar arrangements will apply to the holding cap for 2023, with the correction factor adjusting airport charges for 2025.
19. In the following chapters and Appendices of this document, we set out further details of:
  - the reasons for and effects of a holding price cap for 2023;
  - stakeholders' responses to our proposed holding cap for 2023;
  - our decision on the 2023 holding cap and level of airport charges;
  - our decision on a small number of specific changes to Schedule 1 (Statement of Standards, Rebates and Bonuses) of HAL's licence; and
  - next steps for our H7 programme.

## Next Steps

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20. The holding cap will remain in place up until it is replaced by the main H7 price control by our Final Decision.
21. We aim to publish our H7 price control Final Decision in March 2023.

**CHAPTER 1****The need for a holding price cap for 2023**

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1.1 In the notice we published on 8 December 2022, we explained that a holding cap for 2023 is needed for a number of reasons:

- the strength and continuation of the recovery in passenger numbers at Heathrow is still uncertain, in the context of increased economic uncertainty in the UK and wider global markets;
- forecasts from the Office of Budget Responsibility (“OBR”) which were published on 17 November 2022 were a key input for the H7 price control which we needed to consider;
- particular care is needed in assessing changes to the passenger forecast and the potential for changes to other key price control building blocks (including the possible impact of higher inflation and interest rates on HAL’s cost of capital); and
- HAL and Airlines indicated their support for interim arrangements and suggested that we should take more time to revisit our Final Proposals.

As a result, it was in the interests of consumers, to take further time and conduct additional analysis before reaching our final decision on the H7 price control.

1.2 The need to undertake further assessment and analysis, coupled with the release date for the OBR forecasts, meant that it was no longer possible to reach and implement a Final Decision on all aspects of the H7 settlement before the expiration of the existing holding price cap on 31 December 2022.

1.3 HAL, at the end of August 2022, issued its consultation on airport charges for 2023. HAL’s consultation assumed a yield of £31.92 per passenger (nominal prices)<sup>8</sup> which it derived from our Final Proposals.<sup>9</sup> This charge was amended to £31.57 (nominal prices) with an alternative CPI inflation assumption following HAL’s charges consultation meeting in September 2022.<sup>10</sup>

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<sup>8</sup> See Heathrow Airport Limited Charges for 2023 Consultation Document at <https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/doing-business-with-heathrow/flights-condition-of-use/consultation-documents/2023%20Airport%20Charges%20Consultation%20Document%20-%20Final.pdf>.

<sup>9</sup> Economic regulation of Heathrow Airport: H7 Final Proposals, CAP2365E2. See [www.caa.co.uk/cap2364E2](http://www.caa.co.uk/cap2364E2).

<sup>10</sup> See Appendix C of this document for an explanation of how the holding price cap of £31.57 has been derived.

- 1.4 We also noted that, while correspondence from HAL initially suggested this as an appropriate level for a holding price cap, HAL subsequently wrote to us in November 2022 suggesting that a holding cap of £36.00 (nominal prices) would be appropriate bearing in mind its concerns about its financeability.

## Stakeholder Views

- 1.5 HAL acknowledged the need for a holding cap for 2023 in the circumstances and confirmed that it had adopted a charge of **£31.57** (nominal prices) for 2023 in accordance with its consultation process under ACR2011. Similarly, AOC/LACC, American Airlines, British Airways and Virgin/Delta all agreed that a holding price cap for 2023 was required.
- 1.6 Nonetheless, HAL continued to express concerns about our approach to assessing its financeability. These matters are dealt with in chapter 2.

## Our Assessment

- 1.7 We continue to take the view that it is in the interests of consumers for the CAA to intervene to put in place a holding price cap for 2023 and for it to remain in place until superceded by our Final Decision on the H7 price control.
- 1.8 We note that HAL has adopted charges for 2023 consistent with our approach to the interim cap set out in the notice we published on 8 December 2022. Nonetheless, in the absence of a binding price control for 2023, HAL would be free to set its charges at a level of its choosing, subject only to the procedural protections of ACR2011. Alternative approaches, such as the adoption of binding commitments were explored in 2021 and we do not consider that there is merit in exploring such an approach for 2023 at this stage. As a result, we do not consider that relying on HAL's recent decision for its 2023 charges, in itself, provides consumers with an adequate level of protection.
- 1.9 Certainty over HAL's charges for 2023 also enables airlines to set ticket prices and organise their services, which ultimately provides benefits for consumers. Further, the absence of a price control condition could create a conflict between the interests of "present consumers" travelling during the first half of 2023 and "future consumers" travelling later in the H7 period if the charges HAL sets for 2023 were to be very significantly different from those in the final H7 price control.
- 1.10 In the light of these considerations, the CAA has decided that ensuring that there is a price control in place for 2023 will be in the interests of consumers.

## CHAPTER 2

# The level and other aspects of the holding price cap for 2023

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## The level of the holding price cap

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2.1 As set out in chapter 1, the CAA has decided that setting a holding price cap for HAL for 2023, at an appropriate level and in a timely way, is consistent with furthering the interests of consumers. This section deals with the level of the holding cap.

### Summary of our proposals

2.2 In the notice we published on 8 December 2022, we explained that we had proposed the holding price cap to apply to the Regulatory Year from 1 January 2023 at a level of £31.57 (nominal prices). This was based on the analysis that we set out in our Final Proposals. We noted our view that our Final Proposals:

- were the most up-to-date figure that benefitted from a full analysis, albeit undertaken earlier in 2022 and on evidence available at that time; and
- struck an appropriate balance between the interests of consumers and the other considerations that we are required to consider under CAA12.

2.3 We said that we were taking more time to assess the latest information on passenger numbers and changes in macroeconomic factors such as inflation and interest rates and also explained that:

- to the extent that we might conclude in our Final Decision that a different charge from the holding price cap for 2023 is warranted, we will set the revenue allowance for the five-year H7 period consistent with this different information, so there will in effect be a “truing up” or “truing down” of the revenue allowance for 2023; and
- we were satisfied that the use of the expected airport charge for 2023 from our Final Proposals as the basis for setting the holding price cap for 2023 should not result in an undue financeability challenge for the notional company.

2.4 Further, we noted that HAL in a letter dated 9 November 2022, had revised its position on the level of the charge, stating that recent macro-economic developments had increased expectations around inflation and interest rates and arguing that it faces significant increases in interest and accretion costs which has the effect of reducing its FFO. HAL said this raised the risk of credit rating agencies downgrading its credit rating.

- 2.5 HAL proposed a holding price cap of £36.00 (nominal prices), based on its updated analysis of S&P ratios, to reflect higher passenger number forecasts together with the impact of inflation and interest rate expectations. It suggested that a senior FFO to net debt ratio of around 7.0% for 2023 would be consistent with the financing assumptions for the notional company made by the CAA.
- 2.6 We disagreed with HAL's proposed holding cap of £36.00 (nominal) on the basis that:
- it had based its assessment on credit metrics for the actual company;
  - it appeared to have an undue focus on the financeability of the charge for 2023 based on credit metric projections for a single year; and
  - its analysis omitted the beneficial impact of inflation on the indexation of the RAB in relation to higher cashflows in subsequent years due to higher regulatory depreciation and allowed return.

## Stakeholder Views

### HAL

- 2.7 HAL, in its response to the notice we published on 8 December 2022, continued to say that the level of the proposed holding price cap for 2023 was too low properly to support its financeability and noted that:
- the proposed holding price cap did not reflect the costs of delivering the required service levels and investment at the airport;
  - external factors are putting continued pressure on Heathrow's financeability; and
  - the difference between the required charge and the interim price cap should be trued up in year to ensure cash flow requirements are met.
- 2.8 HAL pointed to its updated December 2022 Regulatory Business Plan ("RBP") in which it updated its forecasts of passenger volumes, operating costs, commercial revenues and WACC. HAL said that the average H7 charge, after adjusting for those updates, should be £40.08 (in CPI 2020 prices).
- 2.9 It observed that while passenger growth has been strong, leading it to revise its traffic forecast for 2023 upwards, there have been material changes which it considered had increased its financeability challenge. In particular, HAL said that its FFO/senior debt ratio for 2023 would be  $\frac{1}{10}$  (lower than the 7% benchmark that S&P indicated in July 2022 could trigger a downgrade in HAL's credit rating).
- 2.10 HAL also said that we had made errors in our assessment of its FFO/debt analysis in its 9 November letter and stated that:

- the gearing of HAL's class A debt is only slightly above 60% which it considered broadly consistent with the notional company;
- FFO/debt is well below 7% on a notional basis, based on HAL's December 2022 update and assuming only 30% of debt being index linked gives an FFO/debt ratio for 2023 of 4.5% and is below S&P's minimum threshold; and
- its actual indexed linked debt stands at around 70% and basing the notional balance sheet on this proportion of index linked debt results in an FFO/debt for 2023 at 5.2%.

- 2.11 HAL rejected our observation that it had only considered the impact of one year's ratio and instead stated that it had provided ratios for three years (2022, 2023 and 2024) consistent with S&P's approach to three-year averaging.
- 2.12 HAL also challenged our view that higher inflation of the RAB would lead to higher cash flows in later years as an incorrect and erroneous analysis of the impact of inflation for a notional company because with debt fixed at 60% FFO/debt would remain unchanged with inflation.
- 2.13 HAL reiterated that, if Heathrow was not financeable, this would reduce its ability to invest, decrease resilience and would result in poorer consumer outcomes at the airport. HAL stated that, by choosing to ignore financeability, the CAA was ignoring its primary duty to consumers.

### Airlines

- 2.14 The AOC/LACC continued to suggest that airport charges should be reduced to reflect (among other things) higher numbers of passengers that have used the airport in 2022 and the latest airline forecasts of passenger numbers for 2023 and beyond.
- 2.15 The AOC/LACC stated that it would be entirely appropriate for the CAA to undertake an uplift at this stage to the passenger forecast in advance of the Final Decision on the H7 price control. It pointed to information that it had submitted in response to the CAA's Final Proposals and HAL's own latest estimates which were around 10 million passengers higher than the CAA's forecasts for 2023. The same point was made by British Airways and Virgin/Delta.<sup>11</sup>
- 2.16 Virgin/Delta also said that the CAA had already been provided with information (in response to the Final Proposals) which demonstrated that the level of the proposed holding price cap is wrong, that a price cap set too high would mean that charges will be too high in 2023 and that this will disadvantage these

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<sup>11</sup> Virgin/Delta also provided 'additional passenger forecasts for 2023' together with an updated external industry-based forecast in support of its claims of increased volumes in 2023 of between 76-79 million passengers travelling through the airport in 2023

consumers compared to those using the airport in later years. They also repeated comments previously made that airport charges at Heathrow are the highest in the world and should be reduced to help protect consumers.

- 2.17 British Airways said that the CAA's failure to ignore the best available evidence before it in setting the interim holding cap higher was in direct conflict with the CAA's primary duty to protect the interests of consumers.

## **Our Views**

- 2.18 We agree with HAL that it will be appropriate to consider recent market developments in finalising our views on the overall price cap for H7. These will be considered in due course in our Final Decision for the H7 price control. Nonetheless, we remain of the view that financeability cannot adequately be assessed on the level of FFO/debt in a single year.
- 2.19 While we acknowledge that HAL provided analysis covering the period 2022-24, we note that:
- this was largely based on HAL's actual position, not the notional company; and
  - notwithstanding its multi-year analysis, the objections HAL has set out in response to the notice we published on 8 December 2022 have largely been based on the level of FFO/debt in 2023.
- 2.20 In assessing HAL's financeability our focus continues to be on the notional company and the financial metrics that derive from our modelling and assumptions for HAL's cost and revenues, including appropriate stress testing. We do not focus on single years or alternative assumptions in relation to HAL's capital structure or cost base and are not unduly concerned if alternative assumptions produce a forecast credit metric significantly below a key threshold for a single year.
- 2.21 We also remain of the view that FFO/debt is expected to improve in later years, which means that the focus on 2023 alone is likely to provide an unduly pessimistic view of this metric in the context of the overall price control. We intend to publish our Final Decision on the H7 price control in March 2023 and this will update the position and set out evidence that shows the notional company is financeable over the period of the H7 price control.
- 2.22 In response to the airlines' suggestions that we should use the most up to date information and, particularly, new passenger forecasting information, we have explained in the notice we published on 8 December 2022, and in the summary section of this notice, that we are taking more time to assess the latest information on passenger numbers and changes in macroeconomic factors such as inflation and interest rates. We also note that our Final Proposals envisaged

airport charges falling from £27.39 in 2022 to £25.88 in 2023 (both in 2020 prices).

- 2.23 Our Final Proposals provide the most up-to-date assessment of the level of the price control that benefits from a full analysis, albeit undertaken earlier in 2022 on the evidence available at that time. We also consider that, for the reasons set out in them, our Final Proposals best reflect the interests of consumers and the other considerations that we are required to take into account under CAA12 (including HAL's financeability).
- 2.24 Given the complexity and the interrelation of the H7 building blocks, it is not possible to simply adopt new passenger forecast numbers without assessing the impact of other inputs on the holding price cap, the traffic risk sharing mechanism, important building blocks such as opex allowances, commercial revenues and the financeability of the notional company.
- 2.25 As a result of the above, we consider that it is appropriate for us to implement a holding price cap to apply to the Regulatory Year from 1 January 2023 on the basis of the level of charges that we set out in our Final Proposals. We consider that this is consistent with our primary duty to protect consumers under CAA12 for the reasons set out above (including that it will provide for a real reduction in charges per passenger) and in chapter 1.
- 2.26 The level of the holding price cap should not be interpreted as indicating that the CAA would necessarily take the view that the figure proposed as part of Final Proposals is the appropriate price cap for the full H7 period. We will set out our approach to these wider matters in the next few months in our Final Decision on the main H7 price control.

## Our Decision

- 2.27 We consider that it is appropriate to set the level of the holding price cap in a way consistent with our Final Proposals and December consultation. Taking this approach, the holding price cap for 2023 should be £31.57 (nominal prices), consistent with the level of the holding cap for 2023 as set out in HAL's Charges for 2023 Consultation Document. Appendix C of this document sets out details of the calculation used to derive the 2023 holding price cap.

## Adjustments to the 2023 and 2022 Holding Price Caps

- 2.28 In the notice we published on 8 December 2022, we stated our intention for the 2023 holding price cap to remain in place for the entirety of 2023. We explained that we would true up or true down the level of holding price cap for 2023 (as with the holding cap for 2022) in our Final Decision on the H7 price control. This should ensure that airport charges are no higher than is necessary over the remaining years of the H7 price control. Any over or under recovery of revenue



by HAL against the 2023 holding cap will also be taken into account in the calculation of HAL's price control revenue correction factor, which typically operates on an n+2 basis and so will affect charges in 2025.

- 2.29 We said that the combination of lower real charges in 2023 (as envisaged in Final Proposals) and the truing up exercise (that, other things being equal, will mean that any increase in passenger numbers above the levels envisaged in Final Proposals will tend to reduce average airport charges in the remaining years of the price control) should provide reasonable and appropriate protection for the interests of consumers.

## Stakeholder Views

- 2.30 HAL, the AOC/LACC, American Airlines, British Airways and Virgin/Delta all agreed that the truing up or down process should take place at the time the CAA makes its Final Decision on the main H7 price control. HAL said that a truing up process was needed to ease its cashflow problems due to the low holding cap charges proposed by CAA for 2023 and those set in 2022. HAL stated that an in-year adjustment would enable it to deliver on newly agreed customer services levels and invest in the necessary capital expenditure at the airport.
- 2.31 Airlines and their representatives noted that HAL had already benefited from over-recoveries running to hundreds of millions of pounds to the detriment of consumers. Furthermore, they took the view that HAL would have had at least one year of the settlement on a broadly risk-free basis and that we should take account of this in our decisions.
- 2.32 Airlines also urged CAA to consider whether the true up for 2022 should be based on actuals or forecast figures and whether this should apply across all building blocks. Airlines also suggested that, if actual passenger numbers were used, then an adjustment should be made to take account of the capacity constraints that HAL introduced at the airport in 2022.

## Our Views

- 2.33 In Final Proposals, we took into account the holding cap for 2022 when setting the allowed revenues for H7. For our Final Decision on the H7 price control, we propose to adopt a similar approach, subject to the price profile being consistent with the financeability of the notional company. That is, when calculating the allowed revenues for H7, we will build the holding price caps for 2022 and 2023 (subject to this being consistent with financeability) into our financial modelling, and conduct price profiling calculations for the latter three years of H7. In essence, truing up/down will happen in the airport charges for 2024 to 2026 on an NPV (net present value) neutral basis and any adjustment to the allowed revenues will be spread over that period.

- 2.34 We note stakeholders' representations that the truing up or down exercise be implemented sooner than 2024, but consider that as long as the overall profile of charges in our Final Decision on the H7 price control is consistent with HAL's financeability, then there is no reason to bring forward and/or create the complexity of a separate truing up/down exercise. We also note HAL has already set its airport charges for 2023 and within year changes in airport charges may not necessarily be passed to passengers. As a result, it is not clear that effecting an immediate reconciliation would be in the interests of consumers.
- 2.35 As for the true up between forecast airport charges and actual airport charges for 2022, we intend to deal with this through the existing correction factor in the price control formula, so that this difference will be reflected in the airport charges for 2024. The correction factor has been in the price control formula since at least 2003 and has been an effective way to account for the difference between forecast airport charges and actual airport charges.
- 2.36 Taken together, these arrangements should provide appropriate protection for the interests of consumers, and if it is appropriate to increase the underlying level of allowed revenue appropriate protection for HAL's financeability.

## **Our Decision**

- 2.37 Our Final Decision on the price control for H7 will address the truing up or down of the price control for H7 to take account of the holding caps put in place for 2022 and 2023. Any residual variance between HAL's actual and allowed revenues arising during 2023 will be addressed through the correction factor mechanism.

## **Other comments made by stakeholders and our views on them**

- 2.38 Respondents also put forward a range of other comments in their responses to the notice we published on 8 December 2022.
- 2.39 HAL said that it had provided a further update to its revised business plan that showed that the average charge over the H7 period should be £40.08 per passenger in 2020 prices and that we should take account of this further information in making our Final Decisions on the H7 price control. We will set out our views on these matters and all the key price control building blocks in our Final Decision document on the H7 price control, which we intend to publish in March 2023.
- 2.40 Virgin/Delta questioned whether the CAA had followed the appropriate consultation process, given that we had targeted early February 2023 for the holding price cap to come into effect. They noted that there was a required statutory six weeks period between issuing a notice of modification and for the interim charge to take effect. Hence, CAA was relying on HAL to abide by the

spirit of the CAA's consultation. British Airways said that the proposed timetable appeared relatively compressed and that we might not be able to consider its representations properly.

- 2.41 As explained above, we have decided that it is appropriate to consider new information, including in relation to passenger numbers and macroeconomic changes, before making our Final Decision on the H7 price control. We have already consulted on the proposed holding price cap through issuing the notice we published on 8 December 2022 and HAL has now closed its Airport Charges consultation process for 2023, with the final charge set at £31.57 (nominal prices) in line with the proposals in that notice. Taken together, we are content that our overall approach allows for both a reasonable degree of flexibility in finalising the regulatory arrangements for H7, while also providing appropriate interim protection for the interests of consumers, and we have no evidence of significant consumer detriment arising from the process we have adopted. We have carefully considered all the representations to the notice we published on 8 December 2022 and this decision document sets out our responses to the points made by respondents.
- 2.42 The AOC/LACC, British Airways and Virgin/Delta in their respective responses drew attention to the CAA's previous commitment, set out in its RAB Adjustment Decision,<sup>12</sup> to assess whether HAL had met service and investment requirements and whether the CAA should make an appropriate reduction in the RAB or make offsetting reductions to HAL's revenues.
- 2.43 The context of the RAB adjustment was the interim price control period before the start of H7 and the focus of CAA's attention at that point was investment and service quality in relation to 2021. There has been a range of service issues across the sector in 2022 and we have encouraged both airlines and airports to take steps to minimise disruption to consumers. At present, we are not planning to engage in a separate review of service quality in 2023.
- 2.44 British Airways repeated its previous requests for access to HAL's forecasting model, claiming that it, along with other airlines, remain at a procedural disadvantage as a result of not having access to HAL's model.
- 2.45 As we had previously explained in our Final Proposals, HAL refused to make its passenger forecast models openly and transparently available to stakeholders citing commercial confidentiality. As a result, we placed less weight on it for our Final Proposals. Although the HAL model remains an input in our considerations, we have undertaken a much broader approach to our forecasting including the use of a wider range of forecasts and forecasting methods, including considering

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<sup>12</sup> [Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment](https://www.caa.co.uk/Economic-regulation-of-Heathrow-Airport-Limited-response-to-its-request-for-a-covid-19-related-RAB-adjustment)  
([caa.co.uk](https://www.caa.co.uk))

bookings and other data provided by airlines. Our approach to finalising the passenger forecasts for the H7 price control will be discussed in detail in the Final Decision which we intend to publish in March 2023. Separately, Final Proposals stated that we intend to carry out a mid-term review of the OBR framework and set out the expected scope of that review. We will confirm our proposed approach, including the issues to be covered, in our Final Decision on the H7 price control, with any mid-term review likely to take place in 2024.

- 2.46 Taken together, we are of the view that none of the wider issues raised by stakeholders warrant a change in approach to the holding price cap for 2023 from that set out in the notice we published on 8 December 2022.

## CHAPTER 3

## Changes to Schedule 1

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- 3.1 In addition to the holding price cap for 2023, the notice we published on 8 December 2022 proposed a small number of changes to Schedule 1 of HAL's licence. These were to remove the requirement for HAL to obtain and publish survey scores for two elements of the current service quality rebates and bonuses ("SQRB") scheme (departure lounge seating availability and flight information) which are not being carried forward into the proposed outcomes based regulation ("OBR") framework for H7.
- 3.2 HAL and airlines agreed to the removal of these requirements from the OBR framework during the engagement that took place in advance of our Initial Proposals, and we reflected this change in both our Initial Proposals and our Final Proposals.
- 3.3 HAL had asked for these elements to be removed from its licence at the same time that the holding cap is introduced. This will have the effect of allowing HAL to roll out the updated Quality of Service Monitor survey in preparation for implementation of the new OBR framework. The AOC/LACC had also informed us that it has no objection to removing these elements from the current SQRB scheme.
- 3.4 We considered that removing these requirements from HAL's licence should allow it to focus its resources for preparing for the introduction of the OBR framework in an efficient and economical way, which will both be in the interests of consumers as well as being consistent with the promotion of efficiency. For these reasons, we considered that these elements of the SQRB scheme are no longer appropriate or in the interests of consumers and the effect of our modification is to remove them from the SQRB scheme for 2023.

### Stakeholder Responses

- 3.5 All respondents agreed with our proposals to make the adjustments to Schedule 1 of HAL's licence for the reasons set out above.

### Our Decision

- 3.6 For the reasons set out above we have decided to make the modifications to Schedule 1 of the Licence set out in Appendix B. We consider that these changes will have the effects we anticipated in the notice we published on 8 December 2022.

## APPENDIX A

## Appendix A: Our duties

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- 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

## Appendix B: Modifications to HAL's licence:

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- B1 This Appendix sets out the text of the modifications we have decided to make to HAL's licence. The reasons for, and effects of these proposed modifications are set out in the Executive Summary and chapters 1 and 2 of this notice.
- B2 Conditions C1.1, C1.2, C2.5 and C2.6 of HAL's licence will be amended as indicated in redline/strikeout below:
- 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~~2023 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 £~~30.4931.57~~.
  - 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 20222023 at levels that exceed the maximum yield per passenger set out in Condition C1.1, the Licensee shall, within one month of Condition C1 Price Control coming into effect in relation to the Regulatory Year ~~2022~~2023, 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.
  - C2.5 Where in respect of any relevant Regulatory Year (apart from the Regulatory Year ~~2022~~2023) 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 Regulatory Year ~~2022~~2023 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
- B3 Paragraphs 2.7, 2.10, 3.9 and 5.1 and Tables 2a, 3a, 4a, 5a, 8 and 10a of Schedule 1 HAL's licence will be amended as indicated below.

- Paragraph 2.7: Delete entire paragraph, replace with “NOT USED”.
- Paragraph 2.10: Delete entire paragraph, replace with “NOT USED”.
- Paragraph 3.9: Delete “departure lounge seating availability, “ and “ , flight information” from each of subparagraphs (a) and (b).
- Paragraph 5.1(a)(i): Delete bullets for “departure lounge seating availability (QSM);” and “flight information (QSM);”and
- Tables 2a, 3a, 4a, 5a, 8 and 10: Delete the entries specific to rows 1 (Departure lounge seating availability) and 4 (Flight information), and replace with “NOT USED”.

## APPENDIX C



## Appendix C: Calculation of the 2023 holding price cap

1. This appendix sets out the calculation for the 2023 holding price cap. In our Final Proposals, the maximum allowed yield per passenger (“ $M_{2023}$ ”) we proposed for 2023 (nominal prices) was derived from the following formula set out in Condition C1.1 of the notice set out at Appendix C of our Final Proposals(see footnote 2):

$$M_{2023} = Y_{2022} \times (1 + CPI_{2023} + X + B_{2021}) + \frac{AC_{2023}}{Q_{2023}} - \frac{T_{2023}}{Q_{2023}} + \frac{TDO_{2023}}{Q_{2023}} - AK_{2023}$$

2. In its charging consultation, HAL used the following inputs for this formula:
- $Y_{2022}$  (the opening yield for 2022): £30.19;
  - $CPI_{2023}$  (the percentage change in inflation between 2022 and 2023): 10.629% – later adjusted by HAL to 9.48%;
  - $X$  (the CPI+X price profiling factor): -5.74%;
  - $B_{2021}$  (the service quality bonus for 2021):0.865%;
  - $T_{2023}$  (the capital trigger factor): £435,000;
  - $Q_{2023}$  (the forecast number of passengers using the airport in 2023): 65,233,000).

HAL set all other factors at zero.

3. Taking this approach HAL calculated the maximum allowed yield for 2023 as follows:

$$M_{2023} = £30.19 \times (1 + 9.48\% - 5.74\% + 0.865\%) + \frac{0.000}{65,233,000} - \frac{435,000}{65,233,000} + \frac{0.000}{65,233,000} - 0.000 = £31.57$$