Consumers and Markets Group

Economic regulation of Heathrow Airport: H7 Final Proposals Section 2: Building Blocks

CAP2524C

Published by the Civil Aviation Authority, 2023

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First published March 2023
Second edition

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The latest version of this document is available in electronic format at: www.caa.co.uk

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Operating expenditure

Introduction

4.1 The allowance that we make for HAL's operating expenditure ("opex") in the H7 price control is a key building block in the calculation of airport charges. Opex arises from the operation of the airport on a day to day basis and comprises a number of components including staff costs (including security personnel), maintenance, facilities, utilities, rent and rates. The experience of consumers using the airport will be materially affected by how well HAL spends opex to deliver a good quality airport experience.

4.2 In this light, setting an appropriate allowance for opex furthers the interests of consumers by ensuring that airport charges are calculated by reference to an efficient level of these costs and so has regard to the need to:

- secure that users' reasonable demands for AOS at Heathrow are met; and
- promote economy and efficiency on the part of HAL in its provision of AOS.

4.3 We aim to incentivise HAL to run the airport efficiently in H7. We do this by setting an allowance for efficient opex for the five year control period together with applying incentives for service quality (see chapter 3 (Outcome based regulation)). If HAL is able to operate the airport while incurring less opex than the amount of this "opex allowance", it is able to retain the difference (other things being equal) until the next price control is set. Conversely, if HAL incurs more opex than the allowance, it must fund the shortfall (other things being equal) until the next price control is set. Applying incentives for appropriate levels of service quality helps to protect against the risk that opex could be saved by providing a lower quality service.

4.4 While our estimate of opex is intended to cover these costs for the five year period, we include a number of adjustment factors for specific costs over which HAL has only limited control, such as costs associated with any unforeseen tightening of security standards, which it is not reasonable to expect HAL to incur within the opex allowance.

4.5 This chapter sets out:

- a summary of the Final Proposals;
- a summary of stakeholders' responses;
- our assessment of those responses; and

- our updated analysis and final decision.

The Final Proposals

4.6 The Final Proposals provided for an opex allowance of £5,800 million over five years (2020, CPI prices). The profile of annual allowances we proposed is reproduced as Table 4.1 below.

Table 4.1: The Final Proposals for H7 opex allowance

2020 CPI deflated prices , £ million	2022	2023	2024	2025	2026	H7
Total	1,106	1,123	1,172	1,208	1,191	5,800

Source: CAA.

4.7 The Final Proposals were approximately £540 million lower than the projections contained in HAL's RBP Update 2 on a like-for-like basis (that is, after controlling for differences in forecasts of passenger numbers and inflation). The principal reasons for this difference were:

- efficient baseline: we considered that the efficient starting, pre-covid level of HAL's opex should be positioned below HAL's out-turn opex for 2019;
- people costs: when estimating changes to the people costs category delivered by HAL in 2020 and 2021 through its "Cost of Change" programme, we allowed for further savings where we considered that the efficiencies delivered are incremental to the efficient baseline. In addition, our wage growth assumptions accounted for the freeze in pay levels in 2020 and 2021, which did not appear to be accounted for in HAL's forecasts;
- other savings: we made allowance for higher savings in the category of operational costs in the early part of the H7 period, due mainly to our use of a higher elasticity of costs (in relation to changes in passenger numbers) than HAL; and
- overlays: we made reductions to several of the overlay additions that HAL had included in its plan. These reductions particularly affected HAL's covid-19 overlay and resilience overlay.[1]

4.8 We said in the Final Proposals that we took comfort from the fact that our estimate of opex per passenger from 2025, was broadly in line with HAL's actual opex for 2019 (in real terms). This accorded with our view that the opportunities that HAL has had, or will have, to make cost savings compared to a pre-covid

[1] See paragraphs 4.55 and 4.56 of the Final Proposals.

starting point are broadly offset by the impact of the economic challenges (or "headwinds") that HAL will likely have to deal with over the H7 period.

4.9 We also said in the Final Proposals that we would consider making changes in three specific areas if new information became available, for example:

- if we were to revise our passenger forecasts and the consequential changes to opex associated with the change to the passenger forecast;
- in relation to business rates, as, at the time of the Final Proposals, HAL remained in discussions with the Valuation Office Agency ("VOA") about these costs from 2023 onwards; and
- on pension deficit repair costs ("PDRCs"), in relation to which we included employer contributions of approximately £20 million a year in the Final Proposals but noted that the latest evidence suggested that the pension scheme had moved into surplus. We stated that, unless HAL provided compelling evidence that this allowance was appropriate and necessary, we could remove the allowance in our final decision.

Summary of stakeholders' views

HAL

4.10 HAL said in its response that the CAA appeared to be assessing the efficiency of an airport operating in a pre-covid environment rather than an airport ramping up from an unprecedented demand shock. HAL said that we had over-estimated savings achieved at the airport during 2020 to 2022 and failed to recognise unavoidable cost increases. HAL also said that, as a result of these errors, its costs in 2022 were likely to be £59 million (or 5 per cent) above the allowance set out in the Final Proposals and the gap between its actual costs and our projected costs would grow further during the H7 period.

4.11 It also said we should:

- remove the efficiency adjustment to the 2019 starting baseline costs;
- reduce our estimate of the ongoing efficiencies that HAL is capable of making, including on the scale and permanence of savings made during 2020 and 2021 and the efficiencies that we had assumed ought to flow from the introduction of the London Living Wage;
- update and increase our allowance for input price inflation, especially in the areas of wages, electricity costs and insurance costs;
- reduce our estimate of the elasticity of costs with respect to passenger volumes;
- reinstate the full value of the overlays included in HAL's plan; and

- eliminate the allowance that we made for costs associated with terminal drop-off charge on the basis that HAL will not be able to apply the charge from 2024 onwards.
- HAL estimated that, after making the required corrections in these areas, its opex allowance would increase by £368 million. HAL also calculated that a switch to its preferred passenger forecast would result in an offsetting cost reduction of £48 million.

4.12 On PDRCs, HAL said that a final decision on employer contributions would not be available until late 2022. However, HAL said that "on a technical provision basis" the Heathrow section of the pension fund remained in deficit and, therefore, its expectation was that deficit repair contributions would need to be allowed throughout the H7 period.

Airlines

4.13 Airlines' objected to the increase in the CAA's opex allowance compared to the figures put forward in the Initial Proposals in October 2021. Several responses expressed the view that it was difficult for airlines to respond to the CAA's proposals because airlines had not been given access to the cost projections information that the CAA received from in HAL support of its RBP Update 2. One response also questioned whether the cost assessment process was, or would become, one-sided, with HAL focusing in its responses on areas where it felt it had been treated too harshly while staying silent about line items where the CAA had been more generous.

4.14 Some of the more specific comments made in responses included the following:

- the AOC/LACC said that it did not agree with our characterisation that end-of-H7 opex per passenger would be no higher than opex prior to the covid-19 pandemic;
- the AOC/LACC also said that the increase in our allowance for security costs since the Initial Proposals raised questions about the case for HAL's transformation programme, since airlines no longer appear to be benefiting from opex efficiency savings. BA also questioned whether we had over-estimated this category of costs;
- BA expressed concern about our assumptions for higher staff numbers. It also asked us to look again at an intra-group mark-up that HAL applies to certain employee contracts;
- BA said that we should have looked into HAL's hedging arrangements before making any allowance for higher energy costs; and
- BA suggested that allowances for covid-19 related costs should cease in 2022, not 2023.

4.15 Airlines did not directly challenge the CAA's allowance for business rates. However, AOC/LACC and BA said that HAL lacked incentive to minimise costs, and requested that airlines be involved in an enhanced governance framework that would oversee HAL's future negotiations with the VOA.

4.16 Airlines stated that there was no longer any basis for including any future PDRCs in the H7 opex allowance. The AOC/LACC said that HAL should be fully responsible for any future deficit repair costs. BA said that a shift from deficit to surplus might necessitate a return of monies from HAL to customers.

CAA's views on stakeholders comments

The CAA's approach

4.17 We have sought to adopt an approach to setting opex allowances that challenges HAL to make efficiencies, while also allowing HAL to provide a high quality service. To achieve these objectives and take account of the risks associated with the asymmetry of information (which have been exacerbated by HAL's tendency to classify a wide range of information as commercially sensitive) we have based our assessment of opex on a range of information and adopted the following approaches:

- we have adopted a "base year-roll forward" approach, under which we started our calculations from what we considered to be a reasonable starting cost base prior to the covid-19 pandemic and then made what we judged to be appropriate allowances for new efficiencies, input price inflation and cost pressures. This approach provides a degree of independence from HAL's business plan forecasts and reduces the risk that we could be over-reliant on HAL's own estimates; and
- we sought to sense-check the results of our analysis by comparing HAL's pre-covid-19 and forecast end-of-H7 cost levels and by seeking to judge whether the overall trajectory for the development of HAL's costs over that time appeared to be reasonable, given our knowledge and understanding of the opportunities that HAL has had already, and will have in the future, to make cost savings, as well as our knowledge and understanding of the economic and cost "headwinds" that will tend to push costs up over the course of H7.

4.18 We note the concern expressed by airlines that, even after taking these steps, the final stages of our review could have become one-sided. We have consistently adopted an approach that uses a range of information to reach an objective conclusion consistent with our statutory duties, including:

- using external benchmarks;
- consulting expert advisors;

- challenging HAL’s cost projection where we have no choice but to rely on airport-specific cost information; and
- continuing to review our overall assessment as described above and to test the reasonableness of the results.

4.19 Given that our approach explicitly recognises the numbers of passengers as a key cost driver, new cost pressures and input price inflation, we are not persuaded by HAL’s broad suggestion that we have failed to take account of costs associated with the recovery from the impact of the covid-19 pandemic and/or unavoidable cost pressures. Our response to the points of detail raised by stakeholders is set out below.

Responses to specific points made by stakeholders

Baseline

4.20 HAL’s response to the Final Proposals did not provide any substantial new evidence that we consider would make it appropriate for us to change our estimate of efficient pre-covid-19 costs. Accordingly, we retain our modest 1.4 per cent downward adjustment to HAL’s pre-2019 opex level.

4.21 In response to BA's concern about intra-group mark-ups, we note that our baselining and roll forward of efficient 2019 opex should address any issues around the potential impacts of HAL's intra-group charging arrangements. Accordingly, we did not judge that it was necessary for us to carry out further detailed work on this matter.

Further efficiencies

4.22 We do not agree that it would constitute “double counting” for us to apply further ongoing efficiencies to this starting baseline with effect from 2020. The covid-19 pandemic presented HAL with a unique opportunity to implement lasting improvements in the way that it operates. Our assessment is that the changes that HAL has asked for in respect of the treatment of cost savings made in 2020 and 2021 would fail to do justice to the scale of the ongoing cost benefits that an efficient airport would be capable of securing, given the opportunities to reset the airport’s cost base during this exceptional period.

4.23 We also note that HAL presented no new evidence in support of its contention that the introduction of the London Living Wage (“LLW”) would have no efficiency benefits. We continue to take the view that it is incorrect to provide for a material uplift in staff wages within the supply chain without also allowing for some increase in productivity and efficiency. We would expect the payment of the LLW to lead to lower levels of absenteeism and lower levels of staff turnover, both improving productivity and reducing costs from recruitment, training and onboarding. This view is supported by a study by researchers from Queen Mary, University of London, which found that paying a living wage led to fewer sick days and lower levels of turnover.[2]

4.24 In relation to BA's concern about the application of an "intra-group mark-up" on staff costs, we have reviewed the analysis supporting our estimates of staff costs for the Final Proposals and our previous analysis on this topic. Following this review, we are content that any intra-group mark-ups that have been applied do not have any impact on our estimates, as we have used information on staff costs recorded on the same basis as HAL's Regulatory Accounts and do not reflect any intra-group mark-ups.

4.25 In response to the airlines' concerns about security costs, we scrutinised HAL's proposals in detail (for example, by assessing its modelling of expected passenger flows through security) to come to our view on these costs and, wherever possible, validated the key assumptions against our experience and understanding of security operations at other airports. The security programme (once delivered) is expected to provide opex efficiencies, although the majority of these are due to be realised later in the H7 period, once most of the programme roll-out has been completed.

Input price inflation

4.26 Consistent with our wider approach to updating for inflation, we have updated our input price inflation forecasts to take account of updated OBR forecasts published in November 2022. Further details of these adjustments are set out in the next section.

Volume growth

4.27 We continue to take the view that it is necessary for us to take account of the effect that changes in passenger numbers have on HAL's opex through considering how elastic its costs are to the number of passengers. While we understand BA's concern that increases in staff numbers need to be appropriately calibrated, we do not think it is tenable to assume that a recovery in volumes will have no cost implications.

4.28 The Final Proposals assumed that every 10 per cent change in passenger volumes results in a 4 per cent change in these staff costs. HAL's response said that we should assume a 10 per cent change in passengers would change its staff costs by 1 per cent. We do not consider that this alternative proposal is

[2] For further details on this issue, see page 23 of the CEPA/Taylor Airey Report on Opex, published alongside our Final Proposals and available here: https://publicapps.caa.co.uk/docs/33/CAP2366I.pdf

credible, as our further analysis of plausible elasticities suggests that an elasticity as low as that suggested by HAL would be well below comparable benchmarks.[3]

Overlays

4.29 The Final Proposals assumed that the impact of the covid-19 pandemic would impose no ongoing costs on HAL from 2023 onwards. We remain of the view that this is a reasonable assumption in the round despite HAL's arguments to the contrary. We understand that covid-19 specific cleaning has now been discontinued and that cleaning activities have now reverted to levels typical of the period prior to the covid-19 pandemic. Therefore, we consider that all cleaning activities can be treated as part of routine cleaning at the airport.

4.30 We also excluded a cost overlay that HAL included in its plans for funding a new dedicated service team to provide additional support to passengers. This was in addition to the costs of the Special Assistance service for disabled and less mobile passengers, which is fully funded within the opex category "Operational costs excluding insurance".[4] We have not included this additional cost overlay in our final decision for the same reasons we excluded these costs from the allowance used in the Final Proposals[5] and remain of the view that HAL has not properly justified the need for additional opex for this wider group of passengers.

4.31 Separately we made a small downward reduction to HAL's "resilience" overlay. The reason for this reduction was that HAL had benefited in 2020 and 2021 from the mothballing of certain of its assets (for example, in Terminal 4), extending the life of some categories of equipment. We continue to take the view that it is appropriate to allow for a modest whole-life cost saving arising from this action.

Business rates

4.32 We note airlines' concerns about HAL's incentive to minimise business rates. The initial evidence that we saw during the 2022 business rate-setting exercise is that, generally, HAL did exert effort during its negotiations with the VOA to keep costs down. As one illustration of this, HAL appears to have succeeded in reducing the final rateable value of its properties materially compared to the VOA's initial view.[6]

4.33 Based on this experience, we do not consider that it is necessary for us at this time to mandate that HAL and airlines enter into particular governance

[3] See Page 38 of the CEPA/Taylor Airey Report on Opex, published alongside our Final Proposals and available here: https://publicapps.caa.co.uk/docs/33/CAP2366I.pdf

[4] For further details, see section 5.3 of the CEPA/Taylor Airey Report on Opex (*ibid.*)

[5] See paragraph 4.74 of the Final Proposals.

[6] The HAL estimate of rateable value effectively assumed that several parts of the airport infrastructure (such as Terminal 4) remained closed as they had been for periods during the covid-19 pandemic, while the VOA initial valuation took into account full usage of the airport infrastructure.

arrangements in relation to business rates. Further information on our approach to business rates is set out below.

Pension costs

4.34 Matters relating to pension costs are dealt with in the following section.

Further work carried out by the CAA

Passenger volumes

4.35 As set out in chapter 1 (Passenger forecasts), we have changed our forecast of passenger numbers during the H7 period.

4.36 Using the analysis and elasticities that we assembled for the Final Proposals, this updated forecast results in an increase of £74 million in our allowance for efficient opex during the five-year period.

Inflation

4.37 As set out in the Summary and above, we have decided to update our forecasts of input price inflation to take account of new data. This Final Decision takes into account:

- the OBR's November 2022 forecasts of economy-wide wage inflation;
- projections of energy (gas and electricity) prices produced by EIC on HAL's behalf using April 2022 inputs; and
- further analysis of insurance costs.

4.38 Our updated estimates use the real rate of input price inflation for each relevant category of cost derived from the OBR's November 2022 forecasts of CPI inflation. This approach recognises that HAL's revenues will automatically increase in line with out-turn CPI inflation.

4.39 The OBR's November 2022 publication generally projected higher economy-wide inflation (when compared to its March 2022 forecasts) in 2022 and 2023. In particular, the OBR projected that general CPI inflation would grow faster than average labour costs[7] in those years, as shown in Table 4.2 below. For example, its November 2022 forecast of the gap between CPI and average labour costs for 2023 was 3.2 per cent rather than 1.2 per cent that it forecast in March 2022.

Table 4.2: Selected OBR forecasts of annual inflation used in opex estimation

[7] As a measure of average labour costs, we use the Average Earnings index forecasts, as presented in Table A.1 of the OBR's November 2022 "Economic and Fiscal Outlook"

Date of forecast	Index	2022	2023	2024	2025	2026
March 2022	CPI	7.4%	4.0%	1.5%	1.9%	2.0%
	– Labour Costs	5.3%	2.8%	2.6%	5.9%	3.2%
	– Variance (CPI- Labour Costs)	2.1%	1.2%	-1.1%	-4.0%	-1.2%
November 2022	– CPI	9.1%	7.4%	0.6%	-0.8%	0.2%
	– Labour Costs	5.9%	4.2%	1.7%	1.7%	1.9%
	Variance (CPI- Labour Costs)	3.2%	3.2%	-1.1%	-2.5%	-1.7%

Source: CAA.

4.40 Use of these updated OBR forecasts led us to estimate larger real reductions in labour costs (compared to CPI) for those two years in particular than envisaged at the time of the Final Proposals. As people costs make up roughly 30 per cent of HAL's opex, and as other elements of the opex calculations are also partly indexed to forecasts of labour costs (for example, the category "facilities and maintenance" contains many costs which are expected to grow in line with labour cost indices), the OBR's update results in the opex allowance reducing by approximately £60 million over the H7 period.

4.41 The actual wages that HAL pays are a matter for its management and in general, we would expect higher levels of productivity by HAL staff to support higher real wages.

4.42 We have also incorporated updated estimates of future energy prices into our opex calculations. Our previous estimates were based on price forecasts produced in late 2021 and, therefore, did not incorporate movements in energy prices in 2022. We have reviewed the updated estimates independently provided by EIC in summer 2022 (using April 2022 data) and the adjustments made by HAL to reflect its hedging position, along with the analysis presented by OBR in its November 2022 publication on forecast energy prices. Our review of the growth rates implied by the updated EIC forecast in comparison to the relevant growth rates implied by the November 2022 OBR forecasts showed a reasonable degree of consistency between the two sources.

4.43 In the round, we consider that the EIC updated forecast represents a reasonable basis from which to update our forecast. This change increases our estimate of efficient opex by approximately £76 million over the H7 period.

4.44 We separately considered whether we should consider updating forecast of insurance costs used in the Final Proposals. We have tested the sensitivity of our opex forecasts to using HAL's insurance assumptions, and carried out further analysis of the underlying data provided by Marsh that HAL used. Following this further analysis, we decided to retain the use of the forecast by SwissRe that we used for preparing the Final Proposals for estimating these costs, as we considered that SwissRe's forecast was more relevant and robust than the

Marsh figures. We have, therefore, decided to retain the use of our estimate of insurance costs (in real terms) from the Final Proposals.

4.45 When we insert the new forecasts into our opex calculations, the effect of these updates relating to staff costs and energy prices is to increase our H7 opex allowance by £16 million in net terms.

Business rates

4.46 In the fourth quarter of 2022, HAL substantively concluded its negotiations with the VOA over the business rates that it will pay for the remainder of the H7 period. The estimated annual payments that HAL is expected to make are lower than the figures that we included in the Final Proposals. Incorporating the new estimated profile (without further review) into our H7 opex calculations would reduce HAL's allowance by around £80 million.

4.47 We said in the Final Proposals that we would conduct a review of the outcome of HAL's negotiations with the VOA in order to determine whether the resulting costs are reasonable. Our present view is that the new estimated profile is a reasonable basis for the future allowance. We will confirm our approach to these matters in the second half of 2023 by carrying out a proportionate review of the costs arising from HAL's negotiations with the VOA. Should any adjustment to HAL's price control be required to reflect the outcome of this review, we would bring forward proposals for a licence modification to put the required changes into effect, alongside any adjustments arising from pension costs as discussed below.

Pension costs

4.48 In August 2022, HAL explained in its response that, while the overall pension scheme was in surplus at the time of the 2021 actuarial valuation, the Heathrow share of the scheme is continuing to experience a deficit. As further evidence in support of its requested PDRCs, it provided a funding update as at 30 September 2022, which presented an apparent deficit in its share of the scheme.

4.49 At the end of Q4 2022, HAL concluded negotiations with its pension fund trustees over contribution rates from 2023 onwards. The final valuation, provided in January 2023, showed that the overall pension scheme is in surplus. HAL argued that we should continue the approach we applied for PDRCs in Q6, and allow PDRCs in H7 for its share of the pension scheme that it says is in deficit.

4.50 HAL's agreement with its pension fund trustees on contribution rates from 2023 onwards was made available to us only at the start of this year. We have not, therefore, had sufficient time to conduct a detailed review of HAL's new deficit repair contributions or to obtain comprehensive advice from our expert advisors the Government Actuary's Department ("GAD"). GAD carried out an initial assessment of the current position based on information that HAL provided in

January 2023. GAD's initial advice suggests that contributions from 2023 onwards do not appear to be required and, therefore, the allowance we made for PDRCs in the Final Proposals could be reduced.

4.51 In the circumstances, and given the materiality of the amounts involved, we consider that it is appropriate for us to continue our work in this area beyond the timescales for this H7 review. We will look to reach a final view on these matters in the second half of 2023. Should any adjustment to HAL's price control be required to reflect the outcome of this review, we would bring forward proposals for a licence modification to put the required changes into effect, alongside any adjustments arising from our review of business rates as discussed above.

The CAA's final decision

4.52 Our decisions on the updated allowances for HAL's opex for the H7 period are set out in Table 4.3 below. The calculations contain three changes from the allowance set out in the Final Proposals, the reasons for which are set out above:

- we have taken account of the impact that we have forecast that passenger numbers will be higher during H7 than we forecast for the Final Proposals and the impact this will have on costs. This has increased the level of the opex allowance we have decided to make by £74 million;
- we have updated our forecasts of real wage inflation which has reduced the level of the opex allowance we have decided to make by £60 million; and
- we have updated our forecasts of real energy costs which increased our forecast by £76 million.

4.53 On this basis the total opex allowance used to calculate the H7 price control is £5,895 million. This is £95 million[8] higher than the allowance that we included in the Final Proposals with the annual figures set out in Table 4.3 below.

[8] The combined impact of all changes to our estimates since the Final Proposals primarily takes account of the three factors described above, and also some other minor adjustments (such as rounding issues) to produce a net effect of £95 million.

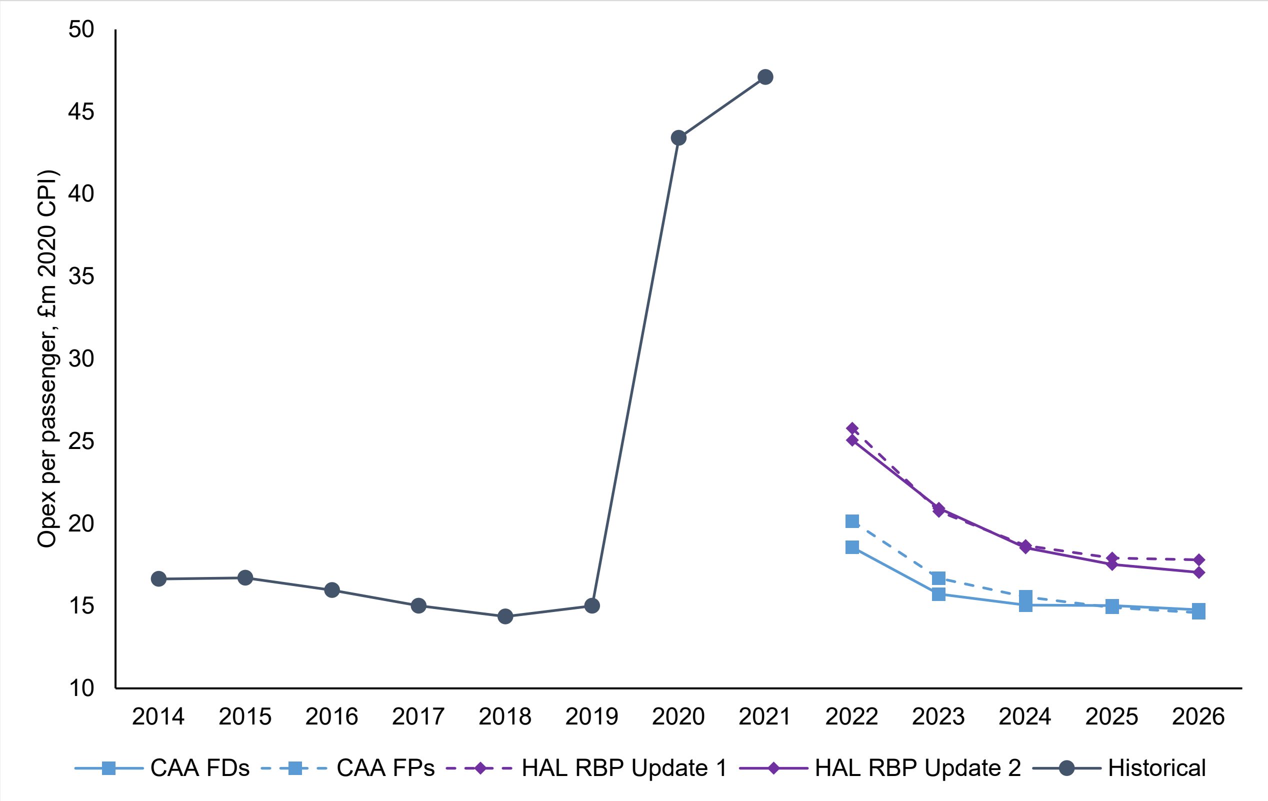
Table 4.3: H7 opex allowance

2020 CPI deflated prices , £ million	2022	2023	2024	2025	2026	H7
Total	1,145	1,148	1,188	1,213	1,201	5,895

Source: CAA.

4.54 Figure 4.1 below shows the progression of real opex per passenger over the course of the five years of the H7 price control period.

Figure 4.1: Real opex per passenger



Source: CAA.

4.55 We are confident that the judgements that we have made in the light of the additional analysis we have undertaken since the Final Proposals has produced allowances for HAL's opex as set out in Table 4.3 and Figure 4.1 that are robust and reasonable, given the evidence we have seen about the ability of HAL to introduce efficiencies into its business notwithstanding the economic headwinds that HAL may face and the importance of providing a high quality of service for passengers.

4.56 We note that our allowance for the first year of the H7 price control will not be identical to the costs that HAL actually incurred in 2022. This is consistent with normal regulatory practice. The regulated company (in this case HAL) does not have the ability simply to pass through its costs to consumers. Rather, it receives an allowance as part of the calculation of its price control that is based on the regulator's estimate of the costs that an efficient operator would incur in running its business.

4.57 We consider that setting an allowance for opex for HAL for the H7 price control will appropriately further the interests of consumers, having regard to the need to:

- secure that users' reasonable demands for AOS at Heathrow are met; and
- promote economy and efficiency on the part of HAL in its provision of AOS.

Implementation

4.58 The estimates for opex identified above have been used in the calculation of the price controls in chapter 13 (Calculating the price cap and financeability).

4.59 We will carry out a further review of the opex allowance for two specific cost categories described above (PDRCs and business rates) with a view to making any final adjustments in the second half of 2023. Should any adjustments to HAL's price control be required to reflect the outcome of this work, we would bring forward proposals for a licence modification to put the required changes into effect in a timely manner.

4.60 We will also make changes to HAL's licence to implement our proposals for the pass through of incremental unanticipated costs relating to security (such as any unforeseen tightening of security standards), through conditions C1.3, C1.4 and C1.5 as set out in Appendix C (Notice of the CAA's decision to modify HAL's licence). This will codify the arrangements for incremental unanticipated security related costs.

Chapter 5

Commercial revenues

Introduction

5.1 Commercial revenues comprise the income from a wide range of HAL's activities at Heathrow airport. These include retail shops in terminals, cargo, property rents, access to the airport (rail, car parks and the terminal drop-off charge) and other services. The commercial revenues that HAL earns from these activities are included in the "single till" with HAL's costs and are deducted from HAL's revenue requirement when we calculate the price control that applies to HAL's airport charges.

5.2 We incentivise HAL to optimise the level of commercial revenues which, in turn, reduces the overall level of airport charges. We do this by setting a fixed allowance for commercial revenues for the five-year control period. If HAL is able to generate higher revenues than the allowance, then (other things being equal) it is able to retain the difference. Conversely, if HAL makes less commercial revenue than our projection then (other things being equal) it must fund the shortfall that this would generate against its revenue requirement until the price control is reset at the next review.

5.3 This approach provides a strong incentive on HAL to increase commercial revenues and furthers the interests of consumers by ensuring that, in the longer term, airport charges are no higher than necessary. It also helps to promote efficiency and economy on the part of HAL's commercial activities.

5.4 This chapter sets out:

- the background to our assessment of commercial revenues, including a summary of the Final Proposals;
- a summary of stakeholders' responses to the Final Proposals;
- our assessment of the responses; and
- our updated analysis and final decision on these matters.

The Final Proposals

5.5 The Final Proposals provided for an allowance for commercial revenues of £4,318 million over five years. The profile of annual allowances is set out in Table 5.1 below.

Table 5.1: Final Proposals: H7 commercial revenues allowance

2020 CPI deflated prices , £ million	2022	2023	2024	2025	2026	H7
Total excl. cargo	678	781	873	931	941	4,204
Cargo	45	28	18	11	11	114
Total incl. cargo	723	809	891	942	952	4,318

Source: CAA.

5.6 The forecasts set out in the Final Proposals were approximately £325 million higher than the projections contained in HAL's RBP Update 2 on a like-for-like basis (that is, after controlling for differences in forecasts of passenger numbers and inflation). The principal reasons for this difference were that we:

- applied a "management stretch" challenge which assumed that an efficient operator would be able to grow its revenue per passenger by 1 per cent each year in real terms;
- considered that (i) recent changes to VAT on airside transactions and duty free rules and (ii) expected changes in the mix of passengers using the airport would have less of an impact on retail revenues than HAL had assumed;
- used a different set of "mode share" estimates for travelling to and from the airport, which resulted in higher commercial revenues overall; and
- took the view that the impact on revenues generated from Heathrow Express following the introduction of Elizabeth Line services would take time to fully materialise, based on the service pattern on offer.

5.7 We said in the Final Proposals that we took comfort from the fact that our estimate of commercial revenues per passenger from 2025, after accounting for the interventions described above, was slightly below HAL's out-turn revenues in 2019 (in real terms). This was in line with our view that the opportunities that HAL has had, or will have, to increase revenues compared to those before the covid-19 pandemic would be likely to be more than offset by the impact of the challenges (or "headwinds") that HAL is likely have to have to deal with over the H7 period, especially in relation to the loss of retail revenues arising from changes to the UK's tax regime and the loss of rail revenues arising from the opening of the Elizabeth Line.

5.8 We also said in the Final Proposals that we would review our allowance for one specific item, the terminal drop off charge ("TDOC") revenue, in 2024, when it would be possible to assess the impact of the Private Parking Code of Practice Act 2019. During the period 2022 to 2024, HAL would share risks around these revenues with airlines in the proportions 65:35. HAL would also be required to notify both airlines and the CAA of any increase in the charge beyond 10 per cent of the baseline level assumed in our modelling.

Summary of stakeholders’ views

HAL

5.9 HAL said in its response that our projections contained computational errors, factual errors and unrealistic assumptions, and taken together these factors had resulted in the CAA overstating achievable commercial revenues by around £400 million[9] over five years.

5.10 HAL said that we should:

- remove our “management stretch” assumptions, which HAL said was a decision with no supporting evidence, based on flawed logic and results in double counting;
- reduce our estimates of future retail revenues to align with the information from data and customer behaviours and the actual impact of VAT changes in the first half of 2022;
- reduce our estimate of property income to take account of the former BMI hangar being vacant and an expected move of revenues relating to the current BA crew car park from commercial revenues to ORCs;
- correct errors in our calculations of rail and bus/coach revenues;
- remove TDOC income from 2024 on the grounds that the impending implementation of the Private Parking Code of Practice Act 2019 means that the charge cannot be enforced;
- make a downward adjustment to our estimates of revenues from short-stay car parks due to the effects that the same legislation is likely to have on car park drop-offs and associated revenues; and
- remove revenues generated by its pod parking product to reflect the appropriate treatment of these revenues outside the single till framework, in line with HAL’s interpretation of our policy on this issue.

5.11 HAL also said that our projections for future commercial revenue were incompatible with the size of the H7 capex allowance set out in the Final Proposals. HAL said we needed either to reinstate its commercial capital programme in full, or reduce our forecasts of revenues by an additional £74 million.

[9] Using our forecasts of passenger numbers

Airlines

5.12 Airlines' responses objected to the reduction in the CAA's allowance compared to the figures put forward in the Initial Proposals. As with the responses on opex, airlines expressed the view that it was difficult to respond to the Final Proposals because airlines had not been given access to the information that the CAA received from HAL in support of the projections in its RBP Update 2.

5.13 Airlines particularly questioned our proposal to set an annual management stretch of 1 per cent rather than 2 per cent. Airlines noted that our consultants, CEPA Taylor Airey (CTA), had set out a clear rationale for a 2 per cent figure and said that our decision to move to the bottom end of CTA's 1 per cent to 2 per cent range sat uncomfortably with our separate decision to apply the management stretch challenge to only certain categories of commercial revenues.

5.14 BA made a number of more specific observations in its response:

- arguing that we had underestimated HAL's ability to sustain its retail revenues even in the face of tax changes, arguing that retailers are able to offset these changes and preserve profits;
- disagreeing with our proposal to insert an overlay in our projections of retail sales per passenger to account for a changing geographic mix of passengers;
- contending that the scope for future rent increases and, hence, growth in property revenues had been underestimated;
- stating that it would be better to treat cargo revenues as part of price-controlled aeronautical revenue rather than as a stream of commercial income;
- asking us to look at a possible inconsistency in our modelling of mode share and car park revenues;
- disagreeing with the way in which we had corrected for an apparent error in HAL's modelling of the TDOC and car park revenues;
- expressing concern that, by adopting HAL's approach for mode share analysis, our estimates were based on another model that has not been released to airlines or subject to independent scrutiny;

- expressing concerns over the estimated reduction in revenues from Heathrow Express due to statements made by HAL about maintaining a price premium to the Elizabeth Line while also using marketing and pricing levers to mitigate the impact of Elizabeth Line services. BA also disagreed with the inclusion of a flat fares overlay in addition to the “Crossrail impact” overlay. As a consequence of these concerns, BA questioned whether the opening of the Elizabeth Line would have the impact that HAL and the CAA have been assuming on HAL’s rail revenues; and
- disagreeing with the CAA’s inclusion of HAL’s positive manual parking overlay to represent the growth of Average Transaction Values despite HAL’s modelling being based upon an assumption that, as passenger numbers increase, the overlay would return to zero.

5.15 Several responses separately expressed concern about HAL’s ability to increase the TDOC during the H7 period. AOC/LACC and BA said that there was no deterrent against HAL raising the charge (without consulting airlines) to a level that could have implications for future traffic demand. AOC/LACC proposed that HAL should be required by the CAA to seek agreement from airlines prior to making any changes.

Our views

The CAA’s approach

5.16 During the H7 review, we have tried to address the risk that we could inadvertently mis-size HAL’s allowance in the following two main ways:

(i) We have adopted a base year - roll forward approach, in which we started our calculations from what we considered to be a reasonable starting revenue base from before the covid-19 pandemic and then made what we judged to be appropriate allowances for long-term underlying growth in revenue per passenger and specific revenue opportunities or headwinds that HAL may face; and

(ii) We have sought to sense-check the results of the base year - roll forward analysis by comparing HAL’s commercial revenues from before the covid-19 pandemic with those we project for the end of the H7 period and assessing whether the overall trajectory appears to be appropriate given our views on the overall balance between the various headwinds and tailwinds that we expect to influence each element of HAL’s revenues.

5.17 We recognise the concern expressed by airlines that, even after taking these steps, the final stages of our review could have become one-sided. We have sought to guard against this risk by:

- using external benchmarks wherever possible;

- challenging HAL's projections and overlays where we have no choice but to rely on airport-specific information; and
- continuing to place our overall assessment in the above-mentioned wider top-down context.

5.18 It is important to bear in mind the reassurance this broad approach gives in considering the more detailed points that HAL and airlines have put to us, as discussed further below. Figure 5.2 of the Final Proposals presented a chart showing historical and forecast commercial revenue per passenger before, during and at the end of the H7 period. We noted that HAL and airlines did not explain in their responses why the overall shape of this chart is wrong. In particular, HAL was unable to articulate why we should allow for an end-of-H7 revenue base that is markedly lower than HAL's pre-covid revenue per passenger, while airlines did not explain why it was wrong for us to conclude that there are more factors weighing revenue per passenger down than there are driving revenue per passenger up.

Responses to specific points made by stakeholders

Management stretch

5.19 HAL and airlines have opposing views on the assumption we should make about the underlying rate of year-to-year growth in revenue per passenger.

5.20 HAL's business plans provided for commercial revenues to grow in line with RPI inflation. Because we index HAL's price controls using CPI, the Final Proposals were developed on the basis that we should provide for a minimum stretch of 1 per cent per annum on top of CPI, to align to HAL's own expectations at that time, as HAL expected that on average RPI would grow at 1 per cent above CPI. HAL in its response has re-iterated reasons why achieving this level of real terms growth will be challenging, as it did in its earlier submissions. We explained in the Final Proposals why we did not accept the arguments previously made by HAL on this issue.[10]

5.21 The evidence compiled by CTA suggested that higher figures for a management stretch of up to 2 per cent could be justified based on HAL's historical performance. However, we took the view in the Final Proposals that we should be cautious, particularly in the light of deteriorating economic conditions in the wider economy. Our view is that the selection of a specific point value from within a calculated range is ultimately a matter of regulatory judgment and we have re-assessed CTA's work[11] and the wider circumstances impacting commercial

[10] See paragraphs 5.32 – 5.36 of the Final Proposals

[11] For more details on CTA's analysis of this issue, which informed our policy, see section 4 of CTA's

revenues and are content that an assumption of 1 per cent stretch remains reasonable.

Retail

5.22 HAL and airlines also had conflicting views about our projections of retail revenues.

5.23 We disagree with HAL's views on the implications of new information on actual retail revenues for 2022.[12] CTA calibrated its view of the impact of tax changes based on Q1 2022 outturn data provided by HAL. There were also limitations to the depth of analysis that CTA could undertake due to the provision of incomplete information by HAL, despite several requests.

5.24 We also do not agree with BA's view that we had underestimated HAL's ability to sustain its retail revenues even in the face of tax changes, as following our review and challenge of information provided by HAL, we do not consider that retailers can offset these changes and hence preserve profits in the way that BA has suggested.

5.25 We also disagree with BA's contention that we have erroneously applied an overlay to our projections of retail sales per passenger to account for a changing geographic mix of passengers, as our analysis of actual data on passengers using Heathrow shows clearly that the geographic mix of passengers has changed since our original analysis of this topic.

Property

5.26 HAL said that we should reduce our allowance for property revenues. We do not consider that this is necessary. HAL estimated that approximately 24 per cent of its rental income is not covered by the standardised Guide Prices.[13] As this income is not directly related to passenger volumes, we have assumed it does not vary with those volumes. Instead, this income is estimated to increase with CPI, in line with general property income.

5.27 In relation to HAL's argument that we should reduce our estimate of property income to take account of reduced revenues from the former BMI hangar and the current BA crew car park, we have reviewed our estimates of property income. While we note the potential for reduced revenues at these two sites, our assessment of property income takes into account a range of potential upsides

Management Stretch Technical Annex, published alongside the Final Proposals as CAP2366J, available here

[12] That is, HAL argued that we should reduce our estimates of future retail revenues to align with the information from data and customer behaviours in the first half of 2022.

[13] These prices use standardised rates published annually by HAL to calculate rental or lease payments, which are tied to specific, fixed increases in rents or lease payments.

and downsides during H7. In the round, we consider that HAL has ample opportunities to offset any reduced revenues at these two sites with increased revenues from other sites in its property portfolio.

5.28 We also disagree with BA's view that we understated the rate of growth in property rents. Market conditions at the time of this Final Decision remain challenging and we do not think that it would be appropriate for us to assume that HAL is capable of unilaterally driving up rental or lease payments.

Surface access

5.29 We have examined the errors that HAL said we had made in the Final Proposals in our projections of rail and bus/coach revenues, and corrected these where required in this Final Decision.

5.30 There was an error in our application of inflation to rail track access charges. This stemmed from a mislabelling in HAL's own spreadsheets.

5.31 We also agree that there was an error in our estimates of Piccadilly Line revenues. This arose because our consultants incorrectly assumed (using HAL's own analysis of this item) that transfer passengers contribute to HAL's revenues when this is not the case. CTA and HAL's analysis also excluded non-airport passengers who travel on the Piccadilly Line, who contribute towards HAL's Piccadilly Line revenues.

5.32 However, we do not agree that there was an error in our modelling of Heathrow Express revenues. After reviewing our calculations, we consider that we have correctly modelled fares, that stayed flat in nominal terms from 2019 to 2022.

5.33 We agree that there was an error in our treatment of bus/coach revenues in that we included the same revenues twice in our financial modelling - once in our allowance for commercial revenues, and again in our allowance for ORCs.

5.34 We have decided that it is necessary to correct for these three errors. The adjustment we have made for the two rail-related errors is set out in the next section. We have removed bus and coach revenues from our estimates of ORCs and instead included them in surface access revenues.[14]

5.35 While we recognise that the revenues that HAL makes from its pod parking product have previously been excluded from the single till framework, we have chosen not to make an adjustment relating to these revenues, for the following reasons:

[14] The treatment of this error is also covered in chapter 8 (Other regulated charges).

- HAL's observations on this matter were made for the first time in its response to the Final Proposals, with HAL opting not to include any such adjustment in its own business plan;
- HAL's calculations of the required adjustment were not set out in detail and focused on simplistic metrics of revenue per parking space, rather than an analysis of the price per hour/day/vehicle that HAL charges for its different parking products; and
- we asked HAL to provide further information on historical revenues from pod parking, which it used to estimate an adjustment to revenues in H7. The information that HAL provided in response was inadequate and therefore did not provide a robust basis for any potential adjustment.

Therefore, we do not have a strong basis for calibrating any adjustment that might be appropriate in relation to pod parking.

5.36 However, noting (in particular) that revenues from pod parking have been excluded from our estimates of commercial revenues at previous price controls, we will consider any further representations HAL has to make on this issue alongside our future considerations on TDOC revenues (see paragraph 5.50 below).

5.37 In relation to BA's points about rail and car park revenues, we note that BA did not provide a specific alternative proposal for surface access revenues. Accordingly, having reviewed our approach and confirmed its robustness, we do not consider that it is appropriate to make any further changes to our approach.

Cargo

5.38 We note BA's comments about the possible alternative treatment of cargo revenues. We note that BA did not provide a specific proposal showing how cargo revenue could be incorporated into a cap on revenue per passenger. Accordingly, we do not consider that it is appropriate to make a fundamental change of this nature to the design of our price cap at this late stage of the review.

Terminal drop-off charge (TDOC)

5.39 We noted in our final proposals that there was some uncertainty about the effect that the implementation of the Private Parking Code of Practice (the "Code") would have on HAL's ability to levy its TDOC. Since June 2022 we have continued to engage with the Department for Levelling Up, Housing and Communities (DLUCH)[15] on this matter. At the time of writing, the expectation is that a revised draft of the Code will be laid before Parliament in the autumn of

[15] As it was titled during the period we engaged with officials from this Department

2023. DLUCH confirmed that the policy intention is that the consideration period is not intended to apply to drop off facilities at airports and it is not within the remit of the code to determine the tariffs for parking, which remain a commercial matter for each business to determine.

5.40 Accordingly, we have retained our estimates of TDOC in full for all years in H7 and remain of the view that the framework we set out in the Final Proposals, including a 65:35 revenue share arrangement for the period 2022 to 2024 and provision for a CAA review in 2024, is a proportionate way of dealing with the uncertainties in this area.[16]

5.41 In response to airlines' concerns about HAL's ability to unilaterally increase the level of the terminal drop-off charge, we consider that the arrangements set out in the Final Proposals provide sufficient protection against significant unilateral increases in the charge, primarily through HAL's obligation to consult airlines on any increases in charges.

Capex

5.42 HAL correctly notes that there is a link between the allowance we make in the H7 price control for commercial revenues and our allowance for capex. We are content that our projections of commercial revenues are achievable given the capex that we allow for in chapter 6 (Assessment of capital expenditure) as we have specifically allowed for the capex proposed by HAL for all such projects that either:

- have the direct objective of protecting commercial revenues; or
- have a positive business case which is forecast to payback within 5 years (that is, within the timespan of a single control period).

5.43 We expect HAL to develop other projects to generate incremental commercial revenues during H7 under our enhanced capex governance arrangements for H7, provided those projects have a compelling business case.

Reflecting the updated passenger forecast in our allowance for commercial revenues

Passenger volumes

5.44 As set out in chapter 1 (Passenger forecasts), we have revised our forecasts of annual passenger numbers during the H7 period.

5.45 Using the modelling approach that we applied for the Final Proposals, this updated forecast results in a net increase of £124 million (taking account of a

[16] Our reasons for use of this particular revenue sharing allocation are set out in paragraphs 5.71 to 5.74 of the Final Proposals

reduction of £22 million in forecast cargo revenues) in our allowance for commercial revenues during the five-year period.

The CAA's final decision

5.46 Our updated allowances are set out in Table 5.2 below. The calculations contain three changes from the Final Proposals:

- we have taken account of the impact that higher passenger numbers will have on commercial revenues (including cargo revenues). This change increases our forecast by £124 million;
- we have corrected for errors in our calculations of surface access revenues as described above. Taken together, these changes decrease our forecast by £38 million[17]; and
- we have updated indexation assumptions using the forecasts published by the OBR in November 2022 for CPI and RPI. This change has an impact on certain categories of income, such as property and reduces our forecast by £24 million.

5.47 As a result, the total allowance for HAL's commercial revenues and cargo that we have decided to make in calculating the H7 price control is £4,379 million over the H7 period, £62 million higher than the allowance that we included in the Final Proposals. This is set out in Table 5.2.

Table 5.2: Final decision on the allowance for HAL's commercial revenues during the H7 period

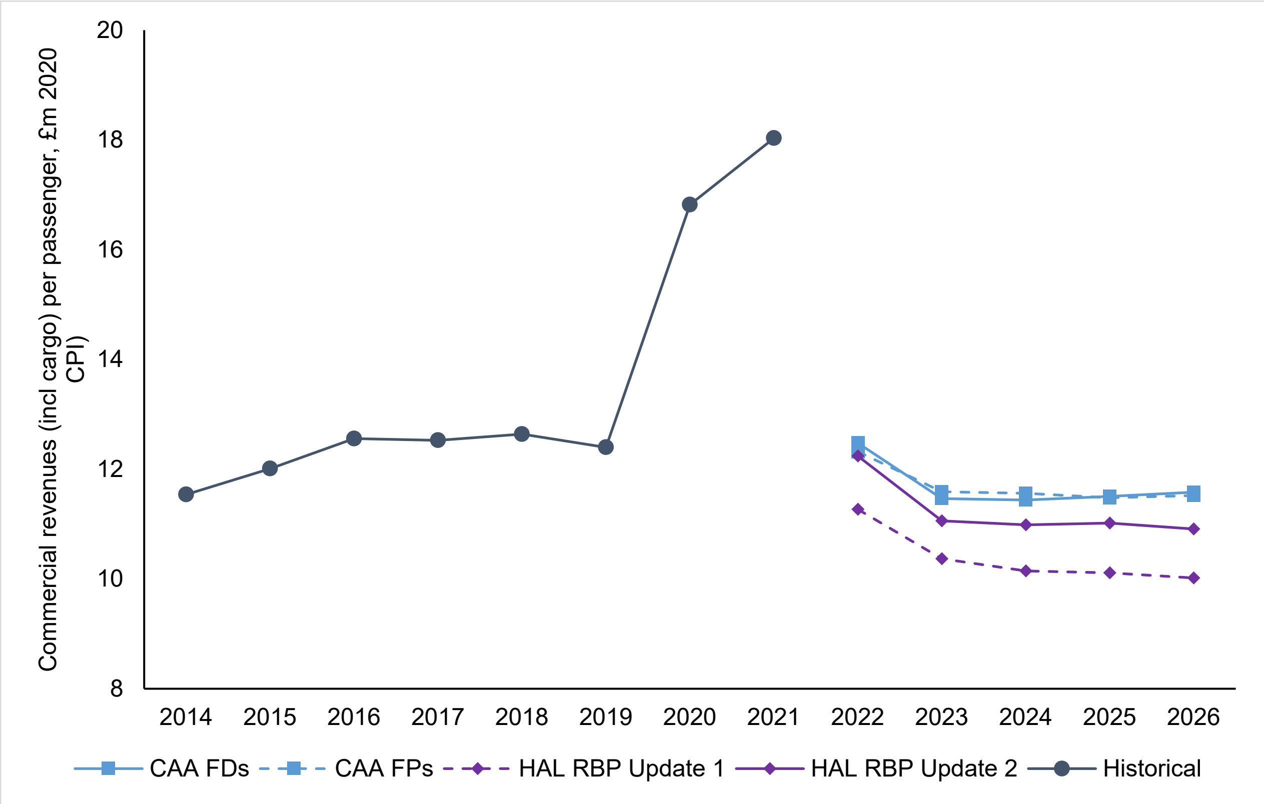
2020 CPI deflated prices , û million	2022	2023	2024	2025	2026	H7
Total excluding cargo	735	816	889	917	930	4,287
Cargo	35	20	14	12	11	92
Total including cargo	770	837	903	928	941	4,379

Source: CAA.

5.48 Figure 5.1 shows the trajectory in revenue represented by the allowance per passenger we have decided on over the H7 period.

Figure 5.1: Real commercial revenue per passenger

[17] The correction to bus/coach revenues had already been implemented in our estimates of commercial revenues in the Final Proposals: correcting other surface access issues decreased our forecasts by £38 m



Source: CAA.

5.49 We consider that the allowances set out in Table 5.2 and the trajectory for such revenues in Figure 5.1 are reasonable given the evidence that we have seen about the scope for HAL to grow its revenues and the offsetting headwinds facing the business. This should further the interests of consumers by encouraging efficiency on the part of HAL and ensuring that airport charges are no higher than necessary.

5.50 As noted above, we intend to conduct a review of our allowance for revenue from the terminal drop-off charge in late 2024. This will enable us to take account of any impacts that the Private Parking Code of Conduct may have on HAL's revenues in 2025 and 2026.

Implementation

5.51 The estimates for commercial revenues identified above have been used in the calculation of the price controls in chapter 13 (Calculating the price cap and financeability).

5.52 We will also make changes to HAL's licence to implement our proposals for commercial revenues in relation to the TDOC. This will codify the risk sharing arrangements for TDOC revenues.

Chapter 6

Assessment of capital expenditure

Introduction

6.1 The capital expenditure (capex) that HAL incurs helps determine the range, availability, continuity, cost and quality of the airport operation services that HAL provides, and supports the safe, secure and reasonably resilient operation of the airport.

6.2 Efficient capex is added to HAL's RAB so that the costs of it can be recovered by HAL from consumers through the allowances we set for regulatory depreciation and returns. Thus capex plays an important role in determining the overall level of airport charges in the longer term.

6.3 We have sought to calibrate the baseline for HAL's capex during H7 (together with our approach to setting capex incentives set out in the chapter 7 (Capex Incentives) in such a way that it will:

- promote economy and efficiency on the part of HAL;
- secure that the reasonable demands of consumers are met; and
- where appropriate, enable HAL to take reasonable steps to mitigate the environmental impact of the airport.

6.4 We recognise that it will not be possible to forecast with certainty the capex requirements up to five years ahead. As set out in the chapter on capex incentives, we have included a flexibility mechanism that will allow for a higher level of capex where this is appropriate and necessary.

6.5 Overall our approach is designed to protect the interests of consumers and to allow HAL to make sufficient invest to provide an appropriate quality of service. The focus of this chapter is the appropriate level of baseline capex for the H7 period. It sets out:

- a summary of the Final Proposals;
- a summary of stakeholders' feedback on the Final Proposals;
- our assessment of these responses; and
- our final decision for the allowance we are making for efficient capex.

The Final Proposals

Our approach to assessing the level of efficient capex

6.6 Our approach to assessing the level of efficient capex for the Final Proposals recognised that, within HAL's capex programme individual projects had not reached the same level of maturity. As a result, the level of detail and quality of the information available at the time of the Final Proposals varied between projects from relatively comprehensive to relatively sparse depending on:

- the maturity of the project; and
- the availability of supporting cost information produced by HAL and its advisors.

6.7 As a result, the approach that we adopted to assessing the efficient level of capex that HAL would be likely to incur during the H7 period explicitly took account of these varying levels of information across HAL's capital plan. For the areas where we found gaps in the evidence provided to us (such as the "efficient airport" programme), we took a "top-down" approach.

6.8 We assessed the baseline level of efficient capex in two stages:

(1) a structured "needs assessment", which allocated the projects and programmes proposed by HAL into categories according to the level of information provided and the overall business case for the project; followed by

(2) an assessment of what the efficient costs of the required investment would be, building on analysis by our technical advisors, Arcadis.

More information on Arcadis' specific technical assessment method is provided in its report.[18]

6.9 Our approach to the second of these two stages (the efficiency assessment) was implemented by:

(1) engaging with HAL to seek clarification on the basis for the material contained in its H7 capital plan and the supporting information HAL had provided, with an initial focus on the regulated security, T2 baggage, and asset management programmes;

(2) conducting a review of how the proposed level of costs was built up, including reviewing the integrity and consistency of HAL's calculations for a sample of elements of estimated project/programme costs (such as the estimated build up of costs for installing equipment required to deliver project

[18] The Arcadis June 2022 Report is published alongside the Final Proposals as CAP2366F here

outputs), and reviewing the scope of each relevant project. Our review was constrained by the limited information available on the scope of many of these projects, given the level of maturity of the programmes at the time of our assessment; and

(3) benchmarking for selected unit rates (such as benchmark unit costs for construction of relatively modular, and hence comparable, assets such as new retail units within the terminal) and assumptions where possible, including through an assessment of the assumptions that underpinned HAL's proposals.

Our estimates of efficient capex

6.10 The Final Proposals presented our estimates of the efficient costs that we considered appropriate for each category and programme, and a summary of our reasons building on the two-stage assessment approach described above.

6.11 Table 6.1 below presents the estimates of efficient capex used for the Final Proposals alongside HAL's estimates. Our assessment of the efficient level of baseline capex for H7 of £3.6 billion was nearly £1 billion (or around 20 per cent) lower than that which HAL considered was appropriate. Overall, the Final Proposals set out that, while HAL had not provided sufficiently detailed information across its capex programme, in some areas the information that HAL had provided (including relatively detailed information on cost build-ups for several programmes) meant that the justification for the level of costs that it was proposing for several projects/programmes was stronger than it had been at the time of the Initial Proposals.

Table 6.1: Capex estimates for Final Proposals

£ million (2020 prices)	2022	2023	2024	2025	2026	Total H7
***- Core*[19]**	*242*	*302*	*277*	*294*	*181*	***1,296***
- Development	*125*	*266*	*426*	*723*	*785*	***2,325***
"Mid Case" estimates	367	567	703	1,017	967	**3,620**
HAL RBP Update 2	446	707	840	1,216	1,326	**4,534**

[19] The governance process around capital expenditure requires a project to proceed through a number of gateways as it is developed and delivered. Gateway 3 ("G3") is the point in the process where the requirement, scope and budget is agreed jointly with airlines and HAL. This is the Gateway through which a project progresses from 'Development' to 'Core'. "Core" projects that have passed through project Gateway 3 are to be distinguished from "development" projects that have not yet passed through Gateway 3.

Source: CAA

6.12 Our “mid case” estimates were similar to the actual total capex that HAL incurred during the Q6 price control period of £3.5 billion (2020 prices).

6.13 We explained that we expected HAL to bring forward the projects relating to the “Development” element of the capex allowance (as presented in Table 6.1 above) during the H7 period through the enhanced capex governance process discussed in chapter 7 (Capex incentives), subject to airline approval. We also noted that, as discussed in the Arcadis report, construction price inflation for H7 is currently difficult to forecast, with the risk that it varies materially from general (CPI) inflation. We expected HAL to manage these risks as part of a greater focus on capital efficiency.

Summary of stakeholders’ views

Issues already raised before the Final Proposals

6.14 In response to the Final Proposals, HAL has put forward similar arguments that it had put forward in response to the Initial Proposals, saying that our allowance is less in the interest of consumers than its capital plan, and so is too low.

6.15 HAL also remained of the view that the additional burden imposed by our proposal for capex incentives (see chapter 7 (Capex Incentives)) would delay delivery of the capex plan and that this would operate to the detriment of consumers.

6.16 Airlines continued to support our view that the limited level of information provided by HAL has made our assessment of capex difficult, and that there is a clear need for HAL to produce better quality capex plans in future.

New issues raised directly in response to the Final Proposals

6.17 HAL argued that we made several errors in the Final Proposals and said in the final allowance we should:

- include the full allowances HAL proposed for the asset management and compliance programme, as HAL believes that:

  (a) our assessment of deliverability (that is, the ability and capacity of HAL to successfully deliver the required investments) is erroneous; and

  (b) this programme is key to ensuring the resilient, safe and reliable operation of the airport.

- not exclude projects rolled over from the iH7 period associated with terminal ramp-up after the covid-19 pandemic from our allowance, as (according to HAL) these have been approved by airlines;

- include the full allowances for the commercial revenue and efficient airport programmes, as HAL believes that these programmes deliver a wide range of positive consumer outcomes, as well as additional revenues and operating efficiencies; and
- not exclude investments for passengers requiring support ("PRS"), as HAL says this would be contradictory to ongoing requests for more personalised assistance services across the airport.[20]

6.18 HAL also provided further (new) information in relation to the efficient airport programme as an appendix to its response.

6.19 Both HAL and airlines supported the development of a "queue measurement and management" project during H7, to complement the improvements delivered by the regulated security programme. This project should enable greater granularity of measurement of security queues through automated per passenger measurement of queues. However, while HAL continues to seek additional funding for this project, airlines argue that the project should be funded within our overall allowance for the regulated security programme.

6.20 Airlines did not consider that the overall level and make-up of the capital plan set out in the Final Proposals was justified, but was instead based on a number of inconsistencies and lack of challenge on HAL. They suggested we had made errors, including that we have:

- not properly assessed the true level of the required capex plan, particularly for the latter years of some programmes;
- missed an opportunity to set a more challenging level of capex that would also incentivise HAL to provide better quality information in the future; and
- accepted many of HAL's requests despite guidance from our own independent consultants: for example, airlines argue that the rationale for the allowance for the asset management and compliance programme being set at the higher end of the range advised by Arcadis was not justified sufficiently in the Final Proposals.

6.21 Airlines also expressed concern that the Final Proposals will be taken by HAL as 'pseudo approval' or specific endorsement of expenditure.

Our views

6.22 It is important to keep in mind that we do not have the same information of HAL and this "asymmetry of information" is further compounded by the constraints on

[20] This issue is discussed further in chapter 4 (Operating Expenditure).

sharing commercially sensitive information with the company's customers, who may then find it difficult to provide a reasonable level of insight and challenge.

6.23 In part this is mitigated by the capex governance framework, which allows for a degree of additional flexibility during the price control period. HAL's overall capital plan will evolve during H7 as projects/programmes are developed, as passenger traffic recovers from the pandemic, and as HAL's plans mature. Through this framework, airline stakeholders (with oversight from the CAA) will have the opportunity to review and challenge projects and programmes as they are developed, and so they will be able to contribute to defining and refining an efficient capex plan.

6.24 HAL and airline criticisms of the Final Proposals should be viewed in this context. While we accept that HAL's estimates of required capex differ from our own estimates, we remain firmly of the view that we have identified an appropriate baseline level of capex and the detail can evolve as projects move from "development" status (before the G3 gateway) to "core" projects once approved by airlines or the CAA.

Specific issues raised by stakeholders

6.25 In relation to HAL's view that we made errors in the Final Proposals, we note that the majority of these relate to projects/programmes where HAL's estimates differ from our own and should be considered in the above context. On specific issues:

- we have reviewed (in conjunction with our technical advisors) our analysis of the deliverability of the asset management and compliance programme and are content that it is robust;
- we looked again at our assessment of capex to support the commercial revenues programme and noting that HAL did not provide significant new information in support of its challenge, we remain satisfied that our assessment of this programme is robust;
- as explained in chapter 7 (Capex incentives) we are content that our approach to enhanced capex incentives will deliver benefits to consumers and encourage more efficient delivery of capex projects; and

- we explained our position in relation to HAL's proposed investments relating to PRS in paragraph 6.36 of our Final Proposals. In summary, HAL appears to have conflated the much broader category of PRS with the narrower category of disabled and less mobile passengers (also referred to as Passengers with Restricted Mobility, or PRMs) who use the Special Assistance service. We note that HAL has made no new arguments on this issue. We look forward to HAL bringing forward appropriately justified PRM-related expenditure as part of the capex governance process.[21]

6.26 We recognise the likely benefits to consumers of the queue measurement and management project and note that both HAL and airlines support it. We have confirmed that expenditure for this project is not explicitly included within the cost build up for the regulated security programme. Nonetheless, we expect this project to be developed and brought forward through the general project governance process during H7, either as an additional project (requiring specific airline approval) as part of the "transformation" element of the regulated security programme, or potentially as part of the efficient airport programme.

6.27 We note the airlines' comments on our approach to assessing capex and the resulting allowance. The recommendations and analysis provided by our expert advisors Arcadis were one of the key inputs to our cost assessment process, which was explained in full in the Final Proposals. Our estimates of efficient capex were based on the structured process presented in Figure 6.2 of the Final Proposals, which builds on industry best practice, as well as taking account of the particular framework for capex at Heathrow. The results of applying this approach, and our reasons, are set out in full in Table 6.5 of the Final Proposals. We remain of the view that our broad approach to assessing capex was reasonable.

Further work carried out by CAA since the Final Proposals

6.28 We have assessed the further information provided by HAL in relation to the efficient airport programme with assistance from our advisors Arcadis. While this further information allowed us to gain a better understanding of the expected outputs from projects within the programme, some of which are supported by airlines, the information contained little evidence to suggest that we should consider changing our H7 capex allowance for this programme.

6.29 Since publication of the Final Proposals, the CAA has engaged extensively with HAL and airlines stakeholders in relation to the governance arrangements for the regulated security programme, with a focus on the proposed G3 approval for the first significant project brought forward under the programme: the upgrade to the

[21] The precise funding mechanism for any new PRM-related capex will depend (among other things) on the nature of the investment, and the extent to which the project can be funded through PRM-related charges.

security facilities in the Terminal 3 Central Search Area ("CSA"). We expect that this approval will shortly be given, to allow this critical project to proceed as planned.

6.30 We expect to continue to monitor this programme closely while also engaging frequently with all stakeholders, with the objective of facilitating delivery of this critical programme, which aims to deliver outputs mandated by DfT.

6.31 We allowed £825 million for the Regulated Security programme as a whole in the Final Proposals and have received no new evidence that suggests that we should review this allowance for our final decision.

6.32 As part of our work to support the implementation of our improved capex incentives see chapter 7 (Capex Incentives) we have also been developing improved information requirements for HAL's capex projects, noting the generally poor quality of information on capex that we have received from HAL during this price control review.

The CAA's final decision

6.33 Bearing all of the above in mind, our estimates of the baseline estimates for H7 capex do not contain any changes from the Final Proposals other than for the general updates that we have made as a result of the new inflation assumptions we are using for this Final Decision.

6.34 Therefore, we have maintained our capex allowance in 2020 CPI terms from the Final Proposals and the total capex allowance of £3,620 million over the five years of the H7 price control is the same as the allowance that we included in the Final Proposals. The updated OBR inflation forecasts change the conversion to nominal terms (which is used in our financial modelling of HAL summarised in chapter 13 (Calculating the price cap and financeability).

Table 6.2: Final decision on the capex allowance for H7[22]

2020 CPI deflated prices , £ million	2022	2023	2024	2025	2026	H7
Total	367	567	703	1,017	967	**3,620**

Source: CAA.

6.35 We remain confident that the allowances set out in Table 6.2 are appropriate given the importance of HAL investing in a safe, secure and reasonably reliable airport, and the scope for it to make efficiencies and deliver capex efficiently.

6.36 We note that our allowance for the first year of the H7 price control is not identical to the costs that HAL actually incurred in 2022. This is consistent with

[22] These numbers are in line with the figures adopted in the Price Control Condition of the Licence using the Office of Budget Responsibility November 2022 inflation forecasts.

normal regulatory practice: the regulated company (in this case HAL) does not have the ability simply to pass through its costs to consumers but instead needs to appropriately manage spending over the five years of the price control period.

6.37 We expect that HAL will bring forward the projects relating to the development element of our allowance during the H7 period through the enhanced capex governance process discussed in chapter 7 (Capex incentives), subject to airline approval. As explained in that chapter, we have also developed a new flexibility mechanism to allow for additional spending if a compelling case for extra spending were to emerge.

6.38 For the reasons set out above, we consider that the level of baseline capex identified in this chapter will work together with our proposals for new capex incentives to:

- promote economy and efficiency on the part of HAL; while
- securing that the reasonable demands of consumers are met; and
- where appropriate, enable HAL to take reasonable steps to mitigate the environmental impact of the airport.

6.39 In this light, we consider that our approach will incentivise HAL to deliver the efficient and timely investment that is key to the delivery of an appropriate level of service for consumers and to allow for the safe and secure operation of the airport, so furthering the interests of consumers.

6.40 As a result of our capex allowance, consumers will benefit from a broad range of investment in the airport infrastructure in H7 and future periods, such as:

- significant improvements to airport security, including an enhanced passenger experience for departing passengers in particular, through the use of enhanced security technology, delivered through the regulated security programme. For example, departing passengers should benefit from a more efficient experience at security at Heathrow, enabled by advanced scanning equipment;
- significant enhancements to the Terminal 2 baggage system, including expected improvements in the average passenger waiting time for baggage, delivered through the T2 baggage programme; and
- improved vehicular access to key areas of the airport campus for both passengers and freight users, delivered through the main tunnel and cargo tunnel projects (as part of the asset management and compliance programme).

Implementation

6.41 The capex allowance set out above is used in the calculation of the price control and our assessment of financeability in chapter 13 (Calculating the price cap and financeability).

6.42 While we recognise the challenging circumstances during the last two years, we are of the firm view that HAL can, and should, produce higher quality and better quantified information in support of many of its projects and programmes. We expect (and will require) HAL to produce better quality information on capex projects during the H7 period that fully reflects reasonable expectations about the maturity of individual projects and programmes.

Chapter 7

Capex incentives

Introduction

7.1 In considering how best to further consumers' interests in relation to the capital expenditure (capex) undertaken at Heathrow Airport, we are required to have regard to the need to promote economy and efficiency on the part of HAL. Ensuring that we have appropriate incentives for HAL to make capital investments efficiently is a core means by which we seek to achieve this. The design of appropriate incentives is also relevant to the CAA discharging its duty to have regard to both the need to secure that HAL can finance its activities and the need to secure that all reasonable demands for AOS are met.

7.2 Given the relatively large size of HAL's capital programmes, promoting the efficient delivery of capex remains a priority in the context of a two-runway airport. The lengthy consultation process that we have undertaken on our approach to incentivising capex by HAL since June 2017[23] has worked towards creating a framework of forward-looking ("*ex ante*") incentives, where HAL:

- shares a proportion of the benefits of appropriately delivering capex projects below a budget that has been set in advance; and
- shares a proportion of any over-spend against that budget.

7.3 The focus of this chapter is on capex incentives. Our approach to estimating the base allowance for HAL's H7 capex is dealt with in chapter 6 (Assessment of capital expenditure). This chapter starts with a summary of our approach to capex incentives as set out the Final Proposals, then deals with respondents views and sets out our final decisions.

The Final Proposals

Scope of *ex ante* incentives

7.4 Through the various consultations we have issued ahead of our Final Proposals, we have made it clear that our intention is to build on the strengths of the current arrangements, while making improvements in areas where we consider this will benefit consumers.

[23] These include: CAP1541, CAP1658, CAP1674, CAP1876, CAP1940, CAP1951, CAP2139, CAP2265D, CAP2365C.

7.5 In the Final Proposals, we said that *ex ante* incentives should apply to all of H7 capex, except certain “pass through” costs (contributions to the cost of Crossrail) and “core” projects[24] that have already progressed through Gateway 3[25] (“G3”) prior to quarter 4 (Q4) of 2022.

7.6 We did not consider pass through costs and core projects that have progressed through G3 prior to Q4 2022 to be appropriate for *ex ante* incentives, as costs are either outside of the direct control of HAL or have already been largely incurred or committed. We said that for other projects HAL has a significant degree of control over the construction and operational environment in which projects are delivered and, therefore, it is appropriate to apply incentive arrangements to this capex as HAL is in a position to be able to respond appropriately to the incentives.

Incentive rate

7.7 We proposed that an incentive rate should:

- apply to any under- or overspend against the individual project budget agreed at G3;
- be set at 25 per cent, as we recognised that it will be the first time that HAL has been subject to ex ante incentives. It was our view that it would be prudent to adopt a relatively cautious approach in the first instance so that we can mitigate the effect of any unanticipated impacts that might arise; and
- be applied on a symmetrical basis to both over- and under- spends. This is because the capex baseline for each project that is set at G3 is based on a reasonably mature cost estimate so that there should be a relatively equal likelihood that the actual costs of that project will turn out to be either higher or lower than the baseline set at G3.

Delivery obligations (“DOs")

7.8 We explained that each project will also need DOs and that the relevant DOs for each project should be agreed with airlines at G3. The DOs should capture the fundamental elements of what the project is expected to deliver and are, therefore, inextricably linked to the determination of the budget for the project. We proposed that these would incorporate the expected output, quality and

[24] “Core” projects that have passed through Gateway 3 are to be distinguished from “development” projects that have not yet passed through Gateway 3.

[25] The governance process around capital expenditure requires a project to proceed through a number of gateways as it is developed and delivered. Gateway 3 (“G3”) is the point in the process where the requirement, scope and budget is agreed jointly with airlines and HAL. This is the Gateway through which a project progresses from ‘Development’ to ‘Core’.

timing for the project, and these could be adapted to reflect the characteristics of the particular project.

7.9 As such, we considered that DOs would be essential to ensure that the underlying capex baseline will reflect the scope, quality and timing of the infrastructure that is to be delivered. Without DOs, there is a risk that HAL may underspend against capex budgets by delaying delivery, or scaling back on the scope and quality expected: this would not be in the interests of consumers.

7.10 Each DO would have a weighting to determine what proportion of baseline capex is to be associated with performance against each DO. We also proposed that SMART[26] indicators be used to determine whether or not each DO has been met, and the level of adjustment to baseline capex associated with non-delivery.[27]

7.11 Failure to meet these DOs for projects above a material value would see an adjustment to the baseline level of capex used for the reconciliation of the capex incentives.

Capex envelope uncertainty mechanism

7.12 In setting the capex allowance for H7, we recognised that there was the potential for the level of capex required for H7 to be greater than we currently anticipate. Increases in capex will eventually feed through to airport charges across the longer term, and this will have an impact on consumers. Therefore, it is important that there are governance arrangements in place to deal with such circumstances and that the CAA is involved where this is appropriate to protect the interests of consumers.

7.13 We therefore proposed that there should be a cap on the overall capex envelope (allowed Core and Development capex projects +5 per cent) used to calculate the price control and that HAL will be allowed two windows in which it can make an application to the CAA for an adjustment to the cap. These were:

(a) 1 February 2024 to 31 March 2024; and

(b) 1 February 2025 to 31 March 2025.

We also said we would use these windows to consider any airline proposals for new capex.

7.14 We stated that in exceptional cases, we might also permit HAL to seek our consent to make an application outside of these windows.

[26] Specific, measurable, achievable, relevant and time-bound.

[27] See Appendix F to the Final Proposals for an illustrative example of a DO: https://publicapps.caa.co.uk/modalapplication.aspx?appid=11&mode=detail&id=11473

Summary of stakeholders' views

Issues already raised before Final Proposals

7.15 In its response to the Final Proposals, HAL repeated criticisms that it has made on a number of previous occasions of our approach to developing a new method for incentivising efficient capex delivery, including that:

- we have not identified any deficiency in the current arrangements for capex efficiency, or found evidence of significant inefficiencies in HAL's delivery of capex projects;
- our proposals are not in the consumer interest, as they will delay projects and add cost to the capex programme. In particular, the application of DOs at a project level will greatly increase the time and resources required to reach agreement with airlines;
- we have not provided an impact assessment demonstrating benefits against the existing framework;
- our inclusion of timing as an element of the DOs will expose HAL to "double jeopardy" because, in HAL's view, projects that over-run their expected delivery date will also be likely to incur additional costs, in addition to being subject to the incentive rate; and
- the capex envelope adjustment mechanism is not required: rather HAL considers that the existing governance arrangements should be used if HAL needs to increase the level of capex it incurs in H7 above the level allowed for in the Final Proposals.

7.16 Airlines have generally been more supportive of our proposals, although they have consistently argued that:

- we are wrong to not retain triggers (as used in Q6) alongside the timing element within each project's DOs; and
- we are wrong to propose a symmetric incentive rate of 25 per cent, and instead should apply a stronger incentive rate, with a penalty for overspending that is greater than the reward for underspending.

New issues raised directly in response to the detail of Final Proposals

7.17 In response to the Final Proposals, HAL made a number of new points, asserting that the CAA's approach was "wrong" in a number of ways, summarised below as alleged errors of fact and/or process, and alleged errors of judgement.

Alleged errors of fact and/or process

7.18 HAL:

- alleged that we are in breach of our overall public law duties by not consulting on our proposed framework of capex efficiency incentives as a whole at an early stage in the process;
- considered that our proposed approach to reconciliation showed errors in application of depreciation, pre-tax WACC, RAB depreciation and calculation of NPVs; and
- asserted that we do not have the power to amend the Licence to enable us to issue notices requiring it to update governance documents, or determine disputes.

Alleged errors of judgement

7.19 HAL:

- stated that we have wrongly assumed that information required to support the setting of DOs is available in existing project documentation;
- alleged that we are wrong not to permit the capex allowance to rise with construction inflation without having to trigger the capex envelope adjustment mechanism; and
- argued that, in assessing the likelihood of a significant overspend, we have mistakenly assumed that the H7 capex plan is smaller and less complex than in previous periods.

7.20 HAL has also asserted that, in making the Final Proposals we had not properly considered its alternative proposal, of replacing DOs with a more general 'scope' obligation for projects over £25m.

Feedback on proposed licence modifications

7.21 HAL also made some comments in response to the licence modifications we set out alongside the Final Proposals. In relation to capex incentives, HAL said that:

- the proposals for H7 capex incentives do not include triggers and, therefore, including the triggers drafting in the Licence without clarification is an error. HAL said that, if the CAA confirms the Final Proposals policy for capex incentives, the Licence should make clear that triggers are for those projects that form part of Q6 and H7 only.
- if the CAA confirms the Final Proposals policy for capex incentives, it should amend the wording under condition C1.9 of the Licence which creates the mechanism under which the capex envelope can be reconsidered by the CAA, as currently there is no route of appeal, other than judicial review, which HAL argues is unsatisfactory and inappropriate.

Our views on stakeholders' comments

Issues already raised before Final Proposals

7.22 We consider that we have repeatedly addressed those points of criticism that HAL has previously raised in relation to our proposal for *ex ante* incentives. We specifically highlight the following.

- As discussed in paragraph 7.2 above and 7.24 below, we have issued a significant number of consultations since April 2017 through which we have consulted on the development of our approach to capex efficiency incentives. Throughout this extended consultation process, we have highlighted the inherent difficulties with conducting ex post reviews[28] and the advantages of an ex ante approach to capex efficiency. In summary, our reasoning is that an *ex post* review to determine efficiency is challenging because of:
  - the passing of time since the projects under review completed which are exacerbated in the case of long-running projects; and
  - the inevitable asymmetry of information between the regulated company and regulator.
- In relation to the provision of an impact assessment, in both the Initial Proposals (at Appendix H) and the Final Proposals (at Appendix G)[29], we provided an Assessment of the H7 capex incentives framework against our statutory duties under CAA12. Together with the associated statutory notice in Appendix C to the Final Proposals, we have discharged our obligations under CAA12 and public law to consult and give reasons for our decisions.
- On the issue of DOs, we have not seen evidence that reaching agreement with airlines on these will result in excessive cost and be time consuming. It is our firm view that the efficient delivery of any capex project requires that project to be properly specified. This specification should set out in detail what the project is expected to deliver. The discussions on implementation which we initiated in the summer of 2022, and continued throughout the remainder of that year, were intended to give all stakeholders an opportunity to suggest ways governance arrangements could be streamlined.

[28] To be clear, this this is not the same as identifying inefficiencies in HAL's capex.

[29] [Economic Regulation of Heathrow Airport Ltd H7 Final Propsals Appendices D-k (caa.co.uk)]

- As for the timing element of DOs, while some late projects will also lead to HAL incurring additional spending, we do not agree that this would always be the case. Once HAL is subject to ex ante incentives, there is a risk that HAL could seek to delay, or even stop, the delivery of individual projects in order to avoid overspending, particularly when it is already experiencing difficulties in delivering that project. For that reason, we consider that having a timing element in the DOs is a critical part of the design of an effective incentive mechanism.
- We gave our reasons in the Final Proposals why we thought it was appropriate for the CAA to take an active decision making role through the implementation of the capex envelope adjustment mechanism to sanction significant increases in capex. Increases in capex will eventually feed through to airport charges and this will have an impact on consumers. Where these impacts could be material, we consider that the CAA should be involved to ensure the consumer interest is protected. We agree, to a limited extent, with HAL's argument that the existing governance arrangements between HAL and airlines offer some capacity to ensure that increases in expenditure are in the consumer interest: this is why we have applied a 5 percent headroom on the starting capex allowance as a threshold that would need to be reached before HAL would need to trigger the mechanism to adjust the capex envelope. We do not agree with HAL's position that the existing governance arrangements are sufficient to protect consumers' interests in relation to a more material increase in expenditure.

7.23 In response to airlines' comments, we continue to consider the reasoning set out in paragraphs 7.93-7.98 and 7.117-7.119 of the Final Proposals is robust and, in particular:

- after considering a plausible range of incentive rates, we consider that 25 per cent is appropriate for H7. We recognise that an increase in this rate might be appropriate for future price control periods, but, in our view, it is appropriate to exercise a degree of caution in implementing these arrangements for the first time at Heathrow. We do not consider that an asymmetric rate would be appropriate because the budget set at G3 should be based on a cost estimate where there is the same likelihood that actual costs will turn out higher or lower; and
- we do not consider there is a need to retain triggers alongside DOs. In our view, the primary purpose of both the timing element within DOs and a trigger penalty are to incentivise HAL to deliver projects on time. Therefore, having both elements would be duplicative and potentially distort other incentives on the delivery of the expected output or quality of a project.

New issues raised directly in response to the detail of Final Proposals

7.24 As explained below, we do not accept HAL's suggestions that we have made errors of fact and/or process or errors of judgement.

Alleged errors of fact and/or process

CAA's Public Law duties and consultation.

- As indicated in paragraph 7.2 above, we have consulted on proposals for ex ante incentives over the course of nine separate documents commencing in June 2017. By early 2020, a recognisable framework with largely the same elements as those set out in the Final Proposals was emerging. The later inclusion of new elements, the most notable of which is the application of DOs at a project rather than capex category level, has been driven by the nature of HAL's H7 capex plan, specifically, the continuing lack of necessary detail in HAL's capex plan on the strategic deliverables that are expected to be achieved through different categories of capex, or projects operating in combination.
- As our approach has been developed through, and with the benefit of, the extensive and lengthy consultation process outline above, it is entirely natural that the final version of our proposals will not have fully emerged until the publication of the Final Proposals. Indeed, for us to have published the final version of the incentive framework earlier and not been open to stakeholders' views after that point would have rendered any such purported consultation invalid.

The approach to reconciliation.

- We have considered the point made by HAL that we should use a post-tax WACC as a discount factor for calculating NPVs. We note that HAL did not provide evidence to demonstrate that use of a post-tax WACC would more closely achieve NPV neutrality. We have used the pre-tax WACC in our modelling for re-profiling of revenues, and we remain of the view that the pre-tax WACC is most appropriate for this purpose. This is so that we are consistent in our use of a pre-tax WACC for all re-profiling adjustments such as those described in chapter 13 (for re-profiling of revenues) and chapter 2 (for calculation of TRS adjustments). We are, therefore, retaining the use of the pre-tax WACC for capex incentives.

- We have considered the points HAL raised in its response (and the associated spreadsheet submitted) in relation to the approach to discounting cashflows. We recognise that to calculate the Opening RAB for H8 to reflect performance under these capex incentives, we will need to uplift into the same price base the following: baselines allowances, incurred expenditure and any expenditure that we disallow. To support this, during H7, HAL should clearly and transparently record and submit to the CAA in a timely fashion the baseline allowances and actual incurred capex annually, with clearly defined price bases, for each project that passes through G3 or is completed, respectively. We will confirm the method of end-of-period adjustments to the RAB in relation to HAL's performance on capex incentives in due course.
- HAL also raised a point around the return that would be earned in relation to expenditure that is logged up in the RAB during H7, which is ultimately disallowed as part of the end of period reconciliation process. HAL argued that the return in relation to any such expenditure should also be removed. We agree with this and note that this approach is consistent with the approach we currently take in relation to our ex post capex adjustments. We intend to remove any return earned in relation to expenditure which is disallowed from HAL's RAB as part of the process of calculating the opening RAB for the next regulatory period.

Updates to governance documents and determinations of disputes.

- While we note that HAL does not consider that the CAA has the power to amend the licence to enable us to issue notices requiring it to update governance documents, or determine disputes, Condition F of the Licence has, since the beginning of Q6, provided for HAL and airlines to refer matters to the CAA for determination. The modifications we proposed in the Final Proposals added clarificatory words, but the substantive obligations remain unchanged. We are firmly of the view that, section 21 CAA12 permits the CAA to include a condition such as this in the Licence.

Errors of judgement

*P*roject documentation.

- In our subsequent engagement with airlines and HAL, we have not seen any evidence that the information required to support the setting of DOs would not naturally form part of the development of good quality project documentation as part of the process for any project beng considered at G3 and, therefore, information to support the setting of DOs should be reasonably available.

Indexation of capex allowance.

- In setting capex allowances, our approach is to include an allowance in the calculation of the overall price control that is sufficient to support expected levels of efficient spending in constant prices. We expect HAL to take active steps reasonably to minimise the impacts of inflation on its capex programme. Where these cannot be managed and HAL is incurring efficient costs, we consider that the capex envelope adjustment mechanism we are introducing for H7 is sufficient to accommodate an increase in the overall quantum of capex.

Assessment of the likelihood of a significant overspend.

- We have not seen evidence to suggest that there is a higher prospect of overspending during the H7 period than we have seen in previous price control periods. The more focused assessment of costs at G3 that is a key feature of our proposals for *ex ante* capex incentives should reduce the likelihood of such over spending. We are also proposing to introduce a new mechanism to allow the overall size of the capex envelope to be adjusted as discussed above and further below.

- We consider that the Final Proposals gave appropriate consideration to HAL's alternative proposal to replace DOs.[30] We also signalled that the nature of DOs could vary across projects, as stakeholders consider appropriate. Our subsequent discussions on implementation have provided stakeholders with further opportunities to consider proposals for a *de minimis* threshold and the approach to setting suitable DOs and SMART targets.

Feedback on proposed licence modifications

- We note HAL's comments around the inclusion of a trigger term in the Licence, in light of the CAA's H7 capex incentives framework not including triggers. However, the wording proposed by HAL could result in the exclusion of trigger payments in relation to projects which commenced in 2023, before the publication of these Final Decisions. Consistent with our policy, we consider that triggers should only apply to projects which pass through G3 before the CAA's proposals come into force, and have made some small adjustments to the drafting of Conditions C1.16 and C1.17 to preserve the use of triggers agreed before either the new capex governance arrangements come into effect or the end of 2023, whichever is the earlier.

[30] See Economic regulation of Heathrow Airport - H7 Final Proposals Section 2 - Building Blocks (caa.co.uk), at para 7.113

- The allowed capex adjustment mechanism set out in the drafting of conditions C1.10 to C1.17 of the licence modifications in the Notice published at Appendix C of the Final Proposals, is the mechanism under which HAL can bring forward proposals to allow its regulated revenue to be increased to fund capex projects in cisrumstances where the costs in question have not been included in the “capex envelope” used to calculate the H7 price control. We consider that this mechanism is “necessary or expedient” to further the interests of consumers because it provides a mechanism that allows funding for capex projects that:
  - HAL had not justified at the time the H7 price control is set; but
  - which HAL can subsequently justify in the interests of consumers.
- The mechanism set out in the licence modifications achieves this and allows a decision to be made in the context of a proper consideration of our secondary duties and therefore provides a means by which consumers' interests can be furthered through the progression of appropriate capex projects and those projects can be financed appropriately.
- We consider that this approach has parallels in other equivalent regulatory regimes, for example, in energy networks where there have for some time been a number of mechanisms that allow for Ofgem to determine the level of particular parameters of the price control at a later date after an “application window”. We consider that the inclusion of this mechanism here is in the interests of consumers for the reasons set out above and in the Final Proposals at paragraphs7.123 to 7.140.
- The inclusion of such a mechanism is permitted by CAA12 because the combined effect of sections 19 and 21 CAA12 expressly contemplates that elements of price control can properly be determined other than through a licence modification. As a result the inclusion of these provisions within HAL's licence is not *ultra vires*.

The CAA's Final Decision

7.25 Having carefully considered the responses from stakeholders, we continue to be of the view that implementing the *ex ante* capex incentive framework set out in the Final Proposals is in the interest of consumers. Our final decision is to implement an *ex ante* capex incentives framework with the following key parameters and characteristics.

- An incentive rate of +/-25 per cent will be applied to any under/overspend against a project's budget agreed at G3.

- Each project will be required to have delivery obligations (DOs) agreed with airlines at G3. These should include a project's expected output(s), quality requirements and timing, and these elements may be adapted to reflect the characteristics of a particular project.
- Each DO will have a weighting to determine what proportion of baseline capex is associated with performance against each DO. SMART indicators should also be established to determine whether or not each DO has been met, and the level of adjustment to baseline capex associated with non-delivery.
- There will be a cap on the overall capex envelope we have assumed for the calculation of the H7 price control plus 5 per cent. HAL will have 2 windows when it can apply for this cap to be increased. These will be:

  (i) 1 February 2024 to 31 March 2024; and

  (ii) 1 February 2025 to 31 March 2025.
- In considering the requirement for new capex, we will take into account airline views.
- In exceptional cases, HAL may seek our consent to make an application outside of these windows.
- The capex envelope will not be indexed to construction inflation. In so far as this runs at a higher level and on a sustained basis than the economy-wide CPI inflation and, if HAL can demonstrate that additional capex will be required over the course of H7 as a result of construction inflation running higher than CPI inflation, then HAL can seek to use the adjustment mechanism and request a higher capex allowance.

7.26 We consider that these final decisions are appropriate to further the interests of consumers and that these incentive arrangements, coupled with the capex adjustment mechanism and our assessment of the appropriate level of funding for capex during H7 set out in Chapter 6 will:

- promote economy and efficiency by HAL in the delivery of capex projects;
- help secure that all reasonable demands for AOS are met by HAL to the extent that this requires the efficient delivery of capex; and
- help secure that HAL can finance its activities.

Implementation and next steps

7.27 For our framework of *ex ante* capex incentives to be effective, it is essential that airlines are sufficiently well-placed to agree capex budgets. To ensure this is the case, HAL must provide airlines with the information and analysis they need to be able to evaluate each project's proposed scope, delivery timetable, cost and benefits adequately for the purposes of a proper aseessment at project gateway G3.

7.28 It is also important that airlines consider carefully the requests for information and analysis that they make, so they are focused on important information that is necessary to determine whether the investment can deliver better outcomes for consumers. We are of the strong view that framework for capex governance and incentives will work best if airlines as well informed users of the airport have a significant role, and both HAL and airlines work together constructively to ensure that the framework delivers efficient and timely investment to meet the needs of consumers.

7.29 We are mindful of the need to minimise any additional cost and time delay to the delivery of projects that the framework of *ex ante* incentives might otherwise cause. Therefore, since the publication of the Final Proposals, we have been engaging with HAL and airlines to understand how the capex governance framework could be improved.

7.30 Through this process of engagement, we have prepared a draft guidance document for capex governance, which we are consulting upon alongside this Final Decision. After we have considered responses to the consultation on it, our guidance will be finalsied and we will expect HAL and airlines to update the existing the capex governance protocols accordingly. Ahead of these protocols being updated, we expect HAL to take reasonable steps to ensure that projects that have not yet progressed through G3 are developed in line with the draft guidance.

7.31 Separately, we will also consider whether any further guidance or information is required to support the procedure for adjusting the capex envelope.

Chapter 8

Other Regulated Charges

Introduction

8.1 Other Regulated Charges ("ORCs") are charges for specified services and facilities that are collected separately from the regulated airport charges (which are subject to the price control). In general, ORCs are levied on a "user pays" and "cost pass through" basis, meaning that users pay a charge that reflects the costs incurred to provide the services they receive.

8.2 These services and facilities currently include the provision of baggage systems, check-in desks, heating, water and electricity utility services, and common IT services. These are all necessary services for airlines and non-airlines (such as ground handlers) to be able to operate at Heathrow airport.

8.3 The costs of providing these services and facilities form part of HAL's cost base and the revenue associated with these charges is included in the single till calculations used to set the price control. Therefore, consideration of ORCs is an important part of the overall price control review.

8.4 It is in the interests of consumers that these important services are provided and charged for in a way that is consistent with economy and efficiency. Therefore, we seek to ensure that costs are efficient and charges are appropriately levied on those parties that make use of the services. Our work on ORCs has indicated that some refinement of the current arrangements would benefit consumers.

8.5 This chapter sets out:

- a summary of the Final Proposals for ORCs;
- a summary of stakeholders' responses to the Final Proposals;
- our assessment of the those responses; and
- our final decisions on these matters.

Summary of the Final Proposals

8.6 The Final Proposals said we would:

- support HAL's proposals to move ORC pricing to a marginal cost approach, under which the fixed infrastructure costs (known as "annuities") and allocated costs for some ORC services would, in general, be recovered through the regulated airport charges rather than ORCs;

- change the scope of the ORCs by moving all costs for check-in facilities, IT, heating and gas so that they are recovered through the regulated airport charge;
- keep the majority of business rates in the regulated airport charges, other than a non-airline element of business rates (amounting to £1.3 million) which should be allocated and recovered appropriately using the ORC framework;
- remove charges for bus and coach services from the scope of ORCs so that these could be addressed through individual commercial arrangements to facilitate more differentiated services to bus and coach operators; and
- introduce more flexibility into the arrangements governed by the Licence to allow additional ORCs to be added to the list of specified services within the H7 price control period through a "self modification" procedure.

8.7 The Final Proposals also included detailed improvements to the ORC governance arrangements, including underpinning the ORC protocols in the Licence. In doing so, we said we would require HAL to:

- use reasonable endeavours to develop, consult and agree governance and consultation arrangements for ORCs with relevant parties in the form of a new ORC protocol;
- appoint an independent person to review HAL's ORC prices including the appropriate allocation of any remaining fixed costs and annuities; and
- allow the CAA to resolve disputes on the ORC protocols.

8.8 We also set out our forecast of ORC revenues for the H7 price control period and used this in calculating the level of the price control and in our financial modelling of HAL's regulated business.

Marginal Cost Approach

8.9 The Final Proposals supported HAL's proposals to move ORCs onto a marginal cost pricing framework as they would amongst other things:

- allow ORCs to focus on the costs that airlines could influence; and
- help improve the effectiveness of governance arrangements.

8.10 However, we also noted that it would not be in consumers' interests to keep those fixed costs and annuities relating solely to non-airline activities within the scope of the regulated airport charges. We therefore included staff car parking costs (£4.3 million) and electricity and water costs (£13.8 million) relating solely to non-airline use (around £18 million in total) within the scope of the framework for ORCs, alongside the non-airline element of business rates.

Summary of stakeholders' views

8.11 HAL objected to returning fixed costs and annuities for these three activities back into the ORC framework. HAL said that our proposals meant that the CAA was effectively mandating a differential charging framework across ORCs. HAL said that including annuities, allocated costs and business rates for non-airline users would render the Final Proposals 'wrong' as this approach would:

- lead to differentiated pricing for different parts of airline operations on the basis of the type of operator, not the activity they are carrying out, which could cause confusion and distort competition;
- lead to large pricing differentials for different users in 2023, partly driven by the estimated under-recovery of charges brought forward from 2022;
- cause distortions, including because a number of users which could be categorised as 'non-airline' and are subject to ORCs are, in fact, close suppliers to airlines such as ground handlers; and
- disincentivise the use of services such as electric vehicle charging.

8.12 HAL also claimed that the 'dual/differential' pricing approach would be burdensome, costly and that it was not confident that it could implement the necessary changes in time for the effective date of the licence modifications. HAL also said that we had made legal errors in not considering how our proposed dual pricing structure would promote environmental benefits and competition.

8.13 AOC/LACC agreed with our assessment that there were advantages to the consumer in setting ORCs on a marginal cost basis. They also supported the CAA's approach of "adding back" non-airline fixed costs and annuities relating to non-airline users on the basis that it would not be appropriate to burden consumers with approximately £90 million of costs relating to these users through the airport charge over the H7 period.

8.14 Both Hilton Garden Inn and the Arora Group did not support our proposals to move the non-airline annuities and fixed costs into the ORC frameworks. The Arora Group, in particular, claimed that the CAA's proposals would result in volatile prices, and both respondents claimed that the proposals ran counter to the objectives (of marginal cost pricing) previously set out by the CAA.

Our views and the CAA's Final Decision

8.15 In response to HAL's claims that we have in error mandated it to implement a differential pricing structure across ORCs, it is important to note that the CAA does not regulate the level or set guidance on the structure of HAL's ORC charges. It is for HAL to devise a ORC pricing structure that allocates and recovers ORC charges on a fair and reasonable manner adhering to the ORC charging principles (including transparency, cost pass through and user pays) and competition law.

8.16 We have not, at any stage, suggested to HAL that it should adopt a dual or differentiated pricing structure for ORCs. We therefore reject HAL's characterisation of our approach and its suggestions of errors.

8.17 The ORC framework is designed to incentivise a collaborative approach between HAL and all ORC users. To that end, any changes that HAL proposes to the structure of its charges will require genuine consultation with all affected parties and, to that end, we point to the views from the airline community on this issue and its strong opposition to adding non-airline costs to airline charges.

8.18 As for HAL's claims that the distinction between airlines and non-airlines is arbitrary and incorrect, we note that it was HAL that initially presented a breakdown of airline and non-airline costs to the ORC Governance Group and to the CAA. Given that the regulated airport charge is paid by airlines, we see no undue difficulty, and significant advantages, in distinguishing between airlines and non-airlines in determining ORCs and we note HAL should be able to develop appropriate charging arrangements to minimise any distortions. While passengers may use and benefit from services provided by non-airline users, it is also possible that other people use these services, for example, users of hotels who do not fly from or to the airport, and it is not appropriate that all passengers should effectively bear the costs of providing these services.

8.19 We have seen no convincing evidence that suggests HAL is not capable of putting in place reasonable and effective charging arrangements for ORCs consistent with the charging principles noted above.

8.20 We note HAL's comments about the potential volatility of ORC pricing stemming from the arrangements that were in place for 2021 and 2022. We are not proposing retrospectively to re-open ORC charges for 2021 and 2022 as it would add unnecessary complexity and uncertainty at this stage of the H7 process. In the event that there are any undue windfall losses or gains to HAL as a result of us not re-opening the 2022 ORC charges, then we would seek to correct for this. If necessary, we would bring forward proposals for a licence modification to put the required changes into effect in a timely manner.

8.21 Bearing the above in mind, our final decision is to continue to support a marginal cost approach to ORC pricing, but do not agree with HAL that non-airline fixed costs and annuities should be allocated to the airport charge. We are not seeking to mandate the structure of regulated airport charges or ORCs and it is for HAL to devise approaches consistent with its obligations under competition law and the ORC charging principles.

Changes to the Scope of ORCs

8.22 The Final Proposals said we would:

- give HAL and airlines the opportunity to agree to add new Specified Facilities to (or remove them from) the list of facilities covered by ORCs in Condition C2 if (i) they collectively consider this to be in the interests of consumers in the future and (ii) we agree;
- remove bus and coach services from the ORC framework so that they can move onto more dynamic commercial arrangements; and
- retain the costs of business rates largely in the scope of the airport charge but with the exception to this is that elements of business rates solely relating to non-airline users.

8.23 We said that these proposals would further the interests of consumers by ensuring that costs falling within the scope of ORCs can be reasonably recovered by the user pays principle.

Summary of stakeholders' views

8.24 HAL welcomed the proposal to remove bus and coach services from ORCs saying that it would allow HAL to improve surface access options and offer bus and coach operators differentiated pricing. Our proposal was also supported by BA. HAL welcomed our suggestion that the same principles could be applied to the Taxi Feeder Park ("TFP") and requested that CAA remove TFP from the ORC framework in our final decision.

8.25 AOC/LACC said that it opposed the proposed removal of bus and coach services from the ORC framework on the basis that it had not been appropriately consulted on this issue by either HAL or the CAA.

8.26 The London Taxi Drivers Association ("LDTA") expressed its opposition to moving the taxi feeder park outside of the ORC framework, claiming that the ORC framework provided a degree of protection to its members from HAL's commercial interests in raising prices.

8.27 The Arora Group supported the proposed self-modification process and requested that other affected parties should be included in the consultation process.

8.28 HAL opposed our proposal to keep an element of business rates, related to non-airline users, within the ORC framework claiming that it would result in a 'dual /differential' pricing approach for ORCs. The AOC/LACC, on the other hand, agreed with us that the non-airline elements of business rates should be borne by the relevant non-airline service providers and this was keeping in line with the key ORC principles.

8.29 All stakeholders supported our proposals to introduce flexibility by implementing a self-modification process.

Our views and the CAA's Final Decision

8.30 We remain of the view that a flexible framework for ORCs that encourages transparency and genuine collaboration between HAL and all users of ORC services is in the interests of consumers.

8.31 We welcome stakeholders' support for our proposals to introduce a new self-modification process to allow HAL to make changes to the list of specified services for the purposes of setting the scope of ORCs.

8.32 This new self-modification process should enable a transparent and collaborative approach by HAL and airlines to ensure that the list of services covered by ORCs remains fit for purpose as envisaged under the ORC framework. Any such changes will be made following appropriate consultation with airlines and affected parties and we expect that the views of affected parties should be properly considered as part of this process.

8.33 We do not intend to remove the TFP from the ORC framework at this stage. The collaborative nature of the ORC framework means that HAL will need to seek the agreement of the relevant stakeholders, in this case the LTDA as well as airlines. In the event that there is a dispute between the parties on this matter, then either party may seek resolution by referring a dispute to the CAA under the new dispute resolution function in the revised ORC protocols.

8.34 We do not agree with the AOC/LACC's claims that it has not been consulted on moving bus and coach services out of the ORC framework. This was discussed in the Initial Proposals in October 2021, which invited stakeholders to comment on these matters.

8.35 We note that bus and coach operators have not engaged on this issue and we have not been presented with any evidence or rationale that suggests removing bus and coach services from ORCs would not be in the interest of consumers.

8.36 There was consensus amongst stakeholders that the majority of business rates should remain in the airport charge. We remain of the view that elements of business rates that relate solely to non-airline users should be allocated to them through the ORC charging framework. This is consistent with ORC charging principles, which ultimately support the interests of consumers.

8.37 In this light, our final decisions are to:

- include provisions in HAL's Licence that will give HAL and airlines the opportunity to agree to add new Specified Facilities to (or remove them from) the list of ORCs in Condition C2 if, following consultation with affected parties, they collectively consider this to be in the interests of consumers in the future and we agree;
- remove bus and coach services from the ORC framework so that they can move onto more dynamic commercial arrangements in line with HAL's surface access strategy at the airport; and
- business rates should largely remain in the airport charge, the exception to this being that elements of business rates solely relating to non-airline use will be covered by the ORC framework.

Governance

8.38 The Final Proposals included improvements to the ORC governance arrangements that would require HAL to:

- develop, consult and agree governance and consultation arrangements for ORCs with relevant parties;
- establish clear rules, processes and information requirements to allow relevant parties to scrutinise, agree and/or where relevant challenge and propose amendments to charges that are subject to Condition C2 (Charges for other services);
- ensure relevant parties are consulted for no less than 28 days and give details on how their representations have been taken into account;
- provide a suite of governance documentation (guides, handbooks, protocols) to cover the proposed requirements;
- appoint an independent person to review HAL's ORC charges including the appropriate allocation of fixed costs and annuities in the implementation of HAL's marginal cost pricing for ORC services; and
- allow the CAA to resolve any disputes on the ORC protocols and allow the CAA to make a determination in the event of a dispute between HAL and relevant parties.

Summary of stakeholders' views

8.39 HAL reiterated its previous objections to changes to the governance arrangements claiming that the CAA risked overstretching its regulatory remit under the CAA12 and that HAL was best placed to reach the right decisions following consultation with users.

8.40 It said that the independent review was not necessary, badly defined and would ultimately add costs to consumers and that if the independent review found any issue in the split of costs then this could lead to a larger under or over recovery of costs on the part of non-airline customers.

8.41 AOC/LACC, BA and VAA and other ORC users (such as the Arora Group) supported our Final Proposals on:

- tightening ORC Governance by underpinning them in HAL's licence;
- the need for an independent dispute resolution function; and
- requiring HAL to facilitate and pay for an independent review of its cost allocation methods.

8.42 AOC/LACC asked that we ensure that the proposed licence amendments do not inadverdently rule out their participation in the ORC process and suggested that CAA retain the relevant text in conditions C2.6 and C2.7.

8.43 The Arora Group said that agreement should be sought from airlines and non-airline ORC users on the appointment of the Independent Reviewer and that the scope of the review should not be unduly narrow and should focus on a broader assessment of how HAL sets ORC shared charges. The Arora Group also requested greater involvement in the development of the ORC protocols.

Our views and the CAA's Final Decision

8.44 We have addressed HAL's concerns on our broad approach to governance in our Final Proposals.[31]

Independent Review

8.45 Given recent disputes over ORC costs and the discussion in this chapter on the appropriateness of moving certain fixed costs and annuities back into the ORC framework, it is important that a one-off independent review of HAL's allocation of the costs of the Specified Facilities between airline and aon-airline users takes place.

8.46 We note the Arora Group's comments that HAL should seek 'agreement' from airlines and other ORC users on the identity of the independent reviewer. In keeping with the collaborative nature of ORC framework, we see merit in HAL consulting both ORC users (on a reasonable endeavours basis) and the CAA prior to appointing the independent reviewer.

8.47 In the event that the one-off review identifies significant issues, these may need to be addressed by the new adjustment term in Condition C1 (Price Control) to

[31] See paras 8.61 to 8.71 in Final Proposals

ensure that the results of the review would not create windfall gains or losses for HAL.

ORC protocols

8.48 Underpinning the ORC protocols in the licence creates a strong incentive on HAL and clarifies the status of the ORC protocols around which there has been, and continues to be, confusion between HAL and stakeholders in terms of expectations around compliance.

8.49 As envisaged in our Final Proposals, alongside this Final Decision document we are publishing a consultation on high level principles-based guidance designed to help the development of new ORC protocols.

8.50 We agree with AOC/LACC that our licence amendments should not inadverdently rule out their participation in the ORC process, or the participation of other key representatives such as the LTDA, and as a result we have reinstated the text 'and their representatives' to both licence conditions C2.6 and C2.7.

8.51 We continue to be of the view that amendments to HAL's licence to strengthen governance measures are needed to ensure ORC arrangements retain flexibility and enable them to continue to deliver benefits to consumers. They are also necessary to provide a level of certainty to parties as they work together to develop the new improved governance protocols and will facilitate an effective dispute resolution process.

8.52 Our final decisions on ORC governance and dispute resolution require HAL to: :

- develop, consult and agree governance and consultation arrangements with relevant parties and their representatives;
- establish clear rules, process and information requirements to allow relevant parties to scrutinise, agree, and/or where relevant challenge and propose amendments to charges that are subject to Condition C2;
- ensure relevant parties are to be consulted for no less than 28 days;
- provide relevant parties a report setting out:
    - the revisions proposed;
    - representations made and not withdrawn; and
    - details of how the representations have been taken into account, including any revisions to the proposed changes as a result of such representations;
- provide a suite of governance documentation (guides, handbooks, protocols) to cover the requirements above;

- appoint an independent person, having consulted and sought agreement with ORC users and the CAA, to review HAL's ORC prices including the appropriate allocation of fixed costs and annuities in the implementation of HAL's marginal cost pricing for ORC services; and
- allow CAA to resolve any disputes on the ORC protocols (including the construct of the protocols themselves) and allow CAA (or another appointed independent person) to make a determination in the event of a dispute between HAL and specified users of ORC services.

Forecasts of the level of ORCs during H7

8.53 The Final Proposals agreed with HAL that basing the forecasts for the level of ORCs during H7 on its opex base was a reasonable starting point. Nonetheless, we proposed certain adjustments to the forecast, to ensure alignment with ORC principles of cost pass through, user pays and transparency of costs as well as our views on passenger numbers and opex. Bringing these considerations together, we:

- used our updated passenger forecast and opex estimates and applied the same proportion of opex (that is 15.5 per cent of opex) over the H7 period:
- added back non-airline fixed costs and annuities relating to non-airline staff car parking amounting to £4.3 million and costs of £13.8 million relating to the provision of electricity and water for non-airline use. These amounted to around £18 million[32] for each year of H7;
- added a proportion of business rates relating solely to non-airline users which amounts to another £1.3 million (nominal) for each year of H7; and
- removed £1.5 million (nominal) for bus and coach revenues from each year of H7 to reflect these services moving onto a more commercial footing.

8.54 Taking into account these adjustments, we set out the forecast in Table 8.1 for ORCs for each year of H7 (in 2020 prices):

Table 8.1 CAA Final Proposals H7 forecast

ORC H7 Final Proposals forecast, £ million (2020 prices)	2022	2023	2024	2025	2026	Total
CAA H7 Final Proposals Forecast	169	172	179	184	181	885

Source: CAA

[32] £18 million has been converted to nominal prices to allow for consistency

Summary of stakeholders' views

8.55 BA expressed concerns around basing ORC costs on a percentage of HAL's opex rather than forecasting them directly on a bottom up basis. BA said that the reliance on HAL's opex was an error as the CAA's proposals appear to have underestimated ORCs and over-estimated residual opex.

8.56 As set out above, HAL did not agree with our proposals to move fixed costs and annuities relating solely to non-airline use. HAL claimed that it was not appropriate to 'hardwire' the forecasts of ORCs for H7 on the split of airline and non-airline costs in 2019 given the variability in ORC use and that past performance and behaviours cannot be accurate predictors, especially in uncertain times.

8.57 In its General Notice of 9 December 2022, HAL confirmed its ORC charges for 2023 and restated its reservations about the CAA's Final Proposals on moving annuities and fixed costs related to non-airline users back into the ORC framework. In a separate letter (of the same date) to the CAA, HAL requested that all annuities and allocated costs for 2022 and 2023 should be reflected in the airport charges in future.

Our views and the CAA's Final Decision

8.58 BA's suggestion that we develop a bottom-up assessment of the cost of ORCs does not appear to be a proportionate approach and our projections benefit from the efficiencies identified in chapter 4 (Operating expenditure) as part of our wider assessment of opex.

8.59 In response to HAL's suggestion that it is not appropriate to hard wire the split of non-airline and airline costs from 2019 into the H7 forecast, we remain of the view that our approach to forecasting provides a reasonable basis to support the setting of the H7 price control. Where appropriate (see paragraph 8.47 above) we have committed to make adjustments to prevent HAL from experiencing windfall gains and losses.

8.60 Our final decisions to move costs solely incurred by non-airline activities out of the calculation of the regulated airport charge reflects an appropriate allocation of costs for the reasons discussed above. It is for HAL to translate these into a reasonable set of charges, bearing in mind the ORC charging principles and its obligations under competition law.

8.61 We have updated our assessment of HAL's opex for the H7 period to reflect the larger than expected increase in passengers numberss during 2022 and our forecasts for the rest of the H7 period. As a consequence, our forecast of the level of ORC charges for the H7 period, is based on revised opex allowance for H7 of £5,299 million set out in chapter 4 (Operating expenditure).

8.62 We have made the corresponding adjustments as we did for Final Proposals to ensure that the forecast we have made for the level of ORCs over the H7 period is in line with ORC charging principles. The effect of these adjustments is reflected in Table 8.2 below which sets out our final decision on the level of the forecast of ORCs for the H7 period.

Table 8.2 CAA ORC H7 forecast

ORC H7 forecast, £ million (2020 prices)	2022	2023	2024	2025	2026	Total
Total Opex (excluding rates)	1,014	1,022	1,057	1,077	1,061	5,229
15.5% of total Opex	157	158	164	167	164	811
Business rates adjusted	1.2	1.1	1.1	1.1	1.1	5.5
Bus and Coach	- 1.3	- 1.2	- 1.2	- 1.3	- 1.2	- 6.3
£18 million transfer of non—airline costs from Airport charge	18	18	18	18	18	90
CAA H7 Final Decision Forecast	**175**	**176**	**182**	**185**	**182**	**900**

Next Steps and implementation

8.63 The forecast of ORC revenues set out above has been used in the modelling of HAL's revenues under the single till revenues and, hence for the calculation of the price control discussed in chapter 13 (Calculating the price cap and financeability).

8.64 Appendix C (Notice of the CAA's decision to modify HAL's licence) to this Final Decision contains the modifications to the Licence and chapter 14 (Implementing through the Licence) sets out further details on:

- Condition C2 (Charges for other services), which explains the regulatory requirements for transparency of costs of the specified facilities and reporting requirements; and
- Condition F1 (Consultation and Governance conditions) which sets out the requirements to develop and agree the relevant arrangements for governance and consultation but leaves the content and structure of those arrangements largely up to HAL and airlines to work out, consistent with guidance issued by the CAA.

8.65 The consultation on our draft guidance on the ORC protocols and dispute resolution process designed to aide HAL and Airlines develop the new Protocols and dispute resolution function is published alongside these Final Decisions. Responses to this consultation should be submitted by 28 April 2023.