

# Heathrow Airport Limited: Response to the CMA Provisional Findings in the NERL RP3 redetermination

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## Heathrow: Response to the CMA Provisional Findings in the NERL RP3 redetermination

### 1. Executive summary

- 1.1 On 24 March 2020, the CMA published its provisional findings regarding its redetermination of the CAA's RP3 decision for NERL (the **Provisional Findings**). The CMA's decision in this redetermination materially and directly affects the operations and future success of Heathrow, and the aviation industry more widely.
- 1.2 The Provisional Findings were issued very shortly before the announcement of the UK government's emergency measures in response to the COVID-19 pandemic which have had a transformational impact on the UK economy, and aviation in particular. At this unprecedented and challenging time for the aviation sector, the CMA's decision has become more critical than could have possibly ever been anticipated at the start of the process. Against that background, the Provisional Findings must inevitably be far more provisional in nature than is normally the case at this stage in the CMA's process.
- 1.3 Heathrow previously provided a written submission to the CMA on 24 December 2019 highlighting important issues for the CMA to consider, including the CAA's decision on the weighted average cost of capital (the **Initial Submission**).<sup>1</sup> Following Heathrow's hearing with the CMA on 26 February 2020, Heathrow also submitted an additional submission to the CMA on 28 February 2020 highlighting the importance of a revised approach to the three-dimensional inefficiency (**3Di**) environmental targets applicable to NERL as the current targets raise significant concerns which have important adverse implications for the effective design of UK airspace and the future success of Heathrow (the **Additional Submission**).<sup>2</sup>
- 1.4 Since the launch of NERL's RP3 price control and Heathrow's engagement with the CMA on this topic, the aviation and airports industries are suddenly facing overwhelming challenges to their businesses in light of the global COVID-19 pandemic. The COVID-19 virus is a stark illustration of the extreme volatility and asymmetry of risk that exists for regulated businesses in the aviation industry creating much greater potential for downside than upside. As the CMA recognises in the Provisional Findings, the pandemic has led to a dramatic decline in traffic volumes<sup>3</sup> and "*there remains considerable uncertainty about the extent and duration of this impact*",<sup>4</sup> although it is already clear that the impact during calendar year 2020 will be substantial. The CMA's Provisional Findings and indeed Heathrow's previous submissions, understandably, could not take into account these new and extreme circumstances and Heathrow welcomes the CMA's request for stakeholder input to address this matter.<sup>5</sup>
- 1.5 In this submission (**Heathrow Response**) Heathrow outlines specific responses to certain substantive issues under review in Sections 2 and 3 and then outlines its

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<sup>1</sup> HAL, [Heathrow Airport Limited: third party submission in the CMA RP3 redetermination](#), 24 December 2019.

<sup>2</sup> HAL, Additional third party submission in the CMA RP3 redetermination, 28 February 2020.

<sup>3</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.23.

<sup>4</sup> CMA, [Provisional Findings](#), 24 March 2020, para 9.

<sup>5</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.23.

recommendations regarding the CMA's further steps in light of the COVID-19 pandemic in Section 4. In summary, these sections cover the following:

- (a) Section 2: the approach to cost of capital in the Provisional Findings: Heathrow submits that there are flaws in the approach to cost of capital taken by the CMA in the Provisional Findings. In particular, these flaws include: the approach taken by the CMA to TMR in relation to inflation and the use of geometric versus arithmetic returns in the calculation of TMR; the appropriateness of not departing from the established approach of "aiming up" when selecting points on a range in this context; and the combined impact of a low risk-free rate (**RFR**) and low notional gearing set by the CMA. In Section 2 and Appendices A-D, Heathrow has therefore set out additional evidence on these specific points which indicate that NERL's true WACC is higher than the current 3.08% (vanilla) in the Provisional Findings.
- (b) Section 3: the approach to 3Di targets in the Provisional Findings: Heathrow submits that the Provisional Findings wrongly include lower level airspace in the 3Di targets for NERL and that the Provisional Findings do not properly take into consideration the important evidence submitted by Heathrow in its Additional Submission on the impracticability and conflicting standards created by the CAA's determination.
- (c) Section 4: the CMA's next steps in this redetermination in light of the COVID-19 pandemic: the unprecedented situation faced by the aviation industry has significantly changed the data underlying the conclusions in the CMA's Provisional Findings – for instance, to traffic forecasts, revenue generation and financeability, all of which will require substantial updating and are affected by significant uncertainty. Therefore, as a minimum and in accordance with the CMA's statutory duties, Heathrow proposes that the CMA in its Final Determination:
  - (i) revises its Provisional Findings in the light of updated traffic and revenue forecasts for 2020 onwards; updates other market and financial data in the light of the latest economic developments and forecasts and re-assesses the Provisional Findings in that light; and
  - (ii) introduces a mechanism which will adjust NERL's regulatory asset base (**RAB**) so that any shortfalls in revenue beyond 10% (of the revenues which NERL would have been expected to be entitled to recover based on existing projections) are added to the RAB and therefore recovered over a longer period. In light of the risk asymmetry prevalent for regulated aviation businesses, this proposal would take account of the potential for extreme downside for NERL, as recent events have demonstrated, as compared against the limited upside. This proposal appropriately balances the interests of NERL and its customers, all of whom are materially affected by the current pandemic in the short run.

1.6 While Heathrow is submitting this detailed response on the issues raised in the CMA Provisional Findings, Heathrow in no way believes that resolving these issues alone will necessarily provide a sustainable basis for regulated aviation businesses going forward and reserves the position that there needs to be a more fundamental review

by the CAA and CMA of the whole basis of the regulatory framework and approach for aviation businesses subject to a price control regime. Proper consideration of these issues does not seem feasible within the current deadline set for the CMA's Final Determination.

- 1.7 The Heathrow Response adopts the defined terms included in Heathrow's Initial Submission, unless otherwise stated.

## 2. Cost of Capital

- 2.1 Heathrow submits that there are number of flaws in the CMA's approach to cost of capital in its Provisional Findings which indicate that NERL's true WACC is higher than the mid-point of the CMA's current range of 2.41% - 3.74% (vanilla) – in particular, Heathrow highlights the following issues:

- (a) Inflation: the Provisional Findings adopt an incorrect approach to inflation when calculating TMR which relies on the CMA's own estimates of CPI-deflated historical returns. Instead, Heathrow considers that the CMA should put much more weight on the use of RPI for adjusting historical returns to estimate TMR. Heathrow also provides updated evidence and analysis of historical breaks in the RPI series which, if properly taken into account by the CMA, would result in the top of the range for TMR being 0.35% higher.
- (b) Geometric averages: the Provisional Findings do not address Heathrow's previous submissions regarding the inappropriateness of geometric averages which, when considered, show that the WACC should be based on the arithmetic average return.
- (c) Aiming up: Heathrow has provided additional evidence of the positive externalities and longer term benefits of investment in airspace infrastructure and NERL's air traffic control functions which points to a continuation of the CMA's previously consistent practice of aiming up in the range.
- (d) Notional gearing and RFR:
- (i) *RFR*: the CAA's use of Index Linked Gilts (*ILG*) to estimate the RFR is inconsistent with CAPM theory. For CAPM to be valid, investors must be able to borrow at the RFR and even the lowest risk investors with AAA credit ratings cannot borrow at this low level. If the RFR is set based on the lowest cost debt available to investors it would be at around -1.0% real (RPI). This would also result in the CAPM estimation of WACC being largely independent of gearing and therefore consistent with the Modigliani and Miller theorem.
- (ii) *Notional gearing*: the Provisional Findings have gone too far in reducing the notional gearing for NERL as a result of concerns around the WACC depending strongly on gearing. The evidence shows that this dependence on gearing is likely caused by the CMA's use of RFR being below the "right" level in the CAPM formulation. Heathrow proposes that a more appropriate gearing level of approximately 50% would ensure that the WACC is not estimated incorrectly as a result of errors in the RFR.

*a. The CMA's Provisional Findings adopt an incorrect approach to inflation*

- 2.2 The CMA's approach in the Provisional Findings sought to estimate CPI-deflated historical returns and then adjust for the forward looking RPI-CPI wedge to calculate an RPI-linked TMR (given NERL's RAB is indexed to RPI). The CMA has relied on its own estimates of CPI-deflated historical returns using an inflation series comprising the consumer expenditure deflator (**CED**) dataset prior to 1947, "backcast" CPI between 1947 and 1987, and official CPI statistics thereafter.
- 2.3 The CMA relied strongly on the backcast CPI series between 1947 and 1987 in their estimation of the real TMR. On 19 March 2020, the ONS published their Consumer Prices Development plan. In this plan, they set out their aim to reassess this series and to produce a new historical series for CPIH by Q4 2020. Given that the series is to be revised, Heathrow considers that the CMA should be particularly cautious about using it for their final assessment of TMR.
- 2.4 Appendix A sets out an updated analysis by Oxera of the appropriate adjustments that need to be made to the historical RPI series as a result of historical breaks.
- 2.5 As Oxera notes, the CMA's view that RPI is a less robust measure of inflation than CPI may be an argument for using CPI instead of RPI to measure inflation today, but does not apply to the past. In particular, CPI has only been published contemporaneously since 1996, whereas RPI has been published since 1947.<sup>6</sup> This extended history for RPI is valuable when deflating historical equity returns since 1900, and forming an estimate of the required rate of return to use when setting price controls.
- 2.6 Using RPI's considerably longer time series of raw underlying price data means that important economic shocks that investors have faced in the past, and may potentially face in the future, can be captured. By contrast, using a back-cast estimate of inflation from CPI means that the majority of the series is estimated rather than observed.
- 2.7 Taken together with the proposed revision of the backcast series by the ONS, which points to caution in respect of historical estimates of CPI, Heathrow considers that the CMA should put much more weight on the use of RPI for adjusting historical returns to estimate TMR.
- 2.8 In Appendix A, Oxera also updates the analysis that was previously submitted to the CMA of historical breaks in the RPI series.<sup>7</sup> This shows that there have been significant methodological changes in the RPI series other than just the 2010 change referred to in the Provisional Findings.<sup>8</sup> Making a selective upward adjustment to the long-run average of RPI inflation based on just the 2010 change, as has been done in the Provisional Findings, ignores these other changes and is therefore not a robust approach and is likely to bias the estimate of long-run RPI upwards.
- 2.9 Oxera shows that the changes in the early 1990s have an impact roughly equal and opposite to the change in 2010. Once these changes are accounted for, they show it would be appropriate to deflate the long-run average equity return using the published RPI data without making any further adjustments for the forecast wedge between RPI

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<sup>6</sup> The Interim Index of Retail Prices was introduced in 1947, which underwent methodological changes and became the Index of Retail Prices in 1956.

<sup>7</sup> Oxera, 'Estimating RPI-adjusted equity market returns', 2 August 2019 – Appendix D to the Initial Submission.

<sup>8</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.207.

and CPI inflation. The CMA should therefore correct the analysis of this point in its Final Determination which would result in the top of the range for TMR being 0.35% higher.

*b. The Provisional Findings do not address Heathrow's previous submissions regarding the inappropriateness of geometric averages*

- 2.10 In its Provisional Findings on TMR, the CMA has not addressed the points in Heathrow's submission dated 24 December 2019 that the WACC should be based on arithmetic average return.<sup>9</sup> The CMA considers that the investors of NERL are long-term and therefore it bases its assessment of the TMR on the returns that might be expected over a holding periods of 10 and 20 years. Whilst we agree that this approach is correct for estimating the required returns of investors over their likely holding period, it is not correct for setting the allowed regulatory return. This is because the allowed regulatory return is used to set a series of annual returns around which there is risk. If the other parameters of the determination are chosen appropriately, then in some years actual returns will be higher than the regulatory allowance and in other years they will be below. The result of this is that, over time, the average achieved return by the regulated company will be below the return used to set charges in each year.<sup>10</sup>
- 2.11 In effect, by using the expected return over a longer period to set the allowed WACC, the CMA is ensuring that the expected returns available to investors are below this expected longer-period return. To avoid this error, the CMA should base its estimate of TMR on the arithmetic average. Table 12.4 of the Provisional Findings shows that the appropriate TMR based on an arithmetic estimate is 6.0% real (RPI) based on the CPI series<sup>11</sup> and 6.7% real (RPI) based on the RPI series.
- 2.12 In summary, in order to allow NERL to achieve the right level of returns over both the short-term and the long-term, the CMA should base its estimate of TMR on the arithmetic average.

*c. There is strong evidence of the welfare benefits associated with the CMA's previous consistent practice of aiming up*

- 2.13 In the Provisional Findings, the CMA states that "*if there are positive externalities and longer-term benefits to consumers from identifying and investing in new capital projects, then we agree that there could be the case for a long-term premium on the cost of capital.*"<sup>12</sup>
- 2.14 Heathrow has provided additional evidence of the positive externalities and longer term benefits of investment in airspace infrastructure and NERL's air traffic control functions which points to a continuation of the CMA's previously consistent practice of aiming up in the range. Appendix B sets out an analysis by Oxera which demonstrates that, to maximise consumer welfare for consumers of NERL's service, the CMA should aim up towards the top end of their range.

<sup>9</sup> HAL, [Heathrow: Third Party Submission in the CMA RP3 Determination](#), 24 December 2019, para 5.28-5.33.

<sup>10</sup> This is because the geometric mean of a series of returns will always be lower than the arithmetic average.

<sup>11</sup> Based on 7.0% real (CPI) and an RPI-CPI wedge of 1.0%

<sup>12</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.289.

- 2.15 The analysis by Oxera builds on the analysis published by the UKRN in March 2018 by relaxing the assumption that all investment is halted if the WACC is too low. Oxera's analysis shows that for NERL:
- (a) Even under a low proportion of investment at risk, aiming up on the WACC is likely to be in consumers interests.
  - (b) The lower the price elasticity of demand, the higher the 'safety cushion' should be between the allowed return and the central estimate of WACC.
  - (c) For realistic values of the price elasticity, customer welfare is maximised by setting the allowed return at or above the 96th percentile of the WACC distribution.
- 2.16 Oxera also shows that aiming up is also appropriate in respect of existing investment as well as new investment. If the return on existing investment is reduced then investors will expect this to be applied to new investments at the next regulatory settlement. This will result in the company's expected return being the blended return over the life of their investments.
- 2.17 In addition to aiming up within the WACC range to ensure consumer welfare is maximised, there are additional reasons why the higher end of the WACC range identified by the CMA is more likely to be appropriate than the lower half of the range including:
- (a) The nature of air travel is that risks are asymmetric as events can lead to much greater downsides than upsides. The impact of COVID-19 is a stark illustration of this asymmetry. The estimation of beta undertaken by the CMA is based on the assumption that returns are normally distributed. Given this assumption does not hold for air travel, it is likely that using the centre of the range for beta will result in returns being too low as a result of the risk asymmetry. As a consequence, the upper end of the beta range is more likely to result in an appropriate rate of return for NERL than the lower half.
  - (b) Heathrow considers that the upper end of the CMA's range for TMR is more likely to be correct than the lower end of the range. The lower end of the range reflects use of historical CPI data that are under review and use of geometric return averages that are not appropriate for setting a series of annual regulatory returns. Given this, Heathrow considers that the lower end of the CMA range is not credible.

*d. The CMA's approach to gearing is inappropriate*

- 2.18 Both the CAA and NERL assume a notional gearing ratio of 60% in their cost of capital estimates.<sup>13</sup> Despite this, in the Provisional Findings, the CMA has opted to use a lower notional gearing ratio of 30% for RP3 on the basis that the established approach of re-levering asset betas at the notional gearing level has the effect that the WACC estimate increases with gearing and therefore results in customers overpaying.<sup>14</sup>

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<sup>13</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.99, 12.100.

<sup>14</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.105, 12.108.

- 2.19 While the CMA acknowledges that the established approach may have become the standard used by UK regulators, the CMA believes that it has the unwelcome effect of resulting in WACCs that strictly increase with levels of gearing (contrary to both academic theory and corporate finance experience).<sup>15</sup>
- 2.20 However, this lower notional gearing ratio of 30% has a significant impact on the equity beta and also affects the cost of debt through increasing the weight on embedded debt.<sup>16</sup> Heathrow submits that the Provisional Findings have gone too far in setting a lower gearing ratio of 30%. As a pragmatic approach for NERL, Heathrow proposes increasing notional gearing to approximately 50% and using an RFR of around -1.0% real (RPI) consistent with CAPM theory. Adopting this approach will result in a combination of parameters that reduces the risk of over or underestimating the NERL's WACC and also provides an estimate with a low dependence on gearing.
- 2.21 Heathrow sets out at Appendix C detailed economic evidence which illustrates that:
- (a) The feature of high dependency on gearing identified by the CMA is primarily a consequence of the low RFR estimated by the CMA in its Provisional Findings. The RFR used in the CMA's CAPM formulation is likely not the "right" RFR for CAPM as it is too low.
  - (b) The theory of CAPM requires that investors are able to borrow at the RFR. Appendix D shows that even the lowest risk AAA rated private investors cannot borrow at a RFR derived from ILG. Heathrow considers that a better approach is to base the estimate of the RFR on the lowest risk corporate debt rather than using ILGs. A RFR of around -1.0% real (RPI) would be consistent with CAPM as this is the actual lowest cost at which investors can borrow in practice. In addition, opting a RFR of -1.0% results in the dependence of WACC on gearing being removed consistent with corporate finance theory.
  - (c) The low gearing level of 30% together with a low RFR results in a high risk that the WACC is significantly underestimated.
- 2.22 It is possible to select a level of gearing that removes the impact of any error in the estimate of the RFR by, in relation to NERL, increasing notional gearing to approximately 50%. This level of gearing results in an equity beta of 1.0 – at this equity beta, the cost of equity is equal to the market return. This adjustment will minimise the impact on the WACC of any errors in the estimation of the RFR. Heathrow therefore urges the CMA to reconsider this level of gearing in its Final Determination and propose a more appropriate level of notional gearing for NERL of approximately 50%.

### **3. NERL's 3Di targets must not be based on matters conflicting thresholds which are outside NERL's control**

- 3.1 As referenced in Heathrow's Additional Submission, NERL is subject to 3Di targets which aim to incentivise NERL to promote fuel efficient routes. NERL proposed *"including vertical cut-offs: removing data below 7,000ft for arrivals and 9,000ft for*

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<sup>15</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.105, 12.107.

<sup>16</sup> CMA, [Provisional Findings](#), 24 March 2020, para 12.98.



departures”<sup>17</sup> in order to focus on achievable efficiencies as well as to align the incentive regime with recent Government policy<sup>18</sup> and CAA guidance which prioritise mitigating the effect of noise on overflowed communities.<sup>19</sup> Heathrow supports NERL’s position which it considers to be in the best interests of air traffic control and the airspace design initiative more broadly.

- 3.2 However, in the CAA’s final decision,<sup>20</sup> the CAA rejected the adjustment proposed by NERL to exclude the lower level airspace without any coherent explanation as to why it considers that the exclusions would not be in airspace users’ interests.<sup>21</sup> The Provisional Findings have also rejected the inclusion of the proposed vertical cut-off in the 3Di metric<sup>22</sup> without fully engaging with the evidence set out in Heathrow’s Additional Submission. Heathrow submits that the reasoning in the Provisional Findings does not justify the current conclusion on 3Di in this respect.
- 3.3 In the Provisional Findings, the CMA recognised that *“it is good regulatory practice to focus on controllable risks, particularly where financial rewards and penalties result from the exposure”*.<sup>23</sup> Nevertheless, the CMA proceeds to act contrary to this sound principle in relation to NERL’s 3Di targets in concluding that *“on balance, [...] imposing a target that combines exposure to both controllable and non-controllable risks is an appropriate approach.”*<sup>24</sup> To support this position, the CMA stated that *“it is not always fully practicable to fully separate controllable from non-controllable risks. NERL is also exposed, for example, to volume risk, the large majority of which will be outside its control.”*<sup>25</sup> The reason given by the CMA for not acting in accordance with its own standard of good regulatory practice in this instance is not apposite: there is an easy and practicable way to design an incentive regime for NERL which is based on controllable risks for NERL.
- 3.4 For the following reasons, Heathrow submits that the CMA’s approach cannot justify the inclusion of airspace below 7,000ft for arrivals and 9,000ft for departures in NERL’s 3Di targets<sup>26</sup>:
- (a) Including lower level airspace cannot reasonably be seen as an appropriate approach “on balance”. In light of the concerns raised in Heathrow’s Additional Submission, it cannot be good regulation or in the public interest to deliberately create incentives for NERL which are at odds with UK Government policy<sup>27</sup> which clearly states that noise reduction should be prioritised over fuel burn

<sup>17</sup> NERL, [RP3 Business Plan – Appendix G](#), 26 October 2018, page 43; CAA, [RP3 decision](#), August 2019, para 3.23.

<sup>18</sup> DfT, [Moving Britain Ahead - Guidance to the CAA on its environmental objectives when carrying out its air navigation functions, and to the CAA and wider industry on airspace and noise management](#), October 2017.

<sup>19</sup> NERL, [RP3 Business Plan – Appendix G](#), 26 October 2018, page 43; CAA, [RP3 decision](#), August 2019, para 3.23.

<sup>20</sup> CAA, [RP3 decision](#), August 2019, para 3.38.

<sup>21</sup> CAA, [Response to NERL Statement of Case](#), December 2019, para 4.17; NERL, [Response to CAA Response](#), 30 December 2019, para 106.

<sup>22</sup> CMA, [Provisional Findings](#), 24 March 2020, para 5.38.

<sup>23</sup> CMA, [Provisional Findings](#), 24 March 2020, para 5.38.

<sup>24</sup> CMA, [Provisional Findings](#), 24 March 2020, para 5.38.

<sup>25</sup> CMA, [Provisional Findings](#), 24 March 2020, para 5.38.

<sup>26</sup> CAA, [RP3 decision](#), August 2019, para 3.23.

<sup>27</sup> HAL, Additional third party submission in the CMA RP3 redetermination, 28 February 2020, para 1.17.

and emissions measures in airspace below 7,000ft.<sup>28</sup> The 3Di targets therefore create an unnecessary and unacceptable level of conflict which may end up distorting insights into NERL's performance on its 3Di targets. This conflict, which is easily avoidable, clearly distinguishes inclusion of lower airspace from risk comparators referred to by the CMA such as volume risk.

- (b) Including lower level airspace has a disproportionate impact on the 3Di targets. The inclusion of the lower level airspace is a non-controllable risk which comprises a considerable proportion of the current proposals for the 3Di target. With *almost half* of the current UK 3Di score coming from flights below 9,000ft for departures and below 7,000ft for arrivals, NERL will be unfairly measured based on the changes made by others. The CAA agreed to exclude "*training, positioning, surveillance, calibration flights and other non-revenue flights*"<sup>29</sup> on the basis these "*may have a disproportionately large impact on the 3Di score and do not typically seek to maximise flight efficiency*".<sup>30</sup> Heathrow submits that the CAA's logic in accepting this adjustment should similarly apply to the inclusion of the vertical cut-off.
- (c) Lower level airspace can be practicably excluded from the 3Di metric. Contrary to the position in the Provisional Findings,<sup>31</sup> the specific uncontrollable risk related to the lower level airspace can in fact be practicably, even easily, excluded from the 3Di targets without "*sanitising the 3Di metric of any real insights into how NERL performs on flight efficiency*".<sup>32</sup> The data for the lower level airspace can simply be removed from the 3Di metric, in contrast to the practical difficulties in addressing volume risk which the CMA appears to use as a relevant comparator.<sup>33</sup> If anything, the exclusion of lower airspace will create a more accurate measure since the area being measured will no longer include airspace subject to conflicting objectives which are beyond NERL's control.
- (d) Detrimental impact on airspace design and operational performance. Heathrow is particularly concerned that the CMA has not fully considered the wider implications if 3Di remains a KPI for the low level airspace which were previously set out in Heathrow's Additional Submission.<sup>34</sup> The Provisional Findings appear to take a generalised approach that does not engage with the reality of the impact the 3Di targets may have on NERL, Heathrow and other airports across the UK including:
- (i) Challenges in negotiating airspace design. The misaligned incentives inherent in the current 3Di target make Heathrow / NERL collaboration far more challenging when negotiating air space design. As explained in the Additional Submission, this significant issue has been highlighted through the recent discussions on airspace design between Heathrow

<sup>28</sup> DfT, [Moving Britain Ahead - Guidance to the CAA on its environmental objectives when carrying out its air navigation functions, and to the CAA and wider industry on airspace and noise management](#), October 2017, para 3.3.

<sup>29</sup> CAA, [RP3 decision](#), para 3.24.

<sup>30</sup> CAA, [RP3 decision](#), para 3.24.

<sup>31</sup> CMA, [Provisional Findings](#), para 5.38.

<sup>32</sup> CAA, [RP3 decision](#), August 2019, para 3.24.

<sup>33</sup> CAA, [RP3 decision](#), August 2019, para 3.24.

<sup>34</sup> HAL, Additional third party submission in the CMA RP3 redetermination, 28 February 2020, para 1.15.

and NERL. The 3Di targets have created an incentive framework which has led NERL to advocate for changes which benefit its 3Di performance, but that operate in direct conflict with Heathrow's requirement to facilitate UK government policy and the interests of local communities. The competing objectives created by the 3Di targets prioritising fuel efficiency and the UK Government policy on noise reduction creates an unacceptable (and unnecessary) level of potential conflict and risk for the already challenging task of airspace design.

- (ii) Challenges in operational performance. As explained in the Additional Submission,<sup>35</sup> as the airspace controllers are measured in the live environment on 3Di - which is improved by shortcutting – there is therefore a real risk that the current approach to NERL's 3Di target undermines the low level design (which is based on noise priority) once in operation.

3.5 The airspace community, and airspace modernisation in particular, are facing unexpected additional challenges due to the current global COVID-19 crisis. At this difficult juncture for the airspace community, it is all the more critical that the CMA does not create additional and unnecessary roadblocks for the redesign of airspace and for the collaborative working relationship between air traffic control and airports.

#### **4. The CMA has a statutory duty to make appropriate revisions to its Final Determination in the light of the extreme challenges and volatility caused by the current COVID-19 pandemic**

4.1 The aviation industry is facing unprecedented upheaval due to the COVID-19 pandemic resulting in extreme volatility. Aviation and airport industries are suddenly being forced to react in various ways to protect their businesses. Global capacity was down 19.4% in March 2020 and is expected to fall close to 60% in April 2020, according to OAG a provider of digital flight data and analytics.<sup>36</sup> Heathrow expects passenger traffic to fall by c.95% in April 2020 with lasting and significant industry-wide effects predicted.<sup>37</sup> It is not clear how long it will take for air traffic to recover or whether it will ever regain its previous level or rate of growth.

4.2 Following the precipitous fall in air traffic, Heathrow has been operating its landings and take-offs from one runway and consolidated two of its four terminals.<sup>38</sup> These drastic measures have been mirrored in airports across the country and affect all players in the air transport industry including NERL. For example, Gatwick has closed one of its two terminals and its runway will only be open for scheduled flights between 2pm and 10pm.<sup>39</sup>

<sup>35</sup> HAL, Additional third party submission in the CMA RP3 redetermination, 28 February 2020, para 1.15.

<sup>36</sup> Forbes, *How COVID-19 Is Transforming Global Aviation's Outlook*, 6 April 2020, <https://www.forbes.com/sites/oliverwymann/2020/04/06/how-covid-19-is-transforming-global-aviations-outlook/#290fa5ae1b9c> (accessed 8 April 2020).

<sup>37</sup> Heathrow estimate for April 2020 based on actual traffic up to 10 April 2020 and forecast for the rest of month.

<sup>38</sup> Heathrow, *Heathrow serves as vital airbridge for the UK amid COVID crisis*, 14 April 2020, <https://mediacentre.heathrow.com/pressrelease/details/81/Corporate-operational-24/12242> (accessed 14 April 2020).

<sup>39</sup> The Independent, *Coronavirus Heathrow to close one runway after major air traffic fall*, 2 April 2020, <https://www.independent.co.uk/travel/news-and-advice/coronavirus-heathrow-airport-runway-close-british-airways-latest-news-a9444556.html> (accessed 16 April 2020)

*CMA duties*

- 4.3 These changes are sudden and generate significant uncertainty thereby materially altering the circumstances and data underlying the CMA's Provisional Findings, which will require substantial updating. The CMA has the power and indeed the duty to update its conclusions in light of the most recent data and to make the necessary provision in its Final Determination to address the impact of the COVID-19 pandemic on NERL.
- 4.4 As the CMA noted in its Provisional Findings, under the Transport Act 2000 (*TA 2000*), the CMA must investigate and report on whether matters in the NERL Reference *"operate against the public interest."*<sup>40</sup> In doing so, the CMA should also specify any modifications to the licence required to prevent or remedy any effects adverse to the public interest.<sup>41</sup> When deciding whether a matter operates against the public interest, the CMA must have regard to the statutory duties imposed on the Secretary of State and the CAA.<sup>42</sup> Importantly, the CAA's primary duty is to maintain a high standard of safety in the provision of air traffic services,<sup>43</sup> and the CAA's secondary duties include ensuring that licence holders will not find it unduly difficult to finance their licenced activities<sup>44</sup> and to further the interests of operators and owners of aircraft.<sup>45</sup>
- 4.5 In the Provisional Findings, Heathrow welcomes the CMA's recognition, in line with Heathrow's previous submissions, that, in making its RP3 decision in accordance with CAA statutory duties, this *"does not mean that [the CMA] is required to follow the same approach that the CAA has adopted or adopt the same methodologies"*.<sup>46</sup> Furthermore, the CMA states that its *"approach should build on, but not be unduly constrained by, the analysis already carried out by the CAA."*<sup>47</sup>
- 4.6 The CMA already mentions the importance of proportionality and good administration in its Provisional Findings in determining which issues to focus on in the price control.<sup>48</sup> In line with these guiding principles, in its Final Determination, the CMA should take account of material changes which have taken place in the interim between its Provisional Findings and the Final Determination as it could not possibly be in the public interest to produce findings which do not take account of these current circumstances.<sup>49</sup> The ability of NERL to continue its operations in a safe and effective

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<sup>40</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.16 – see TA 2000, section 12(1)(a).

<sup>41</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.17 – see TA 2000, section 12(1)(b).

<sup>42</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.19 – see TA 2000, section 12(8).

<sup>43</sup> TA 2000, section 2(1).

<sup>44</sup> TA 2000, section 2(2)(c).

<sup>45</sup> TA 2000, section 2(2)(a).

<sup>46</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.19.

<sup>47</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.20.

<sup>48</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.22.

<sup>49</sup> There are various other examples of the CMA varying its findings between Provisional Findings and Final Determination due to material changes that arose in the interim – for example, in the Movies on pay TV market investigation where the CMA *"reconsidered and revised our original analysis both in light of points raised in response to our August 2011 provisional findings and in light of the developments taking place in the market with which that analysis appeared to be inconsistent"* (see [Report](#), para 51). In addition, Heathrow notes the statements in the CMA's merger guidance which apply equally in these circumstances which anticipate the possibility of *"changes to its provisional decisions on the statutory questions as a result of evidence received following publication of its Provisional Findings"* and suggests that where appropriate the CMA *"may publish, or otherwise disclose to the main parties a description of its reasons for changing its provisional decision in order to provide parties with an opportunity to comment prior to publication of the final report"* (see [CMA2](#), para 13.13).

manner will be contingent on this regulatory decision and the funding required to support its licenced operations, especially at this critical time for the aviation industry.

#### *Heathrow proposals*

- 4.7 On the basis of the CMA's approach set out above, Heathrow submits that the CMA should introduce additional adjustments into its Final Determination to address COVID-19 and sets out below two proposals. Heathrow considers these proposals represent the most appropriate way forward for the CMA in carrying out its statutory duties in the public interest.
- 4.8 First, Heathrow notes that the CMA has already recognised that *"the data used in [the Provisional Findings] (e.g. market data, traffic volumes) will therefore not necessarily be the same data that will be used for a) the CMA's Final Report and b) the final price control. This is particularly the case given the current COVID-19 situation and impact on traffic volumes"*.<sup>50</sup> Accordingly, Heathrow proposes that the CMA in its Final Determination revises its Provisional Findings in light of updated traffic and revenue forecasts for 2020 onwards, updates other market and financial data in the light of the latest economic developments and forecasts, and re-assesses the Provisional Findings in that light.
- 4.9 Second, since the COVID-19 pandemic has significantly affected NERL's operations and revenue, Heathrow proposes that the CMA in its Final Determination introduces a mechanism which will adjust NERL's RAB so that any shortfalls in revenue beyond 10% (of the revenues which NERL would have been expected to be entitled to recover based on existing projections) are added to the RAB. This mechanism could be used to recover the shortfall in revenue in 2020 in a manner that allows it to be recovered over a much longer period and thereby minimises the short-term impact on charges to airlines.
- 4.10 In line with the CMA's statutory duties, this proposal (or another similar mechanism) appropriately balances the need to make provision for NERL to ensure it can continue efficient and safe operation, including in the COVID-19 circumstances, and the interests of NERL's customers, all of whom are materially affected by the pandemic. The ability to spread the cost of any revenue shortfall over a longer period of time is key to acting in the public interest in light of the current drastic impact of the COVID-19 crisis on NERL's customer base which make it difficult to pass on any short term cost increases.
- 4.11 This proposed remedy would also take account of the risk asymmetry prevalent in regulated industries in the aviation sector whereby there is limited potential upside and yet potential downside is vast, as recent events have demonstrated. In addition, this mechanism would reduce adverse impacts on NERL's financeability by assuring lenders that there is an appropriate mechanism in place to recover the shortfall going forward.
- 4.12 Heathrow would be happy to discuss these proposals or any other point raised in this response if that would be of assistance to the CMA.

**17 April 2020**  
**Heathrow Airport Limited**

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<sup>50</sup> CMA, [Provisional Findings](#), 24 March 2020, para 3.21.