Before the Competition and Markets Authority

In the matter of an Appeal under section 25 of the Civil Aviation Act 2012

B E T W E E N:

BRITISH AIRWAYS PLC

Appellant

and

CIVIL AVIATION AUTHORITY

Respondent

NOTICE OF APPEAL

AIRPORT LICENCE CONDITION

H7

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1. INTRODUCTION

1.1 Overview

1.1.1 This Notice of Appeal ("**NOA**") is filed on behalf of British Airways plc ("**BA**" or "**Appellant**"), a company registered in England and Wales under Company Number 01777777. Its principal business is in the provision of domestic and international air transportation services.

1.1.2 BA is a global airline, the United Kingdom's flag carrier airline and the largest subsidiary in the International Airlines Group ("**IAG**"). BA's principal place of business is London, and it has a significant presence at London's airports, including at London Heathrow Airport ("**Heathrow Airport**"). It operates an extensive international schedule on both long-haul and short-haul routes from Heathrow Airport, operating passenger services, and carrying cargo.

1.1.3 Heathrow Airport Limited ("**HAL**") is the operator of Heathrow Airport. Heathrow Airport is a dominant airport within the meaning of section 5 of the Civil Aviation Act ("**CAA2012**"). In accordance with section 3 of CAA2012, HAL holds an economic licence granted by the Civil Aviation Authority ("**CAA**") pursuant to section 15 of CAA2012 which authorises it to levy charges for the airport operation services ("**AOS**") it delivers at Heathrow Airport.

1.1.4 The CAA is an independent economic regulator whose duties in relation to the economic regulation of AOS are set out in CAA2012. Importantly, section 1 gives the CAA a general ("primary") duty to carry out its functions under CAA2012 in a manner which it considers will further the interests of users of airport transport services.

1.1.5 One of the CAA's core responsibilities is to develop, in accordance with its duties under CAA2012, the regulatory frameworks within which dominant airports must operate. Broadly speaking, the CAA describes this as "*designing through analysis and*

consultation a suite of modifications to HAL's economic licence, including limits on the maximum airport charges it can levy on airlines."[1]

1.1.6 Section 19 of CAA2012 provides that the CAA must ensure that HAL's licence includes such price cap condition as the CAA considers "*necessary or expedient having regard to the risk referred to in Section 18(1)(a)*" (that is, the risk that the holder of the licence may engage in conduct that amounts to an abuse of substantial market power in a market for AOS).

1.1.7 These limits on maximum airport charges are given effect to by way of a price control condition in HAL's economic licence. In short, the price control condition prescribes the maximum revenue yield per passenger that HAL is permitted to collect from airlines during the relevant regulatory period.

1.1.8 These airport charges apply on a per passenger basis and, as acknowledged by the CAA, are among the highest in the world.[2] In the H7 Final Decision, the CAA explained that HAL has significant market power which, if left unconstrained, has the potential to damage consumers' interests for example through higher prices, lower quality services and facilities and inefficiencies.[3] The CAA stated that to further the interests of consumers it had sought to ensure that HAL's future charges will be "*no higher than necessary*".[4]

1.1.9 This appeal concerns the H7 Final Decision made by the CAA to modify HAL's licence conditions to give effect to the CAA's Final Proposal's for the H7 price control review

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[1] CAA, *Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow: CAP1541*, June 2017, page 9, paragraph 3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_88/page 6536**.

[2] CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary,* 28 June 2022, page 9 paragraph 27, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_26/page 1362**.

[3] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, page 4 paragraph 4, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 13**.

[4] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, pages 4-5 paragraph 5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 13-14**.

("**H7 Final Proposals**"), published in a notice dated 8 March 2023 ("**H7 Final Decision**").

1.1.10 The H7 Final Decision sets out the CAA's final decision for the price control and associated regulatory framework that will apply to HAL for the five-year period starting in January 2022 and ending in December 2026 ("**H7**"). The licence modifications are due to take retrospective effect on 1 May 2023.

1.2 Request for permission to appeal

1.2.1 BA seeks permission from the Competition and Markets Authority ("**CMA**") under section 25 of CAA2012 to bring an appeal (and, if permission is granted, to appeal) against the H7 Final Decision.

1.2.2 Section 25(2)(b) of CAA2012 provides that a "*provider of air transport services whose interests are materially affected by a decision*" may bring an appeal. Section 69 of CAA2012 provides that:

(a) 'Air transport service' means "*a service for the carriage by air of passengers or cargo to or from an airport in the United Kingdom*".

(b) 'Provider' means "*a person who has the management of the aircraft used to provide the service*".

1.2.3 As more particularly described in the Witness Statement of Alexander James Dawe ("**AD1**") and Gavin Molloy ("**GM1**"):

(a) BA is a provider of air transport services as defined in CAA2012, and holds Air Operator Certificate 441. BA is the largest holder of take-off and landing slots at Heathrow. Heathrow is BA's home base airport from which it flies to more than 200 destinations in 80 countries.

(b) BA's interests are materially affected by the H7 Final Decision because it sets the charges that HAL may impose on airlines- including BA- in relation to passenger services to and from Heathrow Airport. The H7 Final Decision has increased these charges, with the average airport charges payable per passenger by BA and our customers, increasing to **£**23.22 average per passenger (2020p).

(c) The materiality of the errors identified in this NOA result in a further **£**513 million in passengers charge, an increase to the weighted average cost of capital ("**WACC**") of **£**720 million, and a **£**300 million increase to the regulatory asset base ("**RAB**"). Cumulatively, the materiality of these errors is around **£**1,540 million (in 2020p).

1.2.4 This means that BA is directly and materially affected by the H7 Final Decision.

1.2.5 Based on the above, BA has standing to bring an appeal against the H7 Final Decision.

1.2.6 For the reasons developed below, the proposed grounds have (at least) a reasonable prospect of success.

1.3 Scope Of Appeal

1.3.1 In accordance with the Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) ("**CMA Guide**"), on 4 April 2023 BA notified:

(a) the CMA, by email from its legal representative, that it was considering bringing an appeal against the H7 Final Decision; and

(b) the CAA, directly by email, that it was considering bringing an appeal against the H7 Final Decision.

1.3.2 Having regard to the overriding objective for the CMA to dispose of appeals fairly, efficiently and at proportionate cost within the time limits prescribed by CAA2012,[5] BA has carefully considered the H7 Final Decision and has focused its appeal on three issues where BA considers the H7 Final Decision is wrong:

(a) **Ground 1** concerns the CAA's errors in setting the passenger ("**PAX**") forecast for the H7 period too low;

(b) **Ground 2** concerns the CAA's errors in failing to review, reverse or reduce a **£**300 million upward adjustment to the regulated asset base ("**RAB**") of HAL,

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[5] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022, page 3, rule 4.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 4402.**

and in making that adjustment in the first place and then confirming it through the opening RAB for H7; and

(c) **Ground 3** concerns the CAA's errors in setting the Weighted Average Cost of Capital ("**WACC**") for the H7 period too high.

1.3.3 BA submits that the CAA's decision in respect of each of these grounds is "*wrong*" within the meaning of section 26 of CAA2012 for the reasons explained in Sections 3, 4 and 5.

1.3.4 These errors are material because of their harmful impact on consumers, their financial impact on BA over the period covered by the H7 price control, the potential impact on future price controls, and for reasons of regulatory and economic principle.

1.3.5 Details of the relief sought by the BA are set out under each ground of appeal.

1.4 Key Documents

1.4.1 The grounds of this appeal, reasons and supporting evidence are contained in this NOA, in Exhibit **NOA1**, and in expert and witness evidence (including exhibits).

1.4.2 BA has provided written evidence for this appeal in the form of:

(a) Witness Statement of Alexander James Dawe, Group Head of Economics and Regulation at International Airlines Group, dated 18 April 2023 ("**AD1**");

(b) Witness Statement of Gavin Molloy, Director of Airport Regulation and Infrastructure at British Airways, dated 18 April 2023 ("**GM1**");

(c) 'Assessment of the CAA's H7 RAB Adjustment': an Expert Report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023 ("**RAB Report**")[6]; and

[6] AlixPartners, *Assessment of the CAA's H7 RAB Adjustment, Report prepared for British Airways, Virgin Atlantic Airways and Delta Air Lines,* "**RAB Report**", 17 April 2023.

(d) 'Cost of capital issues raised by the Heathrow Airport H7 price control': an Expert Report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023 ("**WACC Report**")[7].

1.4.3 A copy of the H7 Final decision is contained in the bundle titled "BA- CAA H7 Final Decision Bundle", but the key sections of the H7 Final Decision for the purposes of this appeal are those referred to by the CAA as:

(a) A Summary document;

(b) Section 1 on the regulatory framework;

(c) Section 2 on the key price control building blocks;

(d) Section 3 on the financial framework;

(e) Appendix C (which contains Notice of the CAA's decision to modify HAL's licence).

1.4.4 The relevant Statutory Framework is set out at Section 2.

1.4.5 A list of other key documents in **NOA1**, and an indication of relevant sections of such documents, is provided in Schedule 2.

1.4.6 A chronology of the key steps the CAA took in setting the H7 price control, culminating in the H7 Final Decision, is provided in Schedule 3.

1.4.7 A glossary of terms used in this NOA is provided in Schedule 4, which reflects abbreviations and definitions in the CAA's glossary (at Appendix B to the H7 Final Decision) to the greatest extent possible.

1.4.8 BA has endeavoured to provide all of the facts, reasons, documentary evidence and witness statements in support of its appeal within this NOA. However, it may be necessary for the Appellant to apply to the CMA for permission to make further

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[7] AlixPartners, *Cost of capital issues raised by the Heathrow Airport H7 Price Control Report prepared for British Airways, Virgin Atlantic Airways and Delta Air Lines*, "**WACC Report**", 17 April 2023.

submissions or provide supplementary evidence during the course of the appeal (for example, following receipt of the CAA's response and any disclosure).[8]

1.5 Request for appeals to be considered together

1.5.1 Paragraph 2(3) of Schedule 2 to CAA2012 permits the CMA to grant permission to appeal subject to conditions, including conditions requiring the appeal to be considered together with other appeals, including appeals brought by different persons.

1.5.2 If the CMA grants the BA permission to appeal against the H7 Final Decision, and also grants permission to appeal against that decision to any other airline, BA requests that those appeals be considered together:

(a) BA considers that consolidation of appeals by airlines against the H7 Final Decision would be appropriate and consistent with the overriding objective because the appeals are related and it will allow a more streamlined and efficient process.

(b) Moreover, to the extent HAL also appeals on common grounds, BA considers that such appeals should be heard together.

1.5.3 BA further notes that, in the event of multiple appeals against the H7 Final Decision, it would have no objection to the CMA extending the appeal period under section 28(3) of CAA2012 given the additional CMA time, resource and case management which would be required.

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[8] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022, page 19, rule 12.5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 4418**.

1.6 Contact Details

Appellant:

[redacted]

Appellant's legal representatives and address for receiving documents:

[redacted]

2. STATUTORY FRAMEWORK

2.1 Overview

2.1.1 In this section, the Appellant describes the legal framework governing this appeal in six parts:

(a) the statutory grounds of appeal;

(b) the CMA rules regulating the conduct and disposal of airport licence condition appeals;

(c) the CAA's statutory duties;

(d) relevant public law principles;

(e) the standard of review to be applied by the CMA; and

(f) the CMA's powers when allowing an appeal.

2.2 Statutory grounds of appeal

2.2.1 Under section 26 of CAA2012, having granted permission, the CMA may allow an appeal only to the extent it is satisfied that the decision appealed against was "*wrong*" on one or more of the following grounds:

(a) that the decision was based on an **error of fact** (section 26(a) of CAA2012);

(b) that the decision was **wrong in law** (section 26(b) of CAA2012);

(c) that an error was made in the exercise of discretion (section 26(c) of CAA2012).

2.2.2 In determining an appeal, including taking decisions and giving directions, the CMA must, as required by section 30 of CAA2012, have regard to the matters in respect of which duties are imposed on the CAA by section 1 of CAA2012. These matters and duties are addressed in section 2 below.

2.2.3 The CMA must not, however, in accordance with paragraph 23(3) of Schedule 2 to CAA2012, have regard to any matter, information or evidence which was not

considered by the CAA in making the H7 Final Decision unless the CMA considers that:

(a) the CAA could not reasonably have been expected to consider the matter, information or evidence, or the relevant person could not reasonably have raised the matter with the CAA or provided the information or evidence to the CAA during the period in which the CAA was making that decision; and

(b) the matter, information or evidence is likely to have an important effect on the outcome of the appeal, either by itself or taken together with other matters, information or evidence.

2.3 CMA rules regulating the conduct and disposal of appeals

2.3.1 Paragraph 31 of Schedule 2 to CAA2012 provides that the CMA Board may make rules regulating the conduct and disposal of appeals.

2.3.2 The Appellant notes that the CMA Board has recently made the Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) (the **CMA Rules**) and issued the CMA Guide, both dated 27 October 2022 (which supersede the previous rules and guide governing airport licence condition appeals which had effect from 12 February 2014).[9]

2.3.3 The CMA Rules provide (rule 4.1) that their overriding objective is to enable the CMA to exercise its appeal functions fairly, efficiently and in accordance with the time limits prescribed by CAA2012, and that all parties to an appeal must assist the CMA to further this overriding objective (rule 4.2).

2.3.4 The CMA Guide describes the CMA Rules as seeking "*to ensure that the [CMA] has flexibility to manage appeals fairly and expeditiously and at proportionate cost, having regard to the interests of the parties to the appeal and interested third parties and the*

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[9] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022, exhibited to this Notice of Appeal and marked **BA_NOA1_58/page 4398-4423** and CMA, *CMA173 Airport Licence Condition Appeals: Competition and Markets Authority Guide,* 27 October 2022, (**CMA Guide**), exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_59/page 4424-4458**.

statutory time frames" and notes that this "*sentiment is reflected in the overriding objective*".[10]

2.3.5 The Appellant notes that, following determination of an appeal, the CMA may have regard to – among other things – the extent to which each party has assisted the CMA to meet the overriding objective in deciding what (if any) inter parties costs order to make under the CMA Rules (rule 19.3).

2.4 The CAA's statutory duties

2.4.1 Section 1(1) of CAA2012 provides that the **CAA's general duty**[11] in relation to the economic regulation of AOS is to carry out its statutory functions in a manner which it considers will **further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS**. Users of air transport services are defined in section 69 of CAA2012 as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). The CAA collectively refers to them as 'consumers'.

2.4.2 Under section 1(2) of CAA2012, the CAA must further the interests of consumers, where appropriate, by carrying out its functions in a manner which it considers will **promote competition in the provision of AOS**.

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[10] CMA, *CMA173 Airport Licence Condition Appeals: Competition and Markets Authority Guide* (**CMA Guide**), 27 October 2022, page 2, paragraph 1.4, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_59/page 4427**.

[11] Section 1(7) of CAA2012 provides that section 4 of the Civil Aviation Act 1982 (CAA's general objectives) does not apply in relation to the carrying out by the CAA of its functions under this Chapter of CAA2012 – *Civil Aviation Act 2012 c.19*, Part 1 Chapter 1, section 1(7), page 2 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_55/page 4288**.

2.4.3 Section 1(3) of CAA2012 provides that, when performing its statutory duties under subsections (1) and (2), the CAA must have regard to:

(a) the need to secure that each licence holder is able to **finance** its provision of AOS in the area for which the licence is granted (section 1(3)(a))[12];

(b) the need to secure that all **reasonable demands** for AOS are met (section 1(3)(b))[13];

(c) the need to promote **economy and efficiency** on the part of each licence holder in its provision of AOS at the airport to which the licence relates (section 1(3)(c))[14];

(d) the need to secure that each licence holder is able to take reasonable measures to reduce, control or mitigate the adverse **environmental effects** of the airport to which the licence relates, facilities used or intended to be used in connection

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[12] Civil Aviation Act 2012, Explanatory Notes (**Explanatory Notes**) state: "*Whilst this should require the CAA to encourage efficient and economic investment by allowing a reasonable return over time, the financing duty does not require the CAA to ensure the financing of regulated airports in all circumstances, for example the CAA would not be required to adjust regulatory decisions in order to take account of an operator's particular financing arrangements or put the interests of users at risk by making them pay for an inefficient operator's financing decisions*" – *Civil Aviation Act 2012 c.19,* page 7, paragraph 36(a), exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_57/page 4360**.

[13] See note 14 below.

[14] Civil Aviation Act 2012, Explanatory Notes (**Explanatory Notes**) state, with regard to the need to secure that reasonable demands for AOS are met and the need to promote economy and efficiency in the provision of such services: "*One would expect both of those needs to be met in a competitive airports market where airport operators provide the services demanded by passengers at minimum cost. The requirement to have regard to those needs reflects the fact that the ultimate aim of economic regulation is, as far as is possible, to replicate the outcomes of a competitive market*" – s *Civil Aviation Act 2012 c.19,* page 7, paragraph 36(b), exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_57/page 4360**.

with that airport (associated facilities) and aircraft using that airport (section 1(3)(d));[15]

(e) any relevant **guidance** issued to the CAA by the Secretary of State (section1 (3)(e)). In this regard, it should be noted that the Secretary of State for Transport sent an open letter to the CAA on 1 December 2020 entitled 'Secretary of State Priorities for the Civil Aviation Authority.'[16] The first priority – and "*most important immediate task*" set out in that letter was "*supporting the recovery and growth of the aviation industry*";

(f) any relevant **international obligation** of the UK notified to the CAA by the Secretary of State (section 1(3)(f)); and

(g) the **better regulation** principles, namely that regulatory activities should be carried out in a way that is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed (sections 1(3)(g) and 1(4)). These principles are more particularly defined by the Better Regulation Task Force[17] as follows:

(i) Transparent: Regulators should be open, and keep regulations simple and user-friendly.

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[15] Section 1(6) of CAA2012 states that the environmental effects of the airport, associated facilities and aircraft include: substances, energy, noise, vibration or waste, including emissions, discharges and other releases into the environment; visual or other disturbance to the public; effects from works carried out at the airport or the associated facilities or to extend the airport or the associated facilities; and effects from services provided at the airport or the associated facilities – *Civil Aviation Act 2012 c.19*, section 1(6), exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_55/page 4288**.

[16] Department of Transport, *Letter to Sir Stephen Hillier as Chair of the Civil Aviation Authority*, 1 December 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_79/page 6149-6152**.

[17] Better Regulation Task Force, *Principles of Good Regulation*, 2003, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_82/page 6157-6168**.

These principles are further enshrined in the Regulator's Code, to which all UK regulators must comply. Department for Business Innovation & Skills, Better Regulation Delivery Office, *Regulators' Code*, 2014, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_6137-6143**.

(ii) Accountable: Regulators must be able to justify decisions, and be subject to public scrutiny.

(iii) Proportionate: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.

(iv) Consistent: Government rules and standards must be joined up and implemented fairly. This includes the principle that regulation should be predictable in order to give stability and certainty to those being regulated.

(v) Targeted: Regulation should be focused on the problem, and minimise side effects.[18]

2.4.4 Section 1(5) of CAA2012 provides that if, in a particular case, the CAA considers there is a conflict between the interests of different classes of user of air transport services, or between the interests of users of air transport services in the range, availability, continuity, cost and quality of AOS, the CAA's duty is to carry out its functions in a manner which it considers will further such of those interests as it thinks best.

2.4.5 Under section 22 of CAA2012, the Appellant notes that the CAA also has a number of specific procedural obligations with which it must comply in order to make a lawful licence modification decision. Of relevance to this appeal, section 22(7) of CAA2012

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[18] The Appellant also notes that the Government has consulted on Department for Business, Energy & Industrial Strategy, *Reforming the Framework for Better Regulation: A Consultation*, July 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_94/page 8027-8086** and indicated an intention to reform the Better Regulation Framework in the summary to the consultation, HM Government, *Reforming the Framework for Better Regulation: Summary of Responses to the Consultation,* January 2022, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_101/page 9797-9823** and in HM Government, *The Benefits of Brexit: How the UK is taking advantage of leaving the EU*, January 2022, at pages 20-29 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_102/page 9846-9855** (setting out proposals under five new regulatory principles including 'proportionality' ("*we will pursue non-regulatory options where we can", and "will act decisively to put [strong rules] in place and enforce them vigorously*" where they are needed) and 'recognising what works' (regulations will be thoroughly analysed to ensure they work in the real world). Next steps are currently awaited.

provides that the CAA is not to be treated as having complied with the necessary procedural requirements in relation to a modification of a licence if the modification "*differs significantly*" from the modification proposed in the notice.

2.5 Relevant public law principles

2.5.1 As a public body exercising its public function, the CAA must also act in accordance with relevant public law principles when making a licence modification decision. These include acting within its powers (*intra vires)*, rationally and in a procedurally fair manner (including meeting the requirements of proper and fair consultation, including re-consultation[19]).

2.5.2 The starting point in determining the duty to re-consult is an evaluation of the differences, taking account of their nature and extent, between the CAA's proposal and the decision which the CAA in fact made. The duty to re-consult arises:

(a) where it has been determined that it is necessary to re-open key decisions in a staged decision-making process which had already been settled prior to consultation occurring; or

(b) where the key criteria set out for determining the decision and against which the consultation occurred have been changed; or

(c) where a central or vital evidential premise of the proposed decision on which the consultation was based has been completely falsified.[20]

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[19] *R (on the application of Maureen Smith) v East Kent Hospital NHS Trust, Kent, and Medway Health Authority* [2002] EWHC 2640 (Admin), Silber J at pages 9-10, paragraphs 42 to 45 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_68/page 5773-5774**.

[20] *Keep Wythenshawe Special Limited v NHS Central Manchester CCG, NHS North Manchester CCG, NHS South Manchester CCG, NHS Stockport CCG, NHS Tameside and Glossop CCG, NHS Bolton CCG, NHS Bury CCG, NHS Salford CCG, NHS Wigan CCG, NHS Heywood Middleton and Rochdale CCG, NHS Trafford CCG, NHS Oldham CCG v University Hospital of South Manchester NHS Foundation Trust, NHS North Derbyshire CCG, Derbyshire County Council, Stockport NHS Foundation Trust, NHS Commissioning Board (NHS England), High Peak Borough Council at [2016]* EWHC 17 (Admin), Dove J at page 29, paragraph 75 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_74/page 5988**.

2.5.3 As set out in paragraph 2.4.4 above, the CAA must carry out its functions in a manner which it considers will further such interest as it thinks best, if the CAA considers that there is conflict between different users, or classes of users, of air transport services. Antecedent to this discretion are the principles set out in section 1(4) of CAA2012, including the principle of proportionality. This precludes the CAA from intervening where unnecessary, or where less intrusive alternatives are available.[21]

2.5.4 A measure adopted by the CAA will be proportionate if the CMA determines in the affirmative: "*(i) whether its objective is sufficiently important to justify the limitation of a fundamental right; (ii) whether it is rationally connected to the objective; (iii) whether a less intrusive measure could have been used; and (iv) whether, having regard to these matters and to the severity of the consequences, a fair balance has been struck between the rights of the individual and the interests of the community*".[22]

2.5.5 Any failure to act in accordance with these public law principles will be an error of law.

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[21] The Court of Appeal has accepted that goodwill, including commercial contracts, constitute "property" for purposes of the courts' proportionality analysis in relation to an interference with fundamental rights: *Department for Energy, Climate Change v Breyer Group PLC and Others* [2015] EWCA Civ 408, Lord Dyson MR at page 17, paragraph 49 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_73/page 5945**. as cited in *Npower v GEMA* in footnote 22 (below) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_75/page 6008-6054**.

[22] *R (Gravis Solar 1 Limited, AMP GM011 Limited) v Gas and Electricity Markets Authority* [2021] EWHC 490 (Admin) pages 14-15, paragraph 37 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_77/page 6126-6127**. citing the speech of Lord Sumption in *Bank Mellat v HM Treasury (No.2)* [2014] AC 700 [2014] AC 700 at paragraph 20 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_72/page 5867**; and *Npower Direct Limited, Npower Limited, Npower Northern Limited, Npower Northern Supply Limited, Npower Yorkshire Limited, Npower Yorkshire Supply Limited v Gas and Electricity Markets Authority v Competition and Markets Authority* [2018] EWHC 3576 (Admin), at pages 34-40 paragraphs 126 to 132 exhibited to this Notice of Appeal and marked Exhibit **75/page 6041-6047**, concerning near identical provisions to section 1(4) of CAA2012 (namely, section 3A(5A) Electricity Act 1989 exhibited to this Notice of Appeal and marked **BA_NOA1_54/page 4282** and section 4(AA)(5A) Gas Act 1986) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_55/page 4288**.

2.6 The standard of review to be applied by the CMA

2.6.1 The Appellant notes that this is the first airport licence condition appeal to the CMA. However, the CMA's experience in determining energy licence modification appeals[23] will be of assistance as there are similarities between the airport licence condition appeal regime under section 25 of CAA2012 and the CMA's energy licence modification appeal regime under section 23B of the Gas Act 1986, section 11C of the Electricity Act 1989, The Gas (Northern Ireland) Order 1996 and The Electricity (Northern Ireland) Order 1992.

2.6.2 This similarity was recognised explicitly by the CMA in its open letter on the CMA's licence modification appeal rules and guidance, dated 7 December 2021, in which it noted: "*The existing sectors where there are the most directly comparable appeals regimes covering the same or similar grounds of appeal are energy and airports*".[24]

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[23] Namely, British Gas Trading v The Gas and Electricity Markets Authority - Final Determination (***BGT v GEMA* [2015]**) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_61/page 4589-4761**, Northern Powergrid (Yorkshire) Plc v The Gas and Electricity Markets Authority (***NPg v GEMA* [2015]**) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_60/page 4459-4588** in respect of GEMA's RIIO-1 electricity distribution price control, the subsequent appeals by Firmus Energy (*Firmus Energy (Distribution) Limited v NIAUR* [2017] (***Firmus v NIAUR* [2017]**) exhibited to this Notice of Appeal and marked Exhibit **62/page 4762-4970** and SONI Limited (*SONI Limited v NIAUR* [2017]) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_63/page 4971-5282** under The Gas (Northern Ireland) Order 1996 and The Electricity (Northern Ireland) Order 1992 respectively and, most recently, the appeals brought by Cadent Gas, National Grid Electricity Transmission, National Grid Gas, Northern Gas Networks, Scottish Hydro Electric Transmission, Southern Gas Networks and Scotland Gas Networks (jointly), SP Transmission and Wales and West Utilities in relation to Ofgem's RIIO-T2 and RIIO-GD2 price control determinations. *Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited v Gas and Electricity Markets Authority*, Final Determinations, 28 October 2021.

[24] CMA, *Open letter to industry on the CMA's licence modification appeal rules and guidance: Consultation Outcome*, 7 December 2021exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_104/page 9984-9987**.

2.6.3 Based on CAA2012, the CMA Rules, the CMA Guide and previous energy licence modification appeals before the CMA[25], the CMA's approach to the standard of review can be summarised as follows:

(a) The CMA is not limited to reviewing the decision under appeal on conventional judicial review grounds. The standard of review goes further than this. The key question for the CMA to determine is whether the decision was, on the balance of probabilities, wrong on one or more of the prescribed statutory grounds. In order to do that, the merits of the CAA's decision must be taken into account.

(b) In relation to the CAA's exercise of discretion, it is not the CMA's role to substitute its judgment simply on the basis that it would have taken a different view of the matter. The statutory test clearly admits of circumstances in which the CMA might reach a different view from the CAA, but in which it cannot be said that the CAA's decision was wrong on one of the statutory grounds. In relation to questions of regulatory judgment, the CAA will be afforded a margin of appreciation as an expert regulator, and its margin of appreciation will be greatest where all that is impugned is an overall value judgment based upon competing considerations in the context of a public policy decision. However, that margin of appreciation is not unbounded. In circumstances where the CAA has exercised its judgment in reaching a decision on a specific issue, the CAA cannot ignore relevant evidence or base its decision(s) on unreliable data, and the CMA will find an error where there is sufficiently persuasive evidence that an alternative approach is clearly superior. On the other hand, where the alternative options each have competing pros and cons, and none is clearly superior, the CMA will be unlikely to find that the CAA has made an error.

(c) The CMA must determine whether a finding of fact or inference is wrong where that is in issue. The CMA will assess evaluations of fact by the CAA in the same way as the exercise of discretion (i.e. not substituting its judgment for that of the CAA simply on the basis that it would have taken a different view, but only if it is satisfied that the conclusion lies outside the bounds within which

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[25] See footnote 23 above.

reasonable disagreement is possible). The CMA will afford the CAA no margin of appreciation where plain errors of primary fact (or inferences from such primary facts) are identified.

(d) The CMA, in assessing errors of law, will evaluate whether the CAA has misdirected itself on its legal obligations in making its decision or reached a conclusion which was substantively or procedurally unlawful. A decision is also 'wrong in law' where it contravenes the principles applicable in judicial review, including that a decision is unlawful where it falls outside "*the range of responses which a reasonable decision-maker might have made in the circumstances*" (i.e. it is irrational in the public law sense).[26] For example, whether the CAA has failed to take proper account of relevant considerations, acted in defiance of logic, failed properly to inquire, acted disproportionately or in a discriminatory manner with no good reason, reached conclusions without adequate supporting evidence, placed reliance on evidence or assumptions which are flawed, failed to discharge its statutory duties under CAA2012, made methodological errors and/or made procedural errors (e.g. whether the CAA has consulted with an open mind and taken conscientious account of representations received). A decision may also be wrong in law on the basis of an arithmetic error.[27] As regards errors relating to procedure, however, the CMA will only take into account procedural deficiencies if they are so serious that the CMA cannot be assured that the decision was not wrong.[28]

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[26] *Soomatee Gokool & Ors v Permanent Secretary of the Ministry of Health and Quality of Life & Anor* [2008] UKPC 54, at pages 7-8, paragraph 18 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_69/page 5796-5797**.

[27] *Danae Air Transport v Air Canada* [2000] 1 WLR 395, at page 406 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_67/page 5754**.

[28] *Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited v Gas and Electricity Markets Authority*, Final Determinations, 28 October 2021, Volume 1, page 41, paragraph 3.54 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_64/page 5326**.

(e) The CMA's review is distinct from a *de novo* consideration of the merits, but must consider the merits to the extent necessary to determine whether the challenged decision is wrong under the statutory ground(s) relied upon in the appeal. The CMA will review the CAA's decision through the prism of the specific errors that are raised. Where no errors are pleaded, the decision to that extent will not be the subject of specific review.

(f) The CMA will only interfere if it considers that an error is material. Whether an error is material must be decided on a case-by-case basis taking into account the particular circumstances of each case. However, in previous cases the bar for materiality has been low. For example, in its RIIO-2 decision,[29] the CMA found an error amounting to an uplift of only 0.2% to be "*clearly material*". There is therefore no bright-line test for materiality. Relevant factors for determining materiality in each case would include the impact of the error on the overall price control, whether the cost of addressing the error would be disproportionate to the value of the error, whether the error is likely to have an effect on future price controls, and whether the error relates to a matter of economic or regulatory principle. This is not an exhaustive list.[30] The CMA will also consider, where appropriate, whether the cumulative effect of immaterial errors could have a highly significant impact on the price control.[31]

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[29] *Cadent Gas Limited, National Grid Electricity Transmission plc, National Grid Gas plc, Northern Gas Networks Limited, Scottish Hydro Electric Transmission plc, Southern Gas Networks plc and Scotland Gas Networks plc, SP Transmission plc, Wales & West Utilities Limited v Gas and Electricity Markets Authority*, Final Determinations, 28 October 2021, Volume 2B, page 257, paragraph 7.804 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_65/page 5603**.

[30] See *British Gas Trading v The Gas and Electricity Markets Authority - Final Determination* (***BGT v GEMA* [2015]**), pages 24-25, paragraphs 3.57-3.61 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_61/page 4615-4616**. See also *Firmus Energy (Distribution) Limited v NIAUR* [2017] (***Firmus v NIAUR* [2017]),** page 18, paragraph 3.24 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_62/page 4782**.

[31] See *Energy Licence Modification Appeals 2021, Final Determination*, Volume 1, 2021, pages 49-51 paragraphs 3.89-3.97 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_100/page 9667-9669**.

2.6.4 Taking into account the above, and having regard to the CMA's overriding objective, the Appellant has limited its appeal against the H7 Final Decision to areas where that decision was wrong and the errors made are material.

2.7 The CMA's powers when allowing an appeal

2.7.1 By virtue of section 27(2) of CAA2012, if the CMA allows an appeal against a decision by the CAA to modify a licence condition under section 22 of CAA2012, it must do one or more of the following:

(a) quash the decision;

(b) remit the matter back to the CAA for reconsideration and decision in accordance with any directions given by the CMA;

(c) substitute the CMA's own decision for that of the CAA and give directions to the CAA or HAL.[32]

2.7.2 Under section 27(4) of CAA2012, where the CMA substitutes its own decision for that of the CAA, it may give directions to the CAA and HAL. Section 27(5) of CAA2012 provides that the CMA must not give a direction that requires a person to do anything that the person would not have power to do apart from the direction, and section 27(6) of CAA2012 provides that a person to whom a direction is given must comply with it. Section 27(7) of CAA2012 provides that any direction given to HAL is enforceable in England as if it were an order of the High Court.

2.7.3 The CMA must, in accordance with section 29 of CAA2012, determine an appeal by publishing an order containing its decision, with reasons. Where the CMA is

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See also CMA, *CMA172, Airport Licence Condition Appeals: Competition and Markets Authority Rules* (CMA172) (**CMA Rules**), 27 October 2022, pages 21-22 rule 17.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 4420**.

considering appeals or parts of appeals together, it may elect to make a single final determination in relation to two or more appeals in part or in their entirety.[33]

2.7.4 The CMA's determination will take effect at the time specified in the order or determined in accordance with the order.

[33] CMA, *CMA172, Airport Licence Condition Appeals: Competition and Markets Authority Rules* (CMA172) (**CMA Rules**), 27 October 2022, page 22 rule 17.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 4421**.

3. GROUND 1: PASSENGER FORECASTING

This ground concerns the CAA's errors in forecasting the number of passengers travelling to and from Heathrow airport during each year of the H7 price control period (passenger forecasts) too low.

3.1 Key documents

3.2 The key evidence that the Appellant requests the CMA reads when considering this ground is:

3.2.1 Chapter 1 of the H7 Final Decision in which the CAA explains the process it undertook in setting the passenger forecast for H7 and the results of this process;

3.2.2 Chapter 1 of the H7 Final Proposals;

3.2.3 A report by Skylark entitled **"**H7 Forecast Update Review**"** dated February 2023 which was commissioned by the CAA (**"Final Decision Skylark Report"**); and

3.2.4 Paragraphs 45 to 119 of AD1.

3.2.5 The witness statement of GM1.

3.2.6 Table 1.6 of the H7 Final Decision, reproduced below:[34]

H7 Final Decision: Table 1.6 Final Decision passenger forecast, H7 – final stage

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA FP: Mid (shocked)	54.9	67.3	75.4	81.0	81.6	360.2

[34] The Appellant has amended the left-hand column to label each step (and therefore to show more clearly the impact of each step of the CAA's four step methodology (described more fully below), on the passenger forecast.

CAA FP Mid (unshocked)	55.4	67.9	76.0	81.7	82.3	363.4
Step 1: Updated for actuals and bookings	61.6	74.4	80.6	82.2	82.9	381.7
Step 2: Updated for economic forecasts	61.6	73.6	79.6	81.4	82.0	378.2
Step 3: Validated against external forecasts	61.6	73.6	79.6	81.4	82.0	378.2
Step 4: CAA FD Mid (shocked)	61.6	73.0	78.9	80.7	81.3	375.5

3.3 Summary of errors

3.3.1 In making its H7 Final Decision in relation to passenger forecasts, the Appellant contends that the CAA erroneously:

(a) Took as its "baseline" figures which were determined by the use of an outdated and demonstrably inaccurate model provided to the CAA (but not the Appellant or other airlines in a way that permitted meaningful comment) by HAL. This rendered the process unfair (amounting to a material error of law and/or a material error in the exercise of its discretion) and led to the inclusion of a flawed input to the forecasting exercise (resulting in a material error of fact and/or a material error in the exercise of its discretion); and

(b) Concluded that the evident failures in the model could be addressed by a series of "*adjustments*", specifically the four "*steps*" set out at paragraph 1.53-1.67 of Chapter 1 of the H7 Final Decision[35]. Each of those four steps are themselves tainted by material errors. However, even if one were to assume that those "*adjustments*" could be defended, the CAA was in any event wrong to conclude that these were capable of addressing the difficulties posed by the HAL model.

3.3.2 Further details of these errors are set out below.

3.4 Consequence of the errors and materiality

3.4.1 The consequence of these errors, both individually and collectively, is that the maximum allowed yield per passenger (i.e. the per passenger charge) has been set too high, contrary to the interests of consumers.

3.4.2 The errors are material. Once corrected, based on estimates using current data available, the passenger forecast increases by 17 million passengers over the five-year price control period, and resulting in the maximum allowed yield per passenger being reduced by just over **£**1.32 on average over the period.

Table 1. Corrected passenger forecasts considered by the Appellant (April 2023)

Passengers (million)	**2022**	**2023**	**2024**	**2025**	**2026**	**H7**
CAA's decision	61.6	73.0	78.9	80.7	81.3	375.5
Corrected passenger forecasts[36]	64.3	77.6	82.0	83.6	85.0	392.5

[35] CAA, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* Chapter 1, paragraphs 1.53-1.67, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 48-52**.

[36] This is the mid-case considered by the Appellant, as of April 2023. See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 47.

3.5 Summary of Relief

3.5.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it implements these erroneous passenger forecasts. Furthermore, the CMA should exercise its powers to determine the appropriate passenger forecasts by reference to a permissible methodology. The Appellant considers that there are two alternative approaches open to the CMA:

(a) The first (and that which the Appellant considers is most likely to yield an accurate result, for reasons set out in more detail below) is for the CMA to conclude that, in the absence of disclosure, no regard should be had to the HAL model, and that the forecast should instead by reckoned by other inputs. The Appellant invites the CMA to substitute the CAA's passenger forecasts with figures reckoned by the methodology proposed by BA in GM1, and make any consequential amendments to other affected elements of the H7 Final Decision, including in relation to the final passenger charge.[37]

(b) Alternatively, if the CMA considers that it may be appropriate to retain use of HAL's model in reckoning the correct figure, the CMA could issue directions as to how this could fairly occur. Here, the CMA could direct that the relevant iterations of the HAL model (i.e. that provided by HAL to the CAA as well as the version containing the CAA's adjustments, and HAL's December 2022 version) be disclosed in a form that allows the Appellant (with the assistance of external airline forecasting specialists to interrogate the model rigorously and subject to appropriate confidentiality terms) in accordance with 12.2 of the Airport Licence Condition Appeal Rules[38] and paragraph 24 of Schedule 2 of the CAA2012[39]. With the benefit of such disclosure, the Appellant would be in

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[37] See Witness Statement of Gavin Molloy, dated 18 April 2023.

[38] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022 rule 12.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 4416.**

[39] CAA2012, Schedule 2, paragraph 24, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_56/page 4347**.

a position to provide meaningful comments as to the suitability of the model, and any adjustments or amendments which it considers necessary (together with evidence in support of such contentions). The Appellant would expect that the CMA would be assisted by such submissions and evidence (together with HAL and the CAA's responses), and would invite the CMA to make consequential directions as to the timing and process, should this course commend itself to the CMA.

3.6 Overview of Ground 1

3.6.1 This ground concerns the CAA's errors in forecasting the number of passengers travelling to and from Heathrow airport during each year of the H7 price control period (passenger forecasts) too low. Under- or over-estimating passenger forecasts by even a relatively small amount can have significant consequences for the appropriateness of the final figure:

(a) As the H7 Final Decision rightly noted at paragraphs 1.1 to 1.3[40], passenger forecasts are a "*key driver*" of the CAA's calculation of the overall airport charge. The airport charge is calculated on a per-passenger basis, and is therefore highly sensitive to changes in passenger forecasts. Furthermore, passenger forecasts directly influence other key building blocks feeding into the airport charge; in particular, passenger traffic is a key driver of HAL's expected operating expenditure and commercial revenues. Moreover, the adjustments to the airport charge resulting from the traffic risk sharing ("**TRS**") mechanism are calculated with reference to the variations between projected and actual allowed revenues (which are in turn driven by the differences between projected and actual passenger traffic).

(b) Therefore, as the CAA itself highlighted in its H7 Final Decision,[41] ensuring that passenger forecasts are appropriate "*is a fundamental step in allowing us*

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[40] CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* paragraphs 1.1-1.3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 37**.

[41] CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* paragraph 1.3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 37**.

properly to further the interests of consumers, having regard to the matters required by CAA12."

(c) AD1 highlights the significance of the passenger forecast figures at paragraphs 50-53, noting in particular the different passenger forecasts adopted by the CAA throughout the H7 consultation process and the substantial financial impact which these fluctuations have on the total level of the charge HAL is permitted to levy.

3.6.2 As is demonstrated below, what has – in fact – occurred in the H7 Final Decision is that the forecast has been materially under-estimated, with the consequence that HAL will be over-compensated and consumers will be harmed. This is because when actual passenger numbers exceed forecasts, HAL will benefit from additional revenues for the following reasons:

(a) Using lower passenger forecasts as the basis for calculating the price cap results in a higher overall per-passenger charge.

(b) When actual passenger traffic exceeds the forecast, HAL receives additional revenues (equal to the passenger charge multiplied by the difference between forecast and actual passenger numbers).

3.6.3 The materiality of the error is such that, both individually and collectively, the maximum allowed yield per passenger (i.e. the per passenger charge) has been set too high, contrary to the interests of consumers. This has the consequence that HAL will be over-compensated and consumers will be harmed. This is because when actual passenger numbers exceed forecasts, HAL will benefit from additional revenues for the following reasons:

(a) using lower passenger forecasts as the basis for calculating the price cap results in a higher overall per-passenger charge; and

(b) when actual passenger traffic exceeds the forecast, HAL receives additional revenues (equal to the passenger charge multiplied by the difference between forecast and actual passenger numbers).

3.6.4 The errors are material. Once corrected, based on estimates using current data available, the passenger forecast increases by 17 million passengers over the five-year price control period, and resulting in the maximum allowed yield per passenger being reduced by just over £1.32 on average over the period (see Table 1 above).

3.6.5 Furthermore, it is important to recognise that the consequences of this error are not limited to the determination of the correct passenger forecast. This is because (as AD1 explains at paragraphs 50-53 and 89.2) there is a significant interplay between passenger volumes and other building blocks within the price control.

3.6.6 The CAA's assessment of these matters by necessity relies on the underlying HAL model due to the nature of the data and information contained with that model. In the absence of its own modelling, the HAL model was inevitably a key source for the CAA for other building blocks (specifically opex and commercial revenues) which are inherently reliant on detailed data as to (amongst other things) markets and demography of passengers. An example of where CAA must have relied on the HAL model is in the assessment of commercial revenues, the quantification of which is highly sensitive to both volume and type of customer as certain customers in certain markets have a higher propensity to spend than others.

3.6.7 The error stems from the methodology employed by the CAA, as set out in chapter 1 of its H7 Final Decision. There, the CAA erroneously:

(a) Took as its "baseline" figures which were determined by the use of an outdated and demonstrably inaccurate model provided to the CAA (but <u>not</u> to the Appellant and other airlines in a way that permitted meaningful comment) by HAL. This rendered the process unfair (amounting to a material error of law and/or a material error in the exercise of its discretion) and led to the inclusion of a flawed input to the forecasting exercise (resulting in a material error of fact and/or a material error in the exercise of its discretion); and

(b) Concluded that the evident failures in the model could be addressed by a series of "*adjustments*", specifically the four "steps" set out at paragraphs 1.53-1.67 of

Chapter 1 of the H7 Final Decision[42]. Each of those four steps are themselves tainted by material errors (as set out at in part 3.11 below). However, even if one were to assume that those "adjustments" could be defended, the CAA was in any event wrong to conclude that these were capable of addressing the difficulties posed by the HAL model.

3.6.8 The errors in the CAA's methodology for calculating passenger forecasts (and their consequences for the determination as a whole) are such as to render it "*wrong*" within the meaning of section 26 CAA2012.

3.6.9 These errors can be remedied by adopting one of the courses of action set out at section 3.5 above.

3.7 Erroneous Use of HAL's Model

3.7.1 It is important at the outset to understand the CAA's approach and the use which the CAA made of HAL's model.

(a) The starting point here is the CAA's explanation in its H7 Final Proposals of the "*challenging set of circumstances*" it was faced with due to the fact that "*HAL has not been prepared to share its modelling in a full and transparent way with stakeholders*", which had in turn "*undermined [its] confidence in the credibility and robustness of HAL's passenger forecasts and caused us to place less weight on this evidence*"[43].

(b) Nevertheless, as the CAA went on to explain in the section of the H7 Final Proposals headed "*How we have used HAL's model*", "*a forecast using our assumptions and HAL's model remains the starting point for developing our*

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[42] *CAA, CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* Chapter 1, Paragraphs 1.53-1.67, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 48-52**.

[43] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework,* paragraphs 1.15-1.16, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/page 1395**.

own forecasts."[44] In other words, HAL's model was at the core of the CAA's methodology. It was the baseline to which "adjustments" were made.

(c) The adjustments which the CAA had made to the HAL model were (for the most part) those which it had set out in the Initial Proposals[45] and an additional adjustment was made to reflect the reduction in business travel.[46] The result was what the CAA referred to as the "*CAA-amended (unshocked HAL) mid case*", which in turn was described as its "*baseline*"[47]. To arrive at its passenger forecasts in its H7 Final Proposals, the CAA then made a series of further "*adjustments*" to the figure which was produced by the CAA amended HAL model[48].

(d) As a result, whilst the CAA described its approach in the H7 Final Proposals as using "*both HAL's model and a wider range of independent forecasts…drawing on a wider and deeper evidence base to enhance our method, taking into account a wide range of industry views on recovery*", the passenger forecast

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[44] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework*, paragraphs 1.20, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/page 1396**.

[45] CAA, *CAP2265B, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 1: Overall Approach and Building Blocks, 22 October 2021,* paragraph 2.23 -2.43, page 23 - 26, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_21/pages 886 -889.**

[46] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework,* paragraph 1.43, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/1403**.

[47] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework*, paragraph 1.67 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/1409** .

[48] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework,* paragraph 1.42, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/1403**.

remains based upon a CAA adjusted version of the HAL model. In other words, the HAL model was the central input, or the "*baseline*", to the CAA's process.

(e) This methodology set out in the H7 Final Proposals was confirmed in the H7 Final Decision, with adjustments "*to reflect actual demand and forward bookings observed up to December 2022, and the change in economic outlook since we published the Final Proposals*".[49]

(f) While the Appellant's case is that those adjustments are themselves erroneous (for reasons which are addressed separately – see paragraphs 3.8.4-3.8.7), the approach is also flawed for the prior and fundamental reason that the adjustments were made to a figure reckoned by reference to a "*baseline*" determined by an adjusted version of the HAL model.

(g) In other words, the CAA layered adjustment on adjustment to the HAL model. Implicit in this is the assumption that the HAL model produced an acceptable baseline which, when subjected to those adjustments, produced a credible figure. This is simply not an assumption which the CAA could make – for the reasons the CAA itself acknowledged – i.e. because the credibility and robustness of the HAL model was undermined by HAL's lack of transparency and refusal to share the model with the airlines in a way that permitted meaningful comment.

(h) This meant that the CAA was unable to receive informed consultation responses in relation to the methodology it had adopted, and therefore unable itself to make informed conclusions about the HAL model's accuracy. This error was so material that it undermines all of the subsequent steps which the CAA sought to take, starting from the HAL model.

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[49] This approach is also confirmed at paragraph 1.27 of the Final Determination, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1)* where the CAA explains that it had used an "*amended version of HAL's forecast model as well as external forecasts and data and forecasts provided by stakeholders*" so as to produce its forecast, Final Determination, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* paragraph 1.27, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 42**.

(i) To put it shortly, the CAA's error was that, having identified the difficulties with HAL's model, it concluded that these could be cured by adjusting it. For the reasons set out below, this was not possible. Instead, two courses of action were properly open to the CAA:

(i) It could have explained to HAL it would not have any regard to its modelling unless HAL shared that modelling with stakeholders (perhaps subject to the use of a consensual confidentiality ring, as appropriate[50]) in such a manner that enabled them to provide informed comments on it and thus the CAA properly to interrogate its reliability;[51] alternatively

(ii) It could have (as the Appellant and other airlines urged in their representations) developed its own CAA-originated modelling.

(j) Had the CAA adopted either of these positions, the Appellant could have no cause for complaint on this ground. However, having taken the position it did, the CAA has created a situation where the validity of its forecast stands or falls with the validity of the HAL model.

3.7.2 For the reasons set out below, the CAA's use of HAL's model was procedurally unfair (an error of law) and produced a flawed output (an error of fact). These are taken in turn.

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[50] As encouraged in HM Government, *Streamlining Regulatory and Competition Appeals: Consultation on Options for Reform*, 19 June 2013, paragraphs 6.5-6.8, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_84/page 6432**.

[51] See Witness Statement of Alexander Dawe dated 18 April 2023 at 71 and 84, (and as was explained to the CAA at the time) the version of the model which HAL agreed to share had been subjected to hard coding and redaction to such an extent that it was non-executable and impossible to discern how the model functioned. Despite repeated requests by the Appellant for an executable version of the model, HAL was simply unprepared to make a non-redacted version of the model available to BA. Self-evidently (See Witness Statement of Alexander Dawe dated 18 April 2023 paragraphs 77-78 and 117) provision to a third party would not permit BA to scrutinise the model and to provide meaningful comments on it.

3.8 Fairness - the CAA's use of the HAL model was procedurally unfair

3.8.1 The CAA acknowledged in its H7 Final Proposals[52] what it described as a **"***challenging set of circumstances***"** as it was faced with "*HAL not being prepared to share its model in a full and transparent way with stakeholders*."[53]

3.8.2 This is significant because, while the CAA may have been able to apply adjustments of some sorts to the HAL model, and request that changes be made on its behalf, this occurred without the benefit of any input from those most affected, and those best placed to identify the extent of changes which were necessary – that is, the airlines. It also meant that the forecasting exercise was not conducted transparently[54] or fairly.[55] This failure of disclosure was not remedied, as was recognised in the H7 Final Decision.[56]

3.8.3 The consequence is that, while it is accepted that the CAA will have performed its task diligently to the extent allowed by its access to the HAL model, it was simply not in a position where it could reach an informed judgement as to whether it was appropriate

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[52] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework*, paragraphs 1.13-1.19, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/page 1394-1396**.

[53] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraphs 71-84, which, sets out the key events relating to HAL's failure to disclose the HAL model.

[54] Here, the Civil Aviation Act 2012 requires the CAA to have regard to the principle that "*regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent*". *Civil Aviation Act 2012 c.19*, section 1(3)(g) and 1(4)(a).) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_55/page 4288**.

[55] That a fair process requires the disclosure of an executable version of an economic model in circumstances such as the present is well established – see e.g. *R (Eisai Ltd) v National Institute for Health and Clinical Excellence* [2008] EWCA Civ 438 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_70/ page 5799**. This is because those who are not provided with the model are at a "*at a significant disadvantage in challenging the reliability of the model. In that respect it limits their ability to make an intelligent response on something that is central to the appraisal process.*", *R (Eisai Ltd) v National Institute for Health and Clinical Excellence* [2008] EWCA Civ 438, paragraph 66, Richards LJ, Exhibit **BA_NOA1_70/page 5825**.

[56] CAA, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.43, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 46**.

to place <u>any</u> reliance on HAL's model, let alone the level of reliance it in fact placed on it.

3.8.4 This matters because – by definition – a model is a simplification of reality. While designed to provide a credible estimate, no model will ever provide an entirely accurate answer (other than as a stroke of luck). As the aphorism goes, all models are wrong, but some are useful. For a model to be useful, it is necessary to ensure that the inputs to the model, and the weighting which those inputs are given, are soundly based and free from bias. The need for transparency applies in any event, but is enhanced in this context given the unavoidable incentives on HAL to artificially depress forecasts, and the difficulties of benchmarking both in this sector generally, and in the case of HAL specifically.

3.8.5 The Appellant's concern as to the usefulness of this model is not hypothetical. It is clear from that fact that the CAA was compelled to require the adjustments that it did to HAL's forecasting approach that HAL's model was flawed. The difficulty, again, is that without transparency, the Appellant and other airlines are unable to identify what further adjustments are necessary for the HAL model to be a useful, credible, input (or whether the model should be abandoned altogether in favour of a different approach).

3.8.6 Furthermore, and as set out in more detail in paragraphs 3.9.3-3.9.6 below, it is striking that the CAA was not even able to base its figures on HAL's current version of its model. Rather it continued to rely on out-of-date figures, which even HAL knew were wrong.

3.8.7 Yet further, the Appellant are not even able to discern whether the adjustments which the CAA required (a) had the effect of remedying the flaws which had been identified and/or (b) affected other aspects of the model. To have confidence that the adjustments which were made had not affected the internal logic of the model, it would be necessary to understand the modeller's assumptions in the model as a whole (rather than isolating a discrete input). Because a model is a series of formulae working together, an output adjustment in a singular input can undermine the entire model.

3.8.8 In particular, there is significant scope for "*double counting*" in these adjustments, and the Appellant have no way of discerning the extent of this. For example, an adjustment to the assumed level of business travel will inevitably have knock-on effects for other

aspects of the model. If those effects are not identified and addressed, such an adjustment will have unintended consequences elsewhere, with the result that the model no longer functions as the modeller intended and is not, to return the aphorism, useful.

3.8.9 These deficiencies are not alleviated by the fact that the CAA commissioned Skylark Consulting Group to review the approach that was taken.

(a) Skylark's information base was evidently limited – with the CAA only providing "*limited guidance*" such as "*outlining the model structure*".[57] As Skylark themselves acknowledge, they did not solicit the Appellant's views,[58] nor did they take any other steps which might have permitted the Appellant to have meaningful input into its review of the model. Their review was therefore subject to the same limitations as that of the CAA in that Skylark did not benefit from the views of consultees, and was even more limited in that it appears that Skylark did not even have access to HAL's model.

(b) Furthermore, the report itself stops short of giving an unqualified endorsement of the CAA's approach. In particular, at page 13 it explains that the approach adopted was only "*suitable*" because it considered the external forecasts to be "*opaque*" (which is equally true of the HAL models) and because "*[t]he CAA do not have a version of HAL's latest model*." The report also frequently says only that the CAA's approach "*appears*" reasonable, presumably on the basis of the limited information with which Skylark was provided, without significantly interrogating what the CAA has actually done.[59] Further, certain comments in the report are contradictory compared with the approach taken by

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[57] Skylark Consulting Group, *H7 Forecast Update Review, Final Report*, February 2023, paragraph 1.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/396**.

[58] See paragraph 1.1 of the Final Decision Skylark Report which explains that "*no discussion, either verbal or written, has been entered into with HAL, airport users, or any other party.*", Skylark Consulting Group, *H7 Forecast Update Review, Final Report,* February 2023, paragraph 1.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/396**.

[59] For example, Skylark fails to engage in any meaningful quantitative assessment of the CAA's approach to business travel trends.

the CAA – in particular, the report repeatedly highlights the historical resilience of Heathrow airport to economic shocks.[60]

(c) Skylark had in any event at the time of the Initial Proposals recognised that HAL's model contained a number of unduly pessimistic assumptions, validating the airlines' concern that HAL had a systematic financial incentive to under-estimate and over-deliver against its model, a concern which is not addressed by the CAA's approach given the extent of the CAA's reliance on HAL's model.

3.8.10 The consequence of the CAA's reliance on HAL's model in these circumstances is that the passenger forecast in the H7 Final Decision is tainted by a fundamental procedural failing of such gravity that the forecast (and the price cap reckoned in reliance on that figure) is fatally undermined.

3.8.11 Furthermore, as set out at section 3.6 above, it is important to recognise that, due to the significant interplay between passenger volumes and other building blocks within the price control, the consequences of this error are not limited to the determination of the correct passenger forecast.

3.9 Accuracy- the CAA's use of the HAL model produced a flawed output

3.9.1 While (for the reasons set out above) the Appellant is simply unable to determine the extent of the errors with the model, a number of errors are nevertheless apparent from what is known to the Appellant.

3.9.2 The existence and effect of these errors can be starkly illustrated by the variations between HAL's forecast and actual passenger numbers for 2022. This shows that the HAL model underestimated passenger numbers and the passenger numbers should be over one third higher.

(a) The CAA relied in the H7 Final Proposals on the HAL's Revised Business Plan Update 2 from December 2021, in which HAL predicted 45.5 million passengers in 2022. The final actual number of passengers at Heathrow Airport

[60] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraphs 105 -106.

in 2022 was 61.6 million, some 30% higher than HAL predicted. Moreover, actual number of passengers for 2022 would have been materially higher in the absence of Local Rule A ("**LRA**").[61]

(b) HAL has repeatedly adjusted its 2022 passenger forecast. HAL's projections in the Revised Business Plan Update 2 from December 2021 were revised upwards three times in 2022 alone: in April 2022 (52.8 million), in June 2022 (54.4 million) and in September 2022 (61 million).

3.9.3 Unsurprisingly, given its patent inaccuracy, HAL itself no longer considers the version of its model which was provided to the CAA an appropriate basis for forecasting. This is evident from paragraph 1.51 of the H7 Final Decision which explains that "*[i]n December 2022, HAL updated its forecast model assumptions and produced a new traffic forecast. However, this was relatively late in the process and HAL has not provided us with a copy of its latest model spreadsheets.*"[62]

3.9.4 HAL's refusal (on the one hand) to provide the latest version of its model while maintaining (on the other hand) that the CAA ought to use its unadjusted and out-of-date model is striking. While this refusal is unexplained, one can readily infer that HAL's data no longer supported the forecast it was urging the CAA to adopt.

3.9.5 While the CAA acknowledged that the HAL model had significantly underestimated passenger numbers due to its flawed approach to (amongst other things) the speed with which passenger numbers would recover after the Covid-19 pandemic, it erred in concluding that this could be addressed by the expedient of making *ad hoc* adjustments to the model. As explained at paragraphs 3.8.4-3.8.7 above, there can be no confidence that these adjustments have (a) resolved the identified errors and/or (b) not undermined the internal logic of the model, such that its output is arbitrary and not as intended.

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[61] See Witness Statement of Alexander Dawe dated 18 April 2023 at 99.

[62] HAL has been repeatedly forced to increase its 2022 passenger forecast numbers, but it remains unclear why its December 2022 figures still remained around 200,000 lower than actual figures for 2022: See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraphs 85-86.

Given HAL's own position in its response to the H7 Final Proposal [63] (and its adoption of a new model) it is evident that it does not consider that the adjustments which were made resulted in a reliable estimate.

3.9.6 The CAA's use of an evidentially erroneous input as the "*baseline*" for determining what is a critical component of the passenger charge is an error of sufficient gravity as to vitiate this aspect of the H7 Final Decision.

3.10 The Approach on this Appeal

3.10.1 As matters stand, the CMA (and the Appellant) face the same "*challenging set of circumstances*" which the CAA acknowledged. What the CMA is required to do is to place itself (and the Appellant) in a position whereby the appeal can fairly be determined. The Appellant considers that there are two means by which this obligation could be discharged:

(a) The first (and that which the Appellant considers is most likely to yield an accurate result, for reasons set out in more detail below) is for the CMA to conclude that, in the absence of disclosure, no regard should be had to the HAL model, and that the forecast should instead by reckoned by other inputs. The Appellant invites the CMA to substitute the CAA's passenger forecasts with figures reckoned by the methodology proposed by BA in GM1, and make any consequential amendments to other affected elements of the H7 Final Decision, including in relation to the final passenger charge.[64] As this approach utilises the most up-to-date information, it is also the approach which the Appellant considers is likely to yield the most accurate forecast.

(b) The second is that if the CMA considers that it may be appropriate to retain use of HAL's model in reckoning the correct figure, the CMA could issue directions as to how this could fairly occur.

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[63] See *CAP2524D H7 Final Decision Section 3 on the Financial Framework,* paragraph 130 – 132, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4.**

[64] See Witness Statement of Gavin Molloy, dated 18 April 2023.

(i) Here, the CMA could direct that the relevant iterations of the HAL model (i.e. that provided to the CAA by HAL, as well the version containing the CAA's adjustments, and HAL's December 2022 version) be disclosed in a form that allows the Appellant (with the assistance of external airline forecasting specialists to interrogate the model rigorously (subject to appropriate confidentiality terms) in accordance with 12.2 of the Airport Licence Condition Appeal Rules [65] and paragraph 24 of Schedule 2 of the CAA2012[66].

(ii) With the benefit of such disclosure, the Appellant would be in a position to provide meaningful comments as to the suitability of the model, and any adjustments or amendments which it considers necessary (together with evidence in support of such contentions).

(iii) The Appellant would expect that the CMA would be assisted by such submissions and evidence (together with HAL and the CAA's responses), and would invite the CMA to make consequential directions as to the timing and process, should this course commend itself to the CMA.

(c) If the first course of action were not taken, such disclosure would be necessary to achieve the overriding objective of enabling "*the CMA to dispose of appeals fairly, efficiently and at proportionate cost within the time limits prescribed by CAA2012*". [67] In particular, disclosure would be necessary for the fair determination of this ground of appeal, because it is only with this disclosure that the Appellant can fairly advance its case as to the inaccuracies in the HAL model. To proceed in the absence of such disclosure would be to leave the Appellant in the same position as the Court of Appeal recognised the consultees

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[65] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022 rule 12.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/page 17**.

[66] CAA2012, Schedule 2, paragraph 24, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_56/page 4347**.

[67] CMA, *CMA172 Airport Licence Condition Appeals: Competition and Markets Authority Rules (**CMA Rules**)*, 27 October 2022, page 3, rule 4.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_58/4402**.

faced in *R (Eisai Ltd) v National Institute for Health and Clinical Excellence*, and render not only the consultation but also the appeal process unfair.[68]

3.11 Errors in the "Four Steps"

3.11.1 The Appellant contends that the CAA's approach to the "*four steps*" was "*wrong*" within the meaning of section 26 CAA2012 because of the errors of fact, law and discretion set out below.

3.11.2 Before turning to these, it is important to note that these "*four steps*" were not contained in the H7 Final Proposals, and were therefore not the subject of consultation by the CAA. They represent the CAA's attempt to update the CAA-adjusted version of HAL's model to take into account new information received since the date of the H7 Final Proposals. As such, this is the first opportunity the Appellant has had to comment on these matters.[69] What the "*four steps*" do not do (and cannot) do is cure the unfairness which flows from the use of HAL's undisclosed model which (as explained at section

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[68] The disclosure of an executable model is not *always* necessary as a matter of fairness, and in many cases consultees will not even request access to one. However, the instant case is (for the reasons set out above) a paradigm example of where disclosure of an executable version of a model is essential to the fairness of the process. As a matter of law, whether fairness requires disclosure of an executable version of a model is an intensely fact and context sensitive question. The circumstances of the instant case may be contrasted with those in *Easyjet Airline Co Ltd, Regina (on The Application of) v Civil Aviation Authority* [2009] EWCA Civ 1361 where the airlines were content to leave the final stage of interrogating the model in question (concerning security costs at Gatwick during Q5) to the CAA. The CAA was provided with an executable version of the model (para 27) and able to interrogate and adjust the outputs. Furthermore, in advance of the hearing itself Easyjet was provided with a copy of the model, and did not identify any material errors in it, such that they were not in fact prejudiced (para 35). In those circumstances, and where (crucially) the airlines had not insisted on seeing and examining a fully executable version of the model (para 57), no unfairness flowed from the absence of an executable version of the model (paras 53 and 57 per Dyson LJ). The contrast to the present consultation are stark – indeed the airlines (including BA, VAA and Delta) repeatedly requested and were refused access to an executable version of the model, and the CAA itself recognised the unsatisfactory situation this gave rise to. Furthermore, it remains the case that the Appellant has still not been granted access to an executable version of the model and is still (even at the appeal stage) unable to interrogate the model. This is – on any view – unfair.

[69] C f. section 22(7) of the Civil Aviation Act 2012, which requires further consultation where there is a modification which "differs significantly" from that originally proposed.

3.8 above) still lies at the heart of the CAA's methodology. Indeed, the CAA itself evidently concluded that the addition of these four steps was not a "*significant change*" to the methodology set out in the H7 Final Proposals, as if it were, it would have required further consultation.

3.11.3 The consequence for the purposes of this appeal is that the CMA is in *at least* as good a position as to the CAA to evaluate the correct approach in view of the fact that it is itself an expert body and benefits from superior information to that possessed by the CAA at the time it took its H7 Final Decision (in the form of the Appellant's comments, and in the form of accurate, up-to-date, data). It is therefore appropriate for the CMA to consider the correctness of the application of these steps *de novo* with the benefit for the first time of submissions from the Appellant (with a view to substituting its own judgment on these points).

3.11.4 The Appellant emphasises, however, that its ability to comment on the CAA's new approach remains limited, because it is very hard for it to understand the CAA's overall approach for the reasons explained in sections 3.7 - 3.9 above.

3.11.5 In summary, the errors are:

(a) in Step 1, the CAA is wrong to have ignored the impact of Local Rule A and the threatened capacity restrictions in coming to a conclusion for passenger numbers in 2022 and in constructing the appropriate baseline of demand for 2023 onward;

(b) in Step 1, the CAA is wrong to have found 2023 traffic levels would be 92% of 2019 levels, by ignoring relevant evidence and/or not taken proper account of the evidence before it;

(c) in Step 2, the CAA is wrong to have downgraded its forecast for 2023-2026 in response to macroeconomic forecasts;

(d) in Step 3, the CAA is wrong not to have uplifted its forecasts in light of its cross checks against external forecasts; and

(e) in Step 4, the CAA is wrong to apply a shock factor of 0.87% and wrong to apply a shock factor in full to 2023 when some months of 2023 have already elapsed.

Step One: Updating for actual passenger numbers and forward bookings

3.11.6 By Step One, the CAA updated its adjusted version of HAL's model to take account of (a) actual passenger data from 2022 and (b) forward bookings. Based on this updated data, including an assumption that the average passenger numbers would continue to increase in 2023, the CAA produced passenger totals for 2022 and 2023 of 61.6 million (actual) and 74.4 million (forecast) respectively.[70]

3.11.7 This approach is flawed for two reasons.

3.11.8 **First**, the CAA has adopted a flawed approach to determining the appropriate figure for the year 2022. In particular, the CAA did not make any adjustment to reflect the significant capacity restrictions imposed on Heathrow airport in summer 2022 by what is known as "Local Rule A". This set a cap on departing passengers of 100,000 passengers each day, and was in place between mid-July and the end of October 2022. As the CAA explain at paragraph 1.37 of the H7 Final Decision[71] that was "*to increase operational resilience and reduce queues, delays and cancellations*." This was an error. The CAA ought to have used an adjusted figure to take into account the fact that passenger numbers would in fact have been higher in 2022 had it not been for those capacity restrictions. The CAA's reasons for not doing so (set out at paragraph 1.45)[72] refer to "*the exceptional circumstances of the recovery from the covid-19 pandemic and in response to legitimate concerns about the ability of the airport and a range of service providers (including airlines) to cope with a relatively sharp increase in passenger numbers and the difficulties for passengers that might be created if such concerns were*

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[70] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.57, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 48-49**.

[71] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.37, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 44**.

[72] CAA, C CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.45, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 46**.

to crystallise", and suggest that to "*make an adjustment as suggested by airlines would penalise HAL and could create perverse incentives for the future and would not be in the interests of consumers*." As to this:

(a) Local Rule A undoubtedly depressed the number of passengers.[73] This is not expected to be repeated in the H7 period, as the CAA acknowledge by their reference to the "*exceptional circumstances*" which led to its introduction. Not taking this into account when considering how many passengers are likely to be travelling in the future (i.e. when the rule is not in force) was simply irrational.

(b) To the extent that the CAA, notwithstanding the above, considered that there was some risk that any remotely analogous circumstance might recur during the H7 period, this is duplicative not only of the "*risk-weighted*" approach which is taken to the forecasts for the following years,[74] but also of the "*shock factor*" applied at step four and – indeed - of the risk sharing mechanisms elsewhere in the price control (of which this was an integral part). Again, this does not provide any rational reason for discounting the consequences of Local Rule A.

(c) The suggestion that taking account of the effect of Local Rule A would either penalise HAL or create perverse incentives is similarly incorrect,[75] and does not (in any event) provide a basis for ignoring the fact that the 2022 passenger numbers were materially affected by Local Rule A. This is not in any sense a penalty, and it is entirely irrelevant whether (or to what extent) Local Rule A was the result of any fault on HAL's part. What is relevant is that Local Rule A undoubtedly did lead to a significant reduction in passenger numbers, and that this is unlikely to recur during H7. As to incentives, and as explained below in section 4.6, the CAA had, in April 2021, adjusted HAL's RAB precisely to incentivise it to make the necessary to investments to ensure that the

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[73] BA conservatively estimates the total reduction to be approximately 2.7 million, assuming a load factor of 75% and resulting in a total figure for 2022 of 64.3 million.

[74] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.56, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 48**.

[75] See Witness Statement of Alexander Dawe dated 18 April 2023 at 99.4 -99.6.

circumstances which contributed to the need to adopt Local Rule A did not occur. In other words, insofar as it was necessary to incentivise operational readiness by HAL, the issue which arose was anticipated and already provided for by regulatory action.

3.11.9 Overall, the CAA's failure to have regard to the effect of Local Rule A is an error. As a result, the CAA (a) used the incorrect (and too low) figure for 2022 and (b) used an incorrect (and too low) baseline for 2023. Further, as forecasts for 2024 onwards were (to some unknown extent) extrapolated from the actual passengers flown in 2022 and forecasts for 2023, this error would also result in depressing passenger forecasts in 2024 onwards (although, because of the lack of access to the model used by the CAA, the precise effect is not clear).

3.11.10 **Second**, the methodology adopted by the CAA in respect of the years beyond 2022 is entirely opaque. In the absence of transparency about this, the Appellant is severely prejudiced in its ability to make meaningful representations as to its appropriateness.[76] What the Appellant can do, however, is demonstrate that the outputs from that process (i.e. the CAA's estimates) are incorrect. For example, AD1 at 100.11(a) explains what BA's load factor would need to be for the CAA's 2023 forecast of 74.4 million passengers to be accurate, compared to what BA expects itself. The CAA has not identified any basis for suggesting that its load factor would be lower than BA what BA expects, and there is no reasonable basis for assuming that this would be the case. The consequence is that the CAA has under-estimated the 2023 figure alone by some 2.3 million passengers than that which the airlines predict (having regard to current forward booking and expected passenger load data).

3.11.11 The Appellant's ability meaningfully to interrogate the CAA's methodology particularly beyond the years of 2022 is severely impaired as a result of the above. However, based on the information available to it, the Appellant contends that the CAA's methodology for setting the passenger forecast for 2023 was flawed in any event, as (a) regardless of

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[76] For example, see Witness Statement of Alexander Dawe dated 18 April 2023 at 101 it seems that the CAA may have used an inappropriately low number for Heathrow airport's overall terminal capacity. However, it is impossible for the airlines to understand what number the CAA actually used, and what effect if any it had on its forecasts.

the correct figure for November/December 2022, the CAA was wrong to choose a lower bound which assumed only a one percentage point growth in passenger numbers as compared to the 2019 position and (b) it was wrong to treat forward booking data for 2023 as an upper bound.

3.11.12 In both cases, the CAA's forecast was unduly pessimistic given the available evidence of increasing passenger demand and therefore unreasonable. It therefore follows that picking a mid-point between these two points resulted in a forecast for 2023 which materially underestimates the number of passengers likely to fly to and from Heathrow.

3.11.13 The CAA acknowledges that passenger numbers are likely to continue to grow in 2023[77], but arbitrarily used a *lower* bound for 2023 of 90% of the passenger levels seen in 2019, being just a one percentage point (1%) higher than the equivalent figure in the last two months of 2022.

3.11.14 The CAA's reasoning on this point was exceptionally brief, and, in full, was:

"*Although downside risks still exist, we would expect an average forecast for Heathrow airport to continue to increase in 2023 (as was the case for the forecast we used for the Final Proposals and all of HAL's RBP forecasts). Therefore, our minimum forecast for 2023 is 90 per cent of the 2019 actual passenger numbers.*"[78]

3.11.15 As AD1 outlines[79], this is an unduly pessimistic lower bound in circumstances where demand is recovering very strongly based on actual numbers to date. For instance:

(a) actual January 2023 passenger numbers (which will have been available to the CAA since early February 2023, being over a month before its decision) were at 92.5% of 2019 levels;

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[77] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.55, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 48.**

[78] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*,Chapter 1, paragraph 1.40, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 45.**

[79] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.4 -100.5.

(b) demand in February 2023 has continued the strong trajectory of recovery, being 94.8% of 2019 levels; and

(c) demand in March 2023 continues this trajectory of recovery at 95.4% of 2019 levels.

3.11.16 The trend is very clear, and very positive. There is no evidence that a credible lower bound for 2023 would mean that growth in passenger numbers (relative to 2019) would stagnate at just one percentage point over the year.

3.11.17 The approach is also inconsistent with the CAA's recognition that "*covid-19 related requirements have been lifted*",[80] and so the sluggish growth in passenger numbers observed in winter 2021/22 cannot reasonably be expected to be repeated.

3.11.18 Conversely, the CAA used an upper bound of 94% of the passenger levels seen in 2019. This reflects the level of forward bookings, expressed as a proportion of 2019 levels, as at December 2022. In contrast in the H7 Final Proposals, the CAA used forward bookings as a <u>lower</u> bound.

3.11.19 However, in the H7 Final Decision the CAA noted that it was not appropriate to use forward bookings as a lower bound due to (a) the fact the "*majority of bookings for the year are yet to be made*"; (b) downside risks; and (c) non-economic risks including staffing challenges.[81] Bearing those factors in mind, the CAA decided forward bookings from December 2022 should be the <u>upper bound</u> for 2023. This is wrong for the following reasons and as outlined in AD1[82]:

(a) December 2022 forward bookings are likely to have been depressed as a result of HAL's threatened capacity caps for Winter 2022;[83],

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[80] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, Chapter 3, paragraph 3.17, exhibited to this Notice of Appeal and market Exhibit **BA_NOA1_2/page 68-70**

[81] CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraphs 1.55 -1.56, exhibited to this Notice of Appeal and market Exhibit **BA_NOA1_2/page 48.**

[82] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.

[83] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.8(b).

(b) the cyclical nature of ticket sales typically sees significant sales in periods early in the year, with January historically being the largest month for bookings;[84]

(c) downside risk is (one must assume) already captured in the HAL model which is the baseline and so the further inclusion of downside risks is inappropriate as it is duplicative of the other risk factors contained within the model. Whilst the other "*downside risks*" are otherwise not detailed at all:

(i) to the extent that the CAA's consideration was driven by updated macroeconomic forecasts, that would be duplicative of the exercise it carried out in Step 2.[85]

(ii) to the extent the downside risks <u>also</u> informed the lower bound, as one would expect them to do, those downside risks would have been double counted.

(iii) to the extent the downside risks <u>also</u> informed the choice of the midpoint, as indicated by the Final Decision Skylark Report,[86] those downside risks would have been double counted.

3.11.20 In any event, non-economic risks are accounted for in the shock factor applied at Step 4. In particular, the Final Decision Skylark Report notes that the CAA chose the midpoint of 92% in part because of "*industrial action and similar disruption*".[87] The shock factor at Step 4 expressly covers the impact of "*strike action*".[88]

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[84] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.8(c).

[85] The CAA says that its considerations in Step 1 took place "*before considering the effect of the change in economic outlook in step 2*" (H7 Final Decision, Chapter 1, paragraph 1.53), but it is otherwise unclear why the CAA would use such sluggish growth as its lower bound for 2023.

[86] Skylark, *H7 Forecast Review Update*, February 2023 (**Final Decision Skylark Report**), page 7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/page 402**.

[87] Skylark, *H7 Forecast Review Update*, February 2023 (**Final Decision Skylark Report**), page 7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/page 402.**

[88] CAA, CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 51**

3.11.21 Further the CAA does not appear to have taken into account the powerful incentives that airlines have to avoid the downside risks it has identified from crystallising. These include (in particular) the resumption of the 80:20 slot rule which will further incentivise airlines such as the Appellant to fly its aircraft out of Heathrow Airport.[89]

3.11.22 Other metrics available to the CAA would suggest passenger levels in 2023 exceeding 94% of 2019 levels. For example, current on-sale capacity for 2023 is c.98% of 2019[90]. In addition, February 2023 actual passenger levels were 94.8% of 2019 levels and March 2023 actual figures were 95.4% of 2019 levels.[91]

3.11.23 For the purposes of this appeal, what the Appellant would urge the CMA to do is have particular regard to the best available information which is the airlines' up-to-date forward booking data.[92] The Appellant can provide the CMA with updated figures during the course of this appeal (so that the CMA, too, has access to the best available and up-to-date evidence prior to its decision). On the basis of the evidence as it currently stands, it is evident that the forecast adopted by the CAA materially underestimates the likely number of passengers both in 2023 and in every subsequent year – see AD1 at paragraph 118.

Step Two: Updating for economic forecasts

3.11.24 The Appellant is, again, severely prejudiced by the absence of transparency as to the way in which the economic forecasts have been used by the CAA. It is evident that material adjustments have been made, but it is entirely unclear on what basis this has occurred. In particular, no explanation has been provided as to what weighting has been given to the forecasts, which makes it impossible to assess whether that weighting is appropriate in all the circumstances or, as the Appellant considers likely (given the outputs) arbitrary and erroneous.

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[89] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.11(c).

[90] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 100.5

[91] See Witness Statement of Gavin Molloy.

[92] In BA's case, this has been provided to the CAA on a bi-weekly basis since 4 May 2022.

3.11.25 Insofar as the CAA has explained its methodology at Step 2, it is evident that the CAA relies on an updated UK GDP forecast produced by Oxford Economics in December 2022 which shows a negative outlook (per the CAA's summary[93], it "*assumes an L-shaped recovery where the impact on the economy remains structural and does not rebound quickly to previous forecast levels*"). The CAA then says that it has "*taken the experience of the 2008 recession to indicate how changes to UK GDP affect passenger demand at Heathrow, and have applied this to all forecast years of H7 (2023 to 2026)*". This gives rise to a material reduction in the CAA's estimate of passenger numbers throughout the period 2023-2026.

3.11.26 The Final Decision Skylark Report appended to the H7 Final Decision explains that the CAA **"**have assumed that the reduction in the size of the economy will impact demand by 1% from 2023 onwards over the H7 period**"**. However, given the brevity of the CAA's explanation, it is unclear what the CAA has actually done and what weighting has been given to the forecasts (not least as the Appellants are unable in any event to see how this adjustment functions as part of the model used by the CAA, for the reasons explained in section 3.8 above). The Final Decision Skylark Report appended to the H7 Final Decision explains that the CAA **"***have assumed that the reduction in the size of the economy will impact demand by 1% from 2023 onwards over the H7 period***"**.[94]

3.11.27 For example, it is not at all clear why a 1% reduction has been forecast for Heathrow Airport specifically; nor do the figures presented in Table 1.3 in the H7 Final Decision actually apply a 1% reduction to traffic in all years.[95] It therefore appears that the Oxford Economics forecast has **"**fed in**"** to the modelling in some opaque way.

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[93] CAA, CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 51.**

[94] Skylark, *H7 Forecast Review Update,* February 2023 (**Final Decision Skylark Report**), page 10, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/page 405.**

[95] The reduction is *close to* 1% in all years, and it may be that there is a rounding issue, but that is not clear from the H7 Final Decision.

3.11.28 This element of the CAA's approach is therefore flawed for substantially the same reasons as its use of an adjusted version of HAL's model is flawed, with the same consequences (see section 3.8 above).

3.11.29 Moreover, the Appellant contends that the CAA's decision to apply such a downwards adjustment is arbitrary, unjustified and therefore wrong because:

(a) the CAA failed to have proper regard to and/or to give appropriate weight to the evidence that HAL's business is reasonably well insulated to UK macroeconomic factors. The Final Decision Skylark Report, for example, noted that "*traffic at Heathrow remained relatively stable … during the Global Financial Crisis*".[96] It is unclear what account the CAA has taken of the resilience of Heathrow airport's position compared with the overall economy, or of the reasons for optimism about economic forecasts expressed by Skylark.[97]

(b) The CAA failed to have proper regard in Step 2 to the interaction between its macroeconomic adjustment and the continued reliance that it places on the HAL model, which has consistently produced forecasts which are unduly pessimistic and proven to be erroneously low. It is not reasonable or justifiable for the CAA to apply additional downside adjustments when the underlying forecasting model has proven to produce estimates which are inaccurately low.

(c) Moreover, it appears at least possible that the CAA has double-counted downside risks which were already taken into account under Step 1 (see paragraph 3.11.18 above)[98] and has failed to have proper regard in Step 2, and to take account of, other mechanisms that it applies, and methodological steps that it has taken, which reflect a "pessimistic" approach at each stage; namely:

(i) the selection of the "baseline" for 2023 in Step 1;

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[96] Skylark, *H7 Forecast Review Update,* February 2023 (**Final Decision Skylark Report**), page 10, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_8/page 405.**

[97] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 105 -106.

[98] See Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 104.

(ii) the application of a further shock factor in Step 4; and

(iii) the adoption of the TRS mechanism which protects HAL from substantial amounts of downside passenger volume risk.

Step Three: Validating with external forecasts

3.11.30 In the H7 Final Decision, the CAA in Step 3 compares its (unshocked) passenger forecast as against a range of external forecasts. The CAA considers that this exercise "*validates*" its forecast for the H7 period, as its forecast "*is within the range*" of the external forecasts. It notes that its own "*risk weighted*" forecast is in any event expected to "*tend towards the lower end of the range*". As a result, the CAA makes no amendments to its forecasts in Step 3.[99]

3.11.31 The CAA's purported validation of its adjusted version of the HAL model by reference to external forecasts provides little comfort given the problem with reliance on this model identified in section 3.9 above. For the same reasons, the Appellant's ability to comment on the extent to which the CAA has appropriately taken into account external forecasts is limited. However, based on the information available, the Appellant contends the CAA was wrong not to make any adjustments as a result of its comparison to external forecasts, because:

(a) It is apparent from the CAA's Figure 1.4 in the H7 Final Decision (below) that the output from the CAA's adjusted version of HAL's model is, if anything, strikingly low compared with external forecasts, and certainly is not "*validated*"[100]. It appears that the CAA's model is the second-lowest of all those graphed, with the one actual model (non-grey) line clearly below the CAA's model being HAL's. The CAA's model is only tolerably accurate in 2022 because it has been updated to use actual data, and after that falls significantly below the external models (save for HAL's). It seems to be only the inclusion

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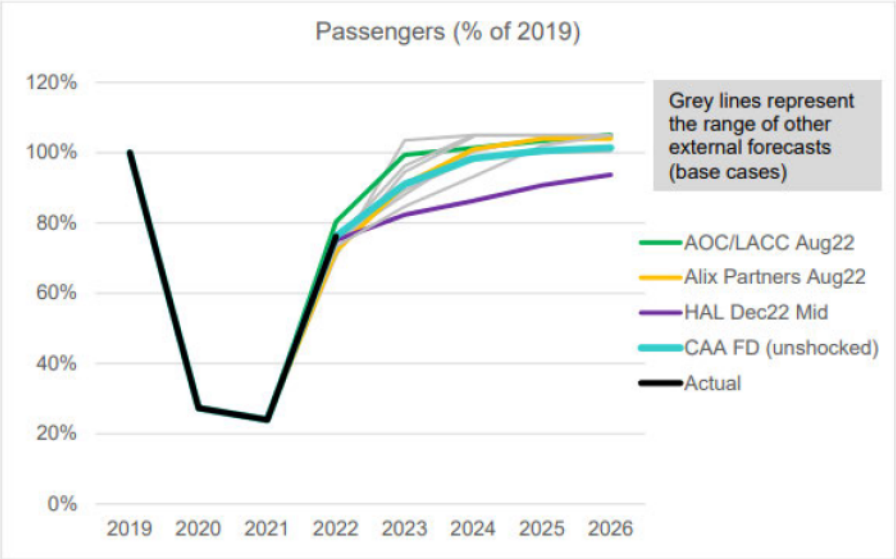
[99] CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64-65 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 51-52**.

[100] CAA, CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64-65 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_51-52**.

of HAL's model which allows the CAA to say that "*updated forecast is within the range of the external forecasts*"[101].

(b) The CAA's forecast assumes a longer time for passenger numbers to reach 2019 levels, and the forecasts only become bunched towards the end of the H7 period where overall invested capacity at Heathrow starts limiting further growth. In other words, the external forecasts provide good reason to consider that the CAA has materially underestimated passenger numbers for 2023 in particular. This is not surprising, given the CAA's errors in forecasting 2023 as detailed in the errors above.

Figure 1.4: Comparison of the Final Decision (unshocked) forecast and external forecasts



Source: CAA

(c) The CAA justifies the adjusted version of the HAL model's departure from the external forecasts (in that it is lower than them) by saying that it is "*risk-weighted.*"[102] The Appellant has no way on commenting on this assertion (since they have not seen the CAA's adjusted version of HAL's model) and so no way of assessing whether the CAA is comparing its model with external forecasts on

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[101] CAA, CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 51**.

[102] CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), paragraph 1.64 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 51**.

a fair basis, nor whether the CAA's model is appropriately risk-weighted. For example, has the CAA decided that its own forecast should be risk-weighted to a greater degree than external forecasts, and if so why, and has it properly taken in to account the extent to which external forecasts are themselves risk-weighted.

(d) Further, the Appellants cannot know whether the CAA's model avoids double-counting bearing in mind that "risk" has already resulted in adjustments at Steps one and four, as well as elsewhere in the price control (e.g. in the WACC) and almost certainly in HAL's model itself.[103]

3.11.32 This element of the CAA's approach is therefore again flawed for substantially the same reasons as its use of an adjusted version of HAL's model is flawed, with the same consequences: see section 3.4 above.

3.11.33 The result of the above is that:

(a) this element of the CAA's approach is therefore again flawed for substantially the same reasons as its use of an adjusted version of HAL's model is flawed, with the same consequences: see Section 3.4 above.

(b) the CAA did not properly have regard to and/or to give appropriate weight to the independent forecasts in coming to its passenger forecast at H7. The CAA failed to engage properly with the clear implication from those forecasts that its own forecast was too low.

3.11.34 For completeness, as well as the external forecasts, the CAA also engaged Skylark to "*provide independent quality assurance*" of the CAA's approach.[104] While in places the Final Decision Skylark Report provides useful further detail as to the approach the CAA has taken, the scope of the Final Decision Skylark Report is very limited and so cannot provide robust support for the CAA approach as opposed to external forecasts.

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[103] See Witness Statement of Alexander Dawe dated 18 April 2023 at 109.

[104] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 34**.

Step Four: Traffic Shocks

3.11.35 The CAA's final adjustment was to apply a 'shock factor' for the years 2023 to 2026 "*as we consider this improves forecast accuracy for the period as a whole by taking account of asymmetric noneconomic downside risks (due to events such as adverse weather, volcanic eruptions, terrorism or strike action*)"[105].

3.11.36 For the reasons set out in AD1 at paragraph 111 -116, this adjustment cannot be supported, and results in an asymmetric downwards adjustment which is duplicative of risk which is already captured elsewhere in the determination – specifically in the cost of capital. The cost of capital will necessarily incorporate the risks to which HAL is exposed, be they economic, political, geographic or other in nature.

3.11.37 Moreover, the selection of 0.87% as the appropriate figure for the shock factor appears wholly arbitrary, based upon an unvalidated calculation made by HAL based on the Q6 methodology using untested information on future shock events, and there is no evidence reasonably capable of supporting such a figure. That the decision is poorly justified is evident in the fact that the CAA has applied a blanket application of a 'shock factor' adjustment of 0.87% to the whole of 2023 despite the fact that the CAA's H7 Final Decision was taken partway through the year and at a time when the CAA had the benefit of actual passenger data and up to date forward booking data, on which it ought to have relied and which already rendered their forecast to be pessimistic.

3.11.38 Overall, the Appellant contends that there is no merit in applying any shock factor and this should be removed.

3.12 Summary and Correct Approach to passenger forecasts

3.12.1 In conclusion, and based on the above, the Appellant submits that there are clear errors of fact, law and/or discretion in the CAA's approach and reasoning. In particular:

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[105] CAA, CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.66, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 52.**

(a) The CAA erred by placing reliance on an outdated and demonstrably inaccurate model prepared by HAL and not provided to the Appellant or other airlines in a way that permitted meaningful comment.

(b) The CAA's four step process has not alleviated those errors and has introduced further errors into the process. This is because it: ignores the impact of capacity restrictions on 2022 and 2023 demand; applies a flawed and pessimistic methodology to forecast 2023 demand; fails to have regard to external forecasts which demonstrate that the CAA has under-estimated demand over the H7 period; and applies unjustified downside adjustments in a context where its estimates are already too low. There are clear overlaps at each Step meaning that it was wrong for the CAA to have applied the steps cumulatively.

3.12.2 These errors individually and collectively render the passenger forecast for H7 "*wrong*" within the meaning of section 26 of the CAA2012. Left uncorrected, these errors will cause direct and enduring harm to consumers as a result of prices that are higher than necessary.

3.12.3 GM1 sets out an approach that corrects for these errors.[106] The corrected numbers based on the most up to date data, are set out below and in Table 1 above.

Table 2. Corrected passenger forecasts considered by the Appellant (April 2023)

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA's decision	61.6	73.0	78.9	80.7	81.3	375.5
Corrected passenger forecasts[107]	64.3	77.6	82.0	83.6	85.0	392.5

[106] See Witness Statement of Gavin Molloy, dated 18 April 2023.

[107] This is the mid-case considered by the Appellant, as of April 2023, see Witness Statement of Alexander Dawe dated 18 April 2023 at 47.

3.13 Relief Sought

3.13.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it implements passenger forecasts, substitute it with a forecast reckoned in accordance with a valid methodology (as to which see below) and make any consequential amendments to other affected elements of the H7 Final Decision, including in relation to the final passenger charge.

3.13.2 As explained above, the Appellant considers that there are two valid approaches open to the CMA. The first (and that which the Appellant considers is most likely to yield an accurate result) is for the CMA to substitute the CAA's passenger forecasts with figures reckoned by the methodology proposed by BA in GM1[108], and make any consequential amendments to other affected elements of the H7 Final Decision, including in relation to the final passenger charge. This methodology compares on-sale capacity to forecasted load factors with appropriate reductions made based on the available data and assumptions supported by evidence (such as the Oxford Economics UK demand forecasts). The Appellant commend this methodology to the CMA as the approach which is likely to yield forecasts which best reflect the likely number of passengers over the H7 period given the best information currently available.

3.13.3 The Appellant appreciates that the CMA will wish to test this proposed methodology with the CAA, other airlines and HAL, and have not therefore sought to provide a final quantified figure. However, on the basis of the evidence as it currently stands, it is evident that the forecast adopted by the CAA materially underestimates the likely number of passengers both in 2023 and in every subsequent year.[109] Based on the current evidence, this would have the following effect on the maximum yield per passenger over the H7 period:

Table 3: Appellant's corrected maximum yield per passenger (April 2023)

[108] See the Witness Statement of Gavin Molloy dated 18 April 2023.

[109] Ibid.

Max yield per passenger (£ 2020p)	2022	2023	2024	2025	2026	Average
H7 Final Decision	26.96	26.06	21.03	21.03	21.03	23.22
Corrected	26.96	26.06	19.49	18.83	18.19	21.90

3.13.4 For the purposes of this appeal, the Appellant would urge the CMA to have particular regard to the best available information which is the airlines' up-to-date forward booking data. In accordance with the overriding objective, the Appellant will provide all such assistance to the CMA as is necessary to secure the implementation of the required relief within the CMA's statutory timetable. If helpful to the CMA, this could include providing the CMA with updated figures during the course of this appeal (so that the CMA, too, has access to the best available and up-to-date evidence prior to its decision).

3.13.5 In the alternative, if the CMA considers that it may be appropriate to retain use of HAL's model in reckoning the correct figure, the Appellant would request that the CMA direct that the relevant iterations of the HAL model (i.e. that provided by HAL to the CAA as well as the version containing the CAA's adjustments, and HAL's December 2022 version) be disclosed in a form that allows the Appellant (with the assistance of external airline forecasting specialists) to interrogate the model rigorously (subject to appropriate confidentiality terms) in accordance with paragraph 12.2 of the Airport Licence Condition Appeal Rules and paragraph 24 of Schedule 2 of the CAA2012. As noted above, the Appellant would suggest that the CMA provide a timetable for the parties to make further representations following the disclosure of this material, so that the CMA has the benefit of informed submissions before reaching a determination as to what use can properly be made of the model (and what consequential directions and/or relief is necessary).

4. GROUND 2: REGULATORY ASSET BASE (RAB) ADJUSTMENT

This ground concerns the CAA's failure properly to review a £300m RAB adjustment made (on a contingent basis) in its April 2021 RAB Adjustment decision, and erred in making that adjustment in the first place and then confirming it in the H7 opening RAB. The RAB adjustment is retained in the H7 Final Decision and implemented by way of modification to HAL's Licence.[110]

4.1 Key Documents

4.1.1 The key evidence that the Appellant requests the CMA reads when considering this ground is:

(a) the April 2021 RAB Adjustment Decision;

(b) the H7 Final Proposals (paragraphs 74-79 of the Summary Document and Chapter 10 of Section 3: Financial Issues and Implementation entitled 'The H7 Regulatory Asset Base and HAL's request for a RAB adjustment' (pages 87-109));

(c) the H7 Final Decision - paragraph 54 of the Summary Document and Chapter 10 of Section 3: Financial Issues and Implementation entitled 'The H7 Regulatory Asset Base' (pages 45-59), in which the CAA sets out its final decision for the H7 opening RAB, including that it has preserved the **£**300 million adjustment set out in the April 2021 RAB Adjustment Decision;

(d) 'Assessment of the CAA's H7 RAB Adjustment': an Expert Report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023 ("**RAB Report**")[111]; and

(e) Paragraphs 129 – 184 in AD1.

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[110] CAA, *H7 Final Decision: Appendix C* (CAP2524E2) (**H7 Final Decision Appendix C**), page 12, New Licence Condition C1.6, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_6/page 277**.

[111] AlixPartners, *Assessment of the CAA's H7 RAB Adjustment, Report prepared for British Airways, Virgin Atlantic Airways and Delta Air Lines,* "**RAB Report**", 17 April 2023.

4.2 Summary of errors

4.2.1 The Appellant contends that:

(a) the CAA erred in failing properly to review a **£**300m RAB adjustment made (on a contingent basis) in April 2021; and

(b) the CAA's overall conclusions as to the appropriate RAB are unsupportable as a result of the CAA's errors of fact, law and/or discretion.

4.3 Consequence of errors and materiality

4.3.1 The consequences of these errors are that:

(a) the CAA failed to review its April 2021 RAB Adjustment Decision in order to give proper consideration to the need to either remove or reduce that adjustment in light of the evidence before it as to HAL's failure to deliver on its specified investment commitments and on capacity and quality of service; and

(b) the RAB has been set at a level which benefits HAL's shareholders at the expense of consumers and will continue to cause consumer harm over the period to 2041.

4.3.2 The CAA's errors are material. The RAB adjustment will cost consumers up to **£**300m in 2020 prices in net present value (**NPV**) terms – and even more in cash terms – with payments being made over multiple price control periods. The RAB adjustment is also damaging to regulatory integrity, and there are important points of economic and regulatory principle at stake which have the potential to affect future price controls.

4.4 Relief

4.4.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it implements the RAB adjustment and that the RAB adjustment be removed from HAL's licence.

4.4.2 To assist the CMA in providing the necessary directions for the CAA to give effect to this relief, Annex A1 to the RAB Report explains the changes required.[112]

4.5 Overview of Ground 2

4.5.1 The CAA erred when reckoning the appropriate RAB for H7. These were material errors, which mean that the RAB is not a reasonable reflection of "*the value of the investments that HAL has made in the regulated business*" (which is what the CAA set out to do – see paragraph 10.1 of its H7 Final Decision).[113]

4.5.2 The first (and fundamental) error is that, for the reasons set out in section 4.6 below, the CAA has erred in fact, law and discretion by failing properly to review a **£**300m adjustment made (on a contingent basis) in April 2021.[114] The consequence is that the CAA failed to give proper consideration to the need to either remove or reduce that adjustment in the light of the evidence before it as to HAL's failure to deliver on its specified investment commitments and on capacity and quality of service. This is a fundamental error, which goes to the heart of the CAA's failure properly to consider in its H7 Final Decision whether a RAB at the selected level could be supported.

4.5.3 Furthermore, and irrespective of the proper approach to the April 2021 Adjustment, the CAA's overall conclusions as to the appropriate RAB are unsupportable as a result of the CAA's errors of fact, law and/or discretion set out in sections 4.8-4.12 below. The consequence is that the RAB has been set at a level which benefits HAL's shareholders at the expense of consumers and will continue to cause consumer harm over the period to 2041. This is:

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[112] RAB Report, 17 April 2023, Annex A1.

[113] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3),* 8 March 2023, paragraph 10.1 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 191**.

[114] The background to the CAA's 2021 adjustment decision is set out in detail in Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 121 - 162, and is not repeated here but referenced where relevant below.

(a) contrary to the CAA's statutory duty to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS (section 1(1) CAA2012);

(b) contrary to the CAA's statutory duty to have regard to the need to promote economy and efficiency on the part of HAL in its provision of AOS at Heathrow Airport (section 1(3)(c) CAA2012); and

(c) inconsistent with the CAA's statutory duty to have regard to the principles of better regulation, in particular that regulatory activities should be carried out in ways that are transparent accountable, proportionate, consistent and targeted (sections (1)(3)(g) and 1(4) CAA2012).

4.6 The CAA's Fundamental Misdirection

4.6.1 The RAB is a well-developed concept that is used as a tool to ensure that airport charges reflect efficient capital expenditure incurred and not paid for in whole by current consumers. Consistent with that objective, the decision to apply an upward adjustment of **£**300m to HAL's RAB in the April 2021 RAB Adjustment Decision was made on the explicit basis that it was to "*secure that all reasonable demands for airport operation services at Heathrow airport are met*", by "*incentivising investment by HAL during 2021 that would further the interests of consumers*".[115] Furthermore, it was contingent on HAL meeting the CAA's expectation that it would be "*proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic.*"

[115] CAA, *CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (**RAB Adjustment Decision**)*, page 7 paragraph 4, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 754**.

4.6.2 The CAA was evidently intending to hold HAL to its commitment (as recorded at paragraph 4.15 of the April 2021 RAB Adjustment Decision)[116] that:

... with appropriate incentives, it would plan to make additional investment in 2021 of around £230 million (£218 million capex and £9m of opex) to maintain and improve quality of services to consumers in 2021 and beyond. This includes investment to provide appropriate capacity at the airport if there is a particularly strong recovery in demand. (emphasis added)

4.6.3 That the adjustment was contingent on HAL actually making the anticipated investments was a critical aspect of the CAA's justification for the April 2021 RAB Adjustment Decision.

(a) As the RAB Report explains at 2.4.4, the economics of incentive regulation are such that the CAA must have understood that making a RAB adjustment in advance of any additional expenditure actually being made would not incentivise the realisation of that expenditure, unless there were controls to ensure such investment is made as needed.

(b) The CAA's commitment to revisit the adjustment in the H7 process was, therefore, an essential component of the decision. Indeed, making an adjustment in the absence of such a commitment would plainly have been irrational. As a matter of good regulatory practice it would have been highly desirable if the CAA had adopted a clearly defined process for tracking and ensuring that incremental efficient expenditure on securing airport operations (as is the approach of other regulators facing similar issues).[117] However, what is important for present purposes is that the CAA undertook to review matters during the H7 process.

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[116] *CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision),* paragraph 4.15, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 791**.

[117] As e.g. Ofgem does in the context of uncertain need for expenditure through Price Control Deliverables in RIIO-ED2 – see RAB Report, 17 April 2023, page 10, paragraph 2.4.6.

4.6.4 Thus, what was promised (and expected) was that HAL would make significant additional investments in 2021, for the purpose of maintaining and improving the consumer experience in 2021 and beyond.[118] That the adjustment was contingent on this actually occurring is evident in several places in the April 2021 Adjustment Decision. In particular, at the start of the April 2021 Adjustment Decision the CAA stated:

"If evidence were to emerge of HAL failing to deliver on quality of service then we will take steps to further protect the interest of consumers by conducting a review of these matters (and we would seek to protect consumers from the costs of any such failures). This should help further incentivise HAL in delivering an appropriate level of investment and quality service to consumers" (emphasis added).[119]

4.6.5 The specific steps which the CAA referred to were set out later in the document under the heading "*Additional protections for consumers*":

"... if evidence were to emerge of HAL failing to deliver on an appropriate quality of service in 2021, we will conduct a review of these matters. This would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in a timely way and maintained service quality. In the event that such a review were to show that HAL had not responded appropriately, including in respect of service levels where this is within HAL's control, we would look to introduce additional protections around service quality in H7 and we would consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue. ..."[120] *(emphasis added).*

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[118] For its part, the CAA considered that this investment would "*support service quality over 2021 and into 2022, including investment necessary for ensuring that the re-opening of terminal capacity is carried out in a timely way*." See CAA, CAP2140 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", dated April 2021 paragraph 3.16 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 776**.

[119] *Ibid.*

[120] *Ibid.*, page 13 para 32.

4.6.6 Further detail was provided at paragraphs 4.21 – 4.25, which reads as follows (again, under the heading "Additional protections for consumers"):[121]

"4.21 Given:

- *the high degree of uncertainty over, and the strength and speed of, the recovery of passenger traffic; and*
- *therefore, whether the RAB adjustment required to meet our duties and objectives might turn out not to have been required*

we have considered additional protections we should put in place for the interests of consumers.

4.22 We would expect HAL to respond to our decision on the RAB adjustment in 2021 by taking proactive steps to prepare for a higher than expected increase in passenger traffic. If evidence were to emerge that HAL was not delivering an appropriate quality of service in 2021, we would conduct a review of these matters.

4.23 In this review, we would seek to understand whether HAL was reasonably prepared for the increase in passengers, provided additional capacity (for example, by reopening terminals) in an efficient and timely way and maintained service quality.

4.24 In the event that this review showed that HAL had not responded appropriately or maintained service levels, we would look to introduce additional protections around service quality in H7. We would also consider reducing the £300 million RAB adjustment or make an offsetting reduction to revenues, making sure not to:

- *"double count" any SQRB penalties that HAL might have incurred; or*

[121] CAA, CAP2140 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", dated April 2021, paragraphs 4.21-4.25, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 793**.

- *disallow any efficient costs that HAL had incurred to meet the increased demand experienced.*

4.25 We would look to provide further guidance on this review as part of the H7 price control review. The SQRB metrics will provide useful information to signal any potential issues with service quality."

4.6.7 As is evident from all of the above, it was patently not the case that, as the CAA asserted in its H7 Final Proposals "*the April 2021 RAB Adjustment Decision was intended to be our H7 Final Decision to give effect to the inclusion of the £300m in HAL's opening RAB for H7 RAB*" such that there was "*a relatively high evidential threshold for us to consider reversing this decision*."[122] To suggest that it was is to misunderstand what the CAA actually decided in April 2021 (to adjust the RAB on a contingent basis) and to impose a heightened evidential threshold for a review without any basis or justification.

4.6.8 This error tracks through to the H7 Final Decision, where the CAA concluded that would not be "*appropriate to revisit our April 2021 RAB Adjustment Decision on the basis of outcomes in 2022,*"[123] before re-affirming that it considered that the relevant question was whether the "*adjustment was justified and appropriately calibrated given the information available at the time*."[124]

4.6.9 This misdirection resulted in the CAA failing properly to assess the evidence, summarised at 4.10 below, of HAL's failure to do as it had promised. In particular, it failed properly to consider the ample evidence that not only had HAL failed to make

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[122] This misdirection appears to be at least to some extent linked to the CAA's misdirection as to the effect of the CMA's Appeal decision in *Phoenix Gas Networks,* which is addressed at 4.7 below. See CAA CAP2365D H7 Final Proposals Section 3 Financial issues and implementation (FP Section 3), paragraph 10.62, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1687.**

[123] CAA, CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3), paragraph 10.69, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 203**.

[124] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3), paragraph* 10.69, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 203**. Quoting CAA, *CAP2365D H7 Final Proposals Section 3 Financial issues and implementation (FP Section 3),* paragraph 10.99, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1693**.

the promised investments, but that this failure had demonstrably resulted in its failure to deliver on an appropriate quality of service. In particular:

(a) Not only did HAL not (as promised) make a significant amount of additional capital expenditure in 2021, its out-turn capital expenditure was lower than in 2020. In other words, HAL did not – in fact- make any incremental expenditure as a result of the RAB adjustment;

(b) The absence of any incremental investment necessarily meant that no consumer benefit resulted from the adjustment. Furthermore, that consumers were positively harmed attributable to the failure to make the promised investments was patent, as (amongst other things) HAL:

(i) were not planning and prepared for, and subsequently were unable to meet demand, in the Summer of 2022 despite airlines' clear and persistent warnings that Summer 2022 would bring a strong rebound in passenger volumes once restrictions had been removed. This led to staffing issues at the Heathrow ID centre and for passenger, for staff and vehicle and security searches. In addition, there was broader failure on HAL's part to operate an effective service for Passengers with Reduced Mobility ("**PRM**"), and significant baggage system resilience issues (for example, due to a lack of maintenance on Hold Baggage Screening machines);

(ii) refused to open T4 until mid-2022 as a direct result of this. This led to congestion at T2 in particular, and significant delays at the UK border across all terminals. It also meant that airlines could not effectively plan for their expected Summer schedule due to terminal location uncertainty; and

(iii) under-performed in its SQRB metrics, particularly in relation to security queue performance, and passenger satisfaction in relation to security also declined.

4.6.10 This is material as it means that the expected investment (and consequent benefit to consumers in "2021 and beyond") demonstrably did not occur. In these circumstances,

no matter what evidential standard applied, it was incumbent on the CAA to conduct the promised review with a view to determining whether to "*reduc[e] the £300 million RAB adjustment or making offsetting reductions to revenue*" (see paragraph 4.6.5 above).

4.6.11 The CAA's failure to conduct the promised review (and therefore properly to assess this evidence, the related absence of consumer benefit, and the consequences which should follow from it) stems from a fundamental misdirection as to what it was required to do. What was required was for the CAA to act *in accordance with* the decision, which in terms contained an undertaking to conduct a review of the RAB adjustment and "*consider reducing the £300 million RAB adjustment or making offsetting reductions to revenue*" if "*evidence were to emerge of HAL failing to deliver on an appropriate quality of service*".[125]

4.6.12 Thus, the CAA in response to numerous airline requests[126], in its H7 Final Proposals and in the H7 Final Decision proceeded on the basis of a mistaken premise. It was not being asked to set aside anything, nor was it being asked to withdraw a favourable treatment which had been accorded on a final basis. The adjustment was <u>always</u> contingent. This misdirection led the CAA to conclude that would not be in the interests of consumers to give consideration to reducing the quantum of the RAB Adjustment as:[127]

(a) the "*adjustment was justified and appropriately calibrated given the information available at the time*"; and

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[125] Moreover, it is apparent that a matter of weeks after obtaining the RAB adjustment, HAL was in discussions with the Government regarding the extent of taxpayer support which would be provided to open a specific terminal for arrivals from "red zone" countries: Financial Times, *Heathrow to open dedicated terminal for 'red list' arrivals*, 21 May 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_95/page 8087-8088**.

[126] Witness Statement of Alexander Dawe dated 18 April 2023 at paragraph 159 -160.

[127] CAA, *CAP2365D H7 Final Proposals Section 3 Financial issues and implementation (FP Section 3)*, paragraph 10.99, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1693**; *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3),* paragraph 10.69, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 203**.

(b) that to "*reverse this now would tend to increase investor perceptions of risk, increase the cost of capital and put upward pressure on airport charges.*"

4.6.13 Thus, while the CAA considered whether it was in the interest of consumers to make a further adjustment as requested by HAL (see H7 Final Decision at paras 10.58 and 10.60), that consideration was entirely one-sided, and did not involve a review of the £300m adjustment which it had already made.[128] In other words, as a consequence of the CAA's misdirection, the only possible outcome of the CAA's review was an increase in the RAB. Neither of the two reasons identified by the CAA provide any justification for such an approach:

(a) What the CAA's first justification fails to appreciate is that the undertaking to consider reducing the quantum of the RAB Adjustment in the light of HAL's subsequent performance was itself a consumer protection measure which the CAA put in place precisely because it was not able on the basis of the information available at the time to be sure that the "*adjustment was justified and appropriately calibrated*". It was for this reason that "*additional protection for consumers*" in the form of the review mechanism was put in place. In other words, when making the £300mn adjustment in April 2021, the CAA recognised that this would lead to consumer detriment if HAL were to fail to make the promised investments so as to improve the consumer experience. This was the *raison d'etre* for the review mechanism.[129]

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[128] See also paragraph 6.72 and 6.73 of *CAP2265C, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 2: Financial issues, 22 October 2021,* exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_22/page 951.**

[129] That operational performance could only properly be judged with the benefit of hindsight is also acknowledged elsewhere in the Final Proposals, where the CAA noted that it was "*particularly conscious of the importance of the summer period in 2022*" in relation to "the recovery of passenger numbers at Heathrow" and "*the potential stresses on airport and other infrastructure and service providers*". It was for this reason that (at that stage) the CAA explained that it planned "*to review HAL's operational performance in the Autumn [of 2022], with a view to ensuring that the interests of consumers are properly protected*".

(b) The short answer to the second point is that the CAA had expressly managed investors' expectations by the clearly contingent manner in which the adjustment was made (see above).[130]

4.6.14 This misunderstanding carried through from the Final Proposals to the H7 Final Decision. Indeed, the H7 Final Decision went further, concluding that it was not appropriate to review HAL's operational performance with a review to determining whether the **£**300m adjustment ought to be reduced as[131]:

(a) this "*would distract from our primary focus of reaching a decision in respect of the H7 price control*"; and

(b) because "*it was it was not clear that the reversal of the April 2021 RAB Adjustment would have been the appropriate remedy in the context of such a review*".

4.6.15 This, again, fails to recognise a review of the appropriateness of the April 2021 RAB Adjustment was not extraneous to the H7 price control exercise. Far from a "*distraction*", a proper calibration of the RAB (including the adjustment) is an essential part of the price control process both for the reasons the CAA itself gave in the April 2021 RAB Adjustment Decision (as set out above) and for the reasons set out below.

4.6.16 Furthermore, the CAA overlooks that by failing to conduct the promised review, it has reneged on a fundamental part of basis on which all concerned parties (including the airlines) proceeded. The airlines did not bring any challenge to the April 2021 decision in part because it was subject to review and the CAA also made it clear "*the majority of issues raised by HAL's request for a RAB adjustment [were] best dealt with as part of the "in the round" consideration of the H7 price control*"; that "*the appropriate forum for oversight of the CAA's decision… would be as part of any appeal to the CMA*"; and

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[130] See also C20 of the April 2011 Decision (p 59), which records HAL itself acknowledging that an early intervention would not "unduly constrain" the CAA's approach in H7, to which the CAA made clear that it would only be "undesirable" to reverse interventions if HAL had not "*manifestly fail[ed] to deliver on investment or quality of service*."

[131] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 10.71, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 203**.

that "*HAL (and the airlines) will be able to challenge all aspects of the CAA's licence modifications to implement the H7 price control by appealing to the CMA on the grounds set out in CAA2012*." The CAA noted that, in the event of such appeal, the CAA "*will not seek to argue that HAL (or airlines) should be precluded from challenging any aspect of the CAA's H7 licence modifications on the basis that it reflects a decision already taken in the [April 2021 RAB Adjustment Decision] that ought to have been challenged by way of judicial review*."[132]

4.6.17 The CAA is now trying to move the goalposts on this in a way that is unfair, procedurally improper and legally impermissible.

4.7 Regulatory precedent

4.7.1 As noted above, the CAA's approach appears to have been motivated by a material misdirection to the effect that H7 Final Decision provides:

"We also note that the reversal of amounts previously included in the RAB has also been explicitly proscribed in a previous CMA appeal. In the appeal by Phoenix Gas Networks of its price control in 2021, the CMA was clear that it would not be appropriate for a regulator to seek to reverse, ex post, amounts previously added to the RAB."[133]

4.7.2 While this refers to a 2021 decision of the CMA, it is evident that this is a reference to the Competition Commission's ("**CC**") 2012 determination in Phoenix Natural Gas Limited ("**PNGL**"). In essence, the CAA formed the view that this decision indicated the CAA was prohibited from reviewing amounts previously added to a RAB. This was a material misdirection, as is apparent from a review of the CC's decision in PNGL.

(a) The context of that case is very important. PNGL was a relatively new gas network in Northern Island and during the second price control period it was

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[132] CAA, *Letter from CAA to Helen Stokes entitled 'Status of CAP2041 "Economic regulation of Heathrow Airport Limited: "Response to its request for a covid-19 related RAB adjustment" (the "Response")'*, 11 May 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_81/page 6155.**

[133] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 10.63, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 202**.

realised that it would be difficult for PNGL to recover its investment costs within its original 20 year licence period. In 2007, following consultations, it was agreed that PNGL would earn a return based on a regulatory asset value or base, including the determination of an opening asset value ("**OAV**"). Crucially:

"25 per cent represented the capitalized value of unspent allowances (ie outperformance arising on operating expenditure (opex), capex and working capital allowances (WCA), volume underperformance, and deferred capex. These are sums that PNGL was granted as allowances and which it could recover from customers, but which it had not spent".[134]

(b) This is an essential point: a key element of the 2007 determination was that going forward the regulatory asset value would include these sums.

(c) Some five years later in a different price control period, the Northern Ireland Utility Regulator ("**UR**") concluded that these sums should no longer be included. Unsurprisingly and reasonably, the CC noted that:

"PNGL said that the 2006 'agreement' (and in particular the 2006 TRV) was subsequently incorporated into PNGL's licence and was intended to 'draw a line under the past'. PNGL said that there was no defect in the 2006 'agreement' and no new information had arisen since it was concluded that would suggest otherwise."[135] *(TRV stands for total regulatory value, which is the same concept as the regulatory asset value or base.)*

(d) It is only in this context that the CC concluded that PNGL should be allowed to retain these sums in its RAB, which included the benefit of outperformance and capex deferrals included in the general classification of outperformance - but

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[134] Competition Commission, *Phoenix Natural Gas Limited price determination*, 28 November 2012 ("***CC 2012 determination in Phoenix Natural Gas Limited***"), paragraph 7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_83/page 6169**.

[135] CC, *2012 determination in Phoenix Natural Gas Limited*, paragraph 10, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1678.**

not those in a separate set that were deferred from 1999/2000 following a change in PNGL's strategy. As the CC observed:

"Turning to outperformance, under the 1996 licence and in the regulatory framework applied under PC01 and PC02, until 2006 PNGL was entitled to receive and retain 100 per cent of its outperformance. The retention by PNGL of outperformance in its entirety contrasts with UR's current view that outperformance should be shared between PNGL and its customers. PNGL was unable to recover this outperformance at the time it accrued."[136] *(emphasis added)*

(e) As regards deferred capex, the regime similarly allowed PNGL to benefit from these and:

"this contributed to PNGL's expectations of how it would be rewarded and helped shape its investment strategy. We think that these rules have and continue to serve as a heightened incentive mechanism (which increases the potential rewards available) and so indirectly increases the degree to which the business is resilient to the effects of risk, and thereby increased its initial willingness to incur risk. We do not consider that the inclusion of historic deferred capex (and the financing returns on these sums) in the TRV operates or may be expected to operate against the public interest."[137]

(f) This set of facts was emphasised by the CC and underpinned its (modest) conclusion:

"In line with normal regulatory practice, our view is that any revision of previous regulatory determinations should be: well-reasoned, properly signalled, subject to fair and effective consultation, clear and understood, and, normally, forward-looking. We consider that some changes are more serious

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[136] CC, *2012 determination in Phoenix Natural Gas Limited*, paragraph 21, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_83/page 6179.**

[137] *CC 2012 determination in Phoenix Natural Gas Limited*, paragraph 26, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_83/page 6180.**

than others, and that to reduce ex post and without clear signalling the opening value of a RAB is a step that should not normally be taken without very good justification, and only then after an appropriate period of consultation on the proposals. In contrast to the case for the deferred capex projects from 1999/2000, a cause for concern is whether UR gave sufficient notice or sufficiently consulted on its proposal to revise the other elements of the TRV. While UR says it indicated that it intended to share historic outperformance (referring to a reference to following best practice in its 2006 consultation document), we consider that it gave no public indication in the 2007 determination (nor any indication until 2011) that it did not intend to allow historic outperformance to remain in the TRV. Any intention to revise the historic outperformance in the OAV that it may have formed appears inconsistent with its actions and statements at that time, which point more towards the OAV having been established and fixed. It is difficult to see how PNGL and its investors could have anticipated these proposals ahead of UR's consultation on the issue in 2011."[138] *(emphasis added)*

4.7.3 Even taken on its own terms (and devoid of the context of that particular case) this decision does not suggest that there is a categorical proscription on the reduction of the value of a RAB. In any event:

(a) In the present case, the scope for review and potential reduction of the RAB adjustment was clearly signalled at the time of the April 2021 RAB Adjustment Decision (as set out above). The April 2021 RAB Adjustment Decision was always contingent, and conducting the clearly signalled review would not offend any principle of good regulation.

(b) The instant case has nothing to do with HAL being rewarded for historic out-performance and capex deferrals under a historic price control regime. The historic price control regime was always that HAL would bear volume risk, and

[138] CC, *2012 determination in Phoenix Natural Gas Limited, paragraph* 32, emphasis added, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_83/page 6181.**

HAL has been allowed to earn a higher WACC as a result than, for example, energy network utilities that are not subject to the same volume risks.[139]

(c) Furthermore, it is telling that the CC decided that PNGL should *not* retain the benefit of the 1999/2000 capex deferrals as PNGL had revised its investment policy many years ago in 1999 such that these projects were not needed in the foreseeable future:

> *"It would appear unreasonable to offer a regulated company a return on an allowance to undertake a project that it has never undertaken and that it is not going to undertake. Therefore we consider that retention of seriously delayed, or irrelevant and superseded projects in the portfolio of intended investments is no longer appropriate and they should be removed and only reinstated when they are immediately relevant to the current strategy."*[140]

4.7.4 For these reasons, the CC's decision in PNGL did not provide a justification for the CAA's failure to review the **£**300m RAB adjustment, and the CAA's conclusion to the contrary was erroneous.

4.8 The Substantive Errors

4.8.1 Further or alternatively, irrespective of the errors identified above, the CAA in any event erred by settling upon an unsupportably high RAB figure for H7. This is because the task for the CAA in its H7 Final Decision was to settle upon the appropriate figure for the H7 period. This required it to engage with the substantive question of whether the selected RAB figure from April 2021 was one which could reasonably be supported. The CAA in both its April 2021 RAB Adjustment Decision and its H7 Final Decision has entirely failed to do so, and has, due to the errors of fact, law and/or discretion set out below, settled upon an erroneous and unsupportable figure for the RAB. The consequence is that the RAB has been set at level that is not reflective of value delivered

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[139] See, for example, CAA, CAP 1115 Estimating the cost of capital: a technical appendix to the CAA's Final Proposal for economic regulation of Heathrow and Gatwick after April 2014, 2013, paragraph 8.37, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_38/page 3008.**

[140] *CC 2012 determination in Phoenix Natural Gas Limited*, paragraph 27, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_83/page 6180.**

and unreasonably compensates HAL's investors at consumers' expense. This will result in a significant and lasting distortion to airport charges.

4.8.2 What the CAA did instead was to confirm the **£**300m RAB adjustment made in April 2021, without considering the substantive question of whether this was an appropriate figure in the light of the up-to-date evidence before it. This failure has resulted in the CAA settling upon a RAB which cannot reasonably be supported as it is set in a manner and/or at a level which is:

(a) inconsistent with the primary purpose of the RAB;

(b) not reasonably justified by any of the reasons identified by the CAA; and

(c) contrary to the interests of consumers.

4.8.3 These are addressed in turn below.

4.9 Was the RAB adjustment consistent with the primary purpose of the RAB?

4.9.1 As the CAA rightly acknowledges in its H7 Final Decision[141] the RAB of a regulated entity plays a central role in incentive regulation. Regulated utilities make long-run investments in assets with long operating lives, such that this capital expenditure ("**capex**") needs to be recovered over multiple price control periods. The RAB represents the regulated capital value of such investments, such that an efficiently operated company is allowed to earn a return (based on its WACC), in order to incentivise it to invest and continue its operation in the long-term interests of consumers.

4.9.2 In particular, a company that invests efficiently is targeted to earn an appropriate return on its investment, through a combination of allowances for regulatory depreciation of the RAB and a return (based on its WACC) each year on the remaining undepreciated part of the RAB. This is a targeted return, not a guarantee. Incentive based regulation provides incentives that reward efficient investment and outputs.

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[141] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraphs 10.1-10.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 191**.

4.9.3 One consequence of this is that any investments made inefficiently should not be fully rewarded, and the company should bear the cost of such inefficiency to the extent prescribed in any cost sharing incentive scheme in force at the time, so as to incentivise only *efficient* investments.

4.9.4 In addition, the WACC applied to the undepreciated part of the RAB is based on that of an efficient, notionally geared company. If the company has higher gearing (i.e. a higher ratio of debt to equity), then the benefits and risks of this higher gearing are a matter for its shareholders rather than consumers.

4.9.5 If the regulatory purpose of the RAB is to be achieved, any adjustments must not distort this primary purpose. A larger RAB leads to long term higher prices for consumers, because (as noted above) the building blocks of HAL's price controls include depreciation charges on the RAB and capital costs equal to the WACC on the undepreciated RAB.

4.9.6 As the RAB Report explains at paragraph 2.2.6, the RAB is not (consistent with the above points) simply the accounting value of the assets of the regulated business. In particular:

(a) Expenditure that has been inefficiently incurred is excluded from the RAB. For example, at the start of Q6 the CAA disallowed **£**30 million of HAL's expenditure from the RAB due to inefficiency in HAL's management of the Terminal 3 Integrated Baggage programme.[142]

(b) In H7, through the Traffic Risk Sharing mechanism, adjustments may be made to the RAB depending on outturn levels of traffic compared to the CAA's forecast. This mechanism de-risks HAL by a mix of (i) reducing the volatility in HAL's revenues and profits and (ii) providing compensation in the RAB, following demand shocks, which in turn yields consumer benefits in the form of lower charges by reducing HAL's WACC.

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[142] CAA, *CAP1103: Economic regulation at Heathrow from April 2014: final proposals,* October 2013, paragraph 10, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_37/page 2563**.

4.9.7 In both of these examples the integrity of the RAB, as an instrument of incentivisation that operates to the benefit of consumers, is maintained. It is for the same reason that the CAA (rightly) refused to grant HAL any further RAB uplift, in respect of alleged historical losses.[143] There could be no possible justification for increasing the RAB, which is already (for the reasons explained above and below) unjustified and excessive.

4.9.8 With these fundamental principles in mind one turns to the critical question for the CAA when considering whether the **£**300 million adjustment to HAL's RAB could reasonably be maintained: namely, does it (or did it, with respect to the period prior to the H7 Final Decision) – in the H7 period - incentivise efficient investment to the benefit of consumers?

4.9.9 In the context of H7 this was a question to which the only reasonable answer was "no" (and the CAA's failure to reach this conclusion was an error of fact, law and/or discretion). This is for two reasons:

(a) **First**, the RAB adjustment is not required to encourage efficient investment. Indeed, in considering the quantum of the RAB adjustment, the CAA explicitly noted that efficient capex investment would be added to HAL's RAB in any case.[144]

(b) **Second**, there is no evidence of HAL's additional investment following the April 2021 RAB adjustment.

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[143] CAP2365D H7 Final Proposals Section 3 Financial issues and implementation (FP Section 3), paragraph 10.39, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1681** where the CAA stated that *"It is in the nature of price control determinations that the forecasts on which the determination is based are typically different from out-turn. Under incentive regulation, we do not retrospectively correct for these forecast errors, even when they are material"* and FD paragraph 10.75 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1688.**

[144] CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision), April 2021, paragraph 4.17 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 792.**

The CAA's reasoning

4.9.10 The CAA gave two primary reasons for the **£**300 million RAB adjustment in the summary section of the April 2021 RAB Adjustment Decision, namely that it was intended to:

"secure that all reasonable demands for airport operation services at Heathrow airport are met. We consider that this intervention will do this by incentivising additional investment by HAL during 2021 that would further the interests of consumers. We expect HAL to be proactive in undertaking necessary investment to maintain service quality and provide necessary capacity during the remainder of 2021 in the event of a stronger than expected recovery in passenger traffic."

and:

"secure that an efficiently (or 'notionally') financed company ... can finance its licensed activities at Heathrow airport. This should avoid a higher cost of debt finance for HAL that could increase charges to consumers in the future. We consider that this intervention will do this by providing a strong signal that the regulatory framework is consistent with enabling a notionally financed company to continue to access cost effective investment grade debt finance. Nevertheless, we recognise that HAL faces significant financial risks if traffic recovery is slower than expected, even with this adjustment to its RAB."[145]

4.9.11 As the RAB Report explains at paragraph 2.3.2, as a point of economic logic, these justifications would (at most) hypothetically apply in mutually exclusive scenarios of, *ex post*, either high demand <u>or</u> low demand. While the CAA understandably wished to allow for both of these eventualities, it is logically the case that, *ex post*, only one of these outcomes can be realised. This is important for two reasons:

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[145] CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision), April 2021, paragraph 4 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 754**.

(a) First, any supposed benefits of one reason cannot be aggregated with the benefits of the other reason, unless of course those benefits are discounted by the probability of traffic being either higher or lower than forecast.

(b) Second, the CAA's justifications are not capable of reinforcing one another, since they will only apply in different demand/traffic scenarios. In other words, if the justifications are individually weak or mistaken, they cannot become legitimate in combination.

4.9.12 In the event, as the RAB Report explains at paragraph 2.5.23s, neither of the two reasons given by the CAA are reasonably capable of justifying a **£**300 million adjustment to HAL's RAB.

4.10 Does the RAB adjustment secure that all reasonable demands for airport operation services are met?

4.10.1 The CAA's first justification at paragraph 4.9.10 above is unsupportable for reasons that would have been readily apparent to it had it conducted the review which it was required to (but failed to) conduct. This is because the evidence before the CAA admitted of only one conclusion – i.e. that HAL had failed to do as it had promised when seeking the RAB adjustment. There is no evidence that HAL had actually made *any* incremental expenditure due to the RAB adjustment. The absence of such evidence is unsurprising as not only did HAL not make a significant amount of additional capital expenditure in 2021, its out-turn capital expenditure was lower than in 2020.

4.10.2 In particular, as AD1 explains[146]:

(a) HAL were not planning and prepared for, and subsequently were unable to meet demand, in the Summer of 2022 despite airlines' clear and persistent warnings that Summer 2022 would bring a strong rebound in passenger volumes once restrictions had been removed.

[146] See Witness Statement of Alexander Dawe at paragraph 180.

(b) This led to staffing issues at the Heathrow ID centre and for passenger, for staff and vehicle and security searches.

(c) In addition, there was broader failure on HAL's part to operate an effective service for PRM, and significant baggage system resilience issues (for example, due to a lack of maintenance on Hold Baggage Screening machines).

(d) HAL refused to open T4 until mid-2022 as a direct result of this. This led to congestion at T2 in particular, and significant delays at the UK border across all terminals. It also meant that airlines could not effectively plan for their expected Summer schedule due to terminal location uncertainty.

(e) HAL under-performed in its SQRB metrics, particularly in relation to security queue performance, and passenger satisfaction in relation to security also declined.

4.11 **Does the RAB adjustment secure that an efficiently (notionally) financed company can finance its licensed activities?**

4.11.1 The second reason that the CAA gives for making its RAB adjustment (at paragraph 4.9.10 above) is concerned with the impact of the Covid-19 pandemic on the financing of Heathrow. The CAA's primary concern here is that deterioration in debt credit metrics, particularly the Regulated Asset Ratio ("**RAR**"),[147] would lead to a risk of credit rating downgrade, and would raise the interest rates HAL needed to pay (on new debt). This, the CAA argued, would not be in consumers' interests.

4.11.2 In all its regulatory decisions the CAA, rightly, focuses on the "notionally financed company" – carrying debt at 60% of the value of the RAB. HAL's actual debt gearing

[147] Defined as the ratio of HAL's debt to its RAB. See CAA, *CAP2098: Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment*, February 2021, (hereafter: "RAB Adjustment Response"), Appendices, Paragraph E7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 674**.

is higher than this,[148] but the benefits and risks of this are taken by shareholders for which neither airlines nor consumers should bear any responsibility.

4.11.3 Under this justification, the CAA's April 2021 RAB adjustment (confirmed in the H7 Final Decision) would not be in consumers' interests if the RAB adjustment exceeds the expected saving in interest payments. The CAA also established a threshold by which this can be judged, namely that the **£**300 million adjustment to the RAB would be justified if it prevents the average interest rates which HAL pays on its debt from rising by 0.1%, or 10 basis points ("**bps**").[149]

4.11.4 The CAA's first error was, as explained at paragraph 2.5.3 of the RAB Report, in failing properly to assess the likelihood of a 10 bps increase in HAL's overall cost of debt. Here:

(a) The CAA's threshold relates to an <u>increase</u> in HAL's <u>overall</u> cost of debt, not merely newly issued debt.

(b) The CAA has already determined that new debt will be only 11.61% of total debt in H7.[150]

(c) It follows that the 10bps increase in average debt costs would require there to effectively be a 10 bps / 11.61% = 86 bps rise in the cost of new debt during H7.

4.11.5 The CAA does not suggest that there is any reasonable basis to expect that such effects will persist beyond the end of H7. Indeed, such a conclusion could not rationally be

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[148] As of 31st December 2022, Heathrow (SP) Limited had a Senior (Class A) Regulatory Asset Ratio ("**RAR**" – or gearing) of 64.9%. This rises to 76.0% with inclusion of Junior (Class B) debt. See Heathrow (SP) Limited, *Results for the year ended 31 December 2022*, 2022, page 40, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_105/page 10027**. (see "Financial ratios applying to Heathrow (SP) Limited and Heathrow Finance plc" for 31st December 2022).

[149] CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision), April 2021, paragraph 31 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_760**.

[150] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3),* section 3, Table 9.6, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 189.**

reconciled with the CAA's projection that Heathrow will once more be running at high levels of capacity by 2024 (specifically, 97.5% of its peak passenger numbers in 2019)[151] such that HAL will no longer under pandemic-induced financial pressure.

4.11.6 Faced with this, the CAA was required to consider both in April 2021 and in the H7 Final Decision whether it could reasonably be expected that HAL's new debt costs would rise by 86 bps, absent the **£**300 million RAB adjustment. This was a question which admitted of only one answer: this could not reasonably be expected. As paragraph 2.5.6 of the RAB Report explains:

(a) What the CAA *did* do was to conduct an indicative analysis of the trading yields of iBoxx indices of relevant ratings and found that a two-notch downgrade from A to BBB would result in a 38.5bps to 56.7bps increase in the cost of debt. However, even taking the higher of these figures and assuming two-notch downgrade, HAL's overall cost of debt would only have increased by around 6.6bps (56.7bps x 11.61%). Therefore, <u>even if,</u> without the adjustment, Heathrow would have received a two-notch credit risk downgrade, the **£**300 million RAB adjustment would still have lacked justification.

(b) Moreover, even on HAL's <u>actual</u> level of gearing (rather than that of a notional company with materially lower gearing), a two-notch downgrade by the debt markets could not reasonably be expected. This should have been clear to the CAA for the reasons set out by paragraphs 2.5.9 to 2.5.15 of the RAB Report, specifically that:

(i) Heathrow Funding Limited's Senior (Class A) and Junior (Class B) debt have maintained investment grade credit ratings throughout 2020-2022, and the CAA recognised that "*an early RAB adjustment [was] not*

[151] CAA, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* Table 1.7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 54**.

necessary to support HAL being able to access investment grade debt or prevent a substantial short term increase in the cost of debt."[152]

(ii) Investors would have been aware of HAL's strong cash position that would protect interest payments even in the event of a prolonged pandemic. Heathrow (SP) Limited's Annual Report and Financial Statements for the year ended 31 December 2020 (published on 24 February 2021, *before* publication of the April 2021 RAB Adjustment Decision and without any reference to such an adjustment) stated - in terms - that:

"*We have sufficient liquidity to meet all our forecast needs until at least April 2022 under the extreme stress-test scenario of no revenue, or well into 2023 under our current traffic forecast. This includes forecast operational costs and capital investment, debt service costs, debt maturities and repayments. This liquidity position takes into account £3,891 million in cash resources as well as undrawn debt and liquidity at Heathrow Finance plc as at 31 December 2020*."[153]

(iii) HAL was able to raise significant debt in 2020 and 2021. Again, this is clear from the Heathrow (SP) Limited Annual Report and Financial Statements.

(iv) Fourth, even on its *actual* financial structure, HAL has stated that a RAB adjustment was not required for compliance with its debt covenants.[154] HAL itself stated:

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[152] CAA, CAP 2140 Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision), April 2021, paragraph 3.26, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 778**.

[153] Heathrow (SP) Limited, *Annual Report and Financial Statements 2020* (hereafter: "**Heathrow 2020 Annual Report**"), December 2020, page 52, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_92/page 7667**.

[154] CAA, *RAB Adjustment Response, Appendices*, February 2021, paragraphs E4-E5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 673-674**.

> "*Compliance with debt covenants is not dependent on [a RAB] adjustment [of £2.7 billion], but urgent action remains critical to demonstrate the good functioning of our regulatory framework and assumptions ...*"[155]

4.11.7 In these circumstances the only rational conclusion was that a RAB adjustment was not required in order for HAL to raise new debt. This factor could not provide a reasonable justification for a RAB adjustment *even if* it was considered appropriate to approach the matter by reference to whether HAL (rather than a notional company with lower gearing) would have faced excessive costs in raising debt.

4.11.8 In addition, the CAA also seeks to justify its RAB adjustment on the risk to the headroom on HAL's *actual* debt gearing covenants. However, given the point made above this is an error: even HAL did not explicitly justify its request for intervention on this basis[156] and the CAA acknowledges that:

> *"We also note that shareholders could remedy the issues with HAL's RAR covenant by making a suitable injection of new equity finance."*[157]

4.11.9 Finally, in H7 the CAA has taken other measures to ensure "the good functioning of our regulatory framework and assumptions", specifically designed to reduce the risks that HAL faces. Investors or lenders would expect that these risk reduction measures, particularly the TRS mechanism and the asymmetric risk allowances, would reduce HAL's risk (as regards the TRS) and increase its expected revenues (as regards the asymmetric risk allowances), thus providing HAL with further protection from default risks compared to its historical position in Q6 and previous price controls.

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[155] Whilst this statement refers to HAL's request of a £2.7 billion RAB adjustment, it must logically apply to the smaller £300 million adjustment awarded by the CAA. See RAB Adjustment Response, *Appendices*, February 2021, paragraph E5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 674**.

[156] CAA, *RAB Adjustment Response, Appendices*, February 2021, paragraphs E4-E5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 673-674**.

[157] CAA, *RAB Adjustment Response, Appendices*, February 2021, paragraphs E12, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 675.**

4.11.10 The CMA has previously recognised in its redetermination of PR19 that credit rating agencies will be more concerned with the ability of the future regulatory package to enable financeability, rather than "temporary weakness in ratios":

"As a result, in addition to finding that the average ratios for AMP7 are consistent with strong-investment grade, our view is also that our determinations are consistent with a positive trend in the companies' financial position. Our view is that that rating agencies would be less likely to react to a temporary weakness in ratios if they were expected to be resolved during AMP7. The agencies have referred to 'persistent' weakness in credit ratings being a signal for a risk of downgrade."[158]

4.11.11 In conclusion, for these reasons (and for those which are set out in greater detail in the section 2.5 of the RAB Report and paragraphs 120 - 185 of AD1) it was an error for the CAA to assume that HAL was at risk of an increase in debt costs – and certainly not of the order to justify a **£**300 million RAB adjustment. Such an adjustment could only have been justified if the cost of new debt for a notional or efficient company would otherwise (in the absence of the RAB adjustment) have increased by a material amount over H7 by around 86 bps. The CAA could not reasonably conclude that there would be anything like such an effect (which would significantly exceed even its estimated impact of a two-notch credit downgrade).

4.12 Consumer harm

4.12.1 The CAA has further erred in its assessment of whether the RAB adjustment provided "*the best balance of our objectives and meets our primary duty to further the interests of consumers*".[159] This conclusion rested on its (heavily qualified) assessment that:

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[158] CMA, *Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report,* 17 March 2021, paragraph 10.133, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_96/page 9224**.

[159] CAP 2140 *Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision)*, April 2021, paragraph 3.62 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1**_778; CAP2365D *H7 Final Proposals Section 3 Financial issues and implementation (FP Section 3)*, paragraph 10.99, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1625**.

"it is plausible that the relatively small increase in the aeronautical charge of approximately £0.30 per passenger (or 1.5%) implied by the adjustment would be offset by benefits to consumers from (i) a reduction in the WACC [which I assume is a reference to a previous point in the paragraph that the RAB adjustment may have "potential benefits for debt financing costs and hence the cost of capital for H7"]; (ii) an increase in investor confidence supporting investment in service quality (if there is a quick recovery in traffic volumes in 2021); and (iii) an improvement in the notional company's financing position going into H7 (for example, if traffic is weaker in 2021). We would also take account of the RAB adjustment in coming to a view on the cost of capital for H7."[160] *(emphasis added)*

4.12.2 As paragraphs 1.2.2 to 1.26 of the RAB Report details, this framing cannot reasonably be supported.

(a) As explained at paragraph 4.9.6 above, the RAB adjustment is contrary to the key principle of the RAB and incentive regulation; namely that only efficiently incurred capex should be added to the RAB. This should have been the CAA's starting point.

(b) Moreover, the relevant question is whether it can be *reasonably expected* that a RAB adjustment of **£**300 million *would* yield **£**300 million of consumer benefits over time; "plausibility" is not an appropriate standard in circumstances where the consumer costs of the RAB adjustment will persist in future price control periods until the **£**300 million addition is fully depreciated away.

(c) It is simply incorrect to suggest that consumers *may* be better off as a result of a fall in the WACC due to the RAB adjustment. There was not (for the reasons set out above) any reasonable scenario in which the adjustment would lead to a fall in HAL's debt costs of the magnitude that would be required to offset the costs of the adjustment.

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[160] CAA, CAP 2140 *Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision)*, April 2021, paragraph 3.62 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 787**.

4.12.3 On the CAA's own logic, the benefit to consumers must be in terms of securing the ability to meet reasonable demands on airport operations (in the event that traffic recovery is faster than expected), or securing that an efficiently financed Heathrow can finance its licensed activities (in the event that passenger traffic is below forecasts).

4.12.4 As regards the scenario of higher than forecast traffic.

(a) the CAA indicated that the RAB adjustment:

"... should also provide HAL with additional financial flexibility and incentives to carry out appropriate further investment, including the £218 million of capex that HAL set out to maintain service quality across a full range of demand scenarios and provide necessary capacity during 2021".[161]

Elsewhere the CAA comments that:

"HAL's request for an adjustment of £800 million is not proportionate to the investment it is seeking to make of around £218 million in capex (which in any case would be added to HAL's RAB) and £9 million in opex"[162] *(emphasis added)*

(b) As paragraph 2.6.6 of the RAB Report explains (and disregarding for the moment HAL's actual incentives to make any such investments given the CAA's April 2021 RAB Adjustment Decision), this additional expenditure adds up to **£**227 million, of which **£**218 million in capex would "in any case" be added to HAL's RAB. After the RAB adjustment, if this capex had been made, then HAL's RAB would have increased by **£**518 million. This sum represents the present value of what consumers will be required to pay in future. Thus, even in the case where passenger traffic exceeds forecasts *and* HAL had spent an

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[161] CAA, CAP 2140 *Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision)*, April 2021, paragraph 28 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 759**.

[162] CAA, CAP 2140 *Economic regulation of Heathrow Airport Limited, response to its request for a covid-19 related RAB adjustment (RAB Adjustment Decision)*, April 2021, paragraph 3.15, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_19/page 775-776**.

additional **£**227 million, consumers would be worse off by **£**291 million (**£**518 million - **£**227 million).

(c) Even this loss of **£**291 million assumes that HAL would have needed to spend all of the estimated **£**227 million in the event of higher than expected traffic forecasts. It is for this reason that the commitment to review the appropriateness of the April 2021 RAB Adjustment in the context of H7 was essential. As the RAB Report explains at 2.6.7, consumers were – in effect - paying not for Actual expenditure, but rather a "*real option*" that HAL undertakes the expenditure to prepare for the eventuality that the additional capacity was required. Actual real option value that consumers received would be considerably less than **£**227 million, due to the non-zero probability that it would not be required, or only partially required. Reductions in capex would also reduce the normal addition to the RAB (i.e. that which would occur in any case, regardless of the RAB adjustment). If HAL had incurred no additional capex, then the RAB adjustment would cost consumers the full **£**300 million RAB adjustment.

(d) Furthermore, these calculations assume that HAL was actually incentivised to make additional investments by the April 2021 RAB Adjustment Decision. However, and as paragraphs 2.6.9 to 2.6.10 of the RAB Report explains this is not the case for two reasons.

(i) **First**, to the extent that HAL may have needed to invest to ensure quality of service and capacity to meet a potential increase in demand, the associated expenditures would have been allowed into the RAB in any case (as the CAA has confirmed). Therefore, HAL did not require any supplementary incentive beyond the standard RAB-based approach already available.

(ii) **Second**, in the absence of the promised review, the **£**300m RAB adjustment provides *no incentive* since the additional revenue to HAL (return and depreciation on the addition to the RAB) with the adjustment is not conditional on any incremental investment taking place (absent further measures), nor is it even conditional on HAL having enabled

higher than expected demand to be met. This is (to repeat the point made above) why it is critical that an ex-post review of HAL's operational performance is essential.

4.12.5 In the event that traffic forecasts were lower than expected, and even in the case where absent the £300 million RAB adjustment HAL received a two-notch downgrade (which was never in reasonable prospect for the reasons set out above), consumers would effectively be paying 1.4-2.2 times[163] what is necessary to maintain Heathrow's credit rating (e.g. £0.13-£0.20 per passenger for a £0.30 cost): see paragraph 2.6.11 of the RAB Report.

4.12.6 The consequence is that in either case (passenger numbers either above or below forecasts), consumers are required to pay for something that provides no equivalent benefit, and so is contrary to their interests. The CAA erred in concluding to the contrary.

4.12.7 Alternatively, *even if* there was a financeability issue with the notional company (which, for the reasons set out above, there was not), requiring consumers to pay more to fix the issue is not a reasonable or lawful response. This is because:

(a) It effectively provides more value to shareholders who are already benefiting from the expectation of earning the allowed cost of equity on their investment.

(b) The CAA has itself recognised that equity investors could provide cash injections if necessary to maintain HAL's debt covenants. This was, as a matter of regulatory principle, the appropriate response, as was recognised by the CMA in its PR19 redetermination:

"Whilst our financeability analysis is based on the notional company, the water companies also have a licence condition to maintain an investment grade credit rating for their debt, and we consider that if any of the Disputing Companies were facing a financeability constraint, they would be in a position to consider a range of mitigating actions to address impact. This could include absorbing

[163] 86bps/56.7bps=1.4 times, and 86bps/38.5bps=2.2times.

headroom in credit ratios, or requiring a contribution from equity, eg to forego dividends or inject fresh capital."[164]

4.13 Conclusion

4.13.1 For the reasons set out above, the Appellants submit that the CAA erred in fact, law and/or discretion both at the time of April 2021 RAB Adjustment Decision and when it chose to retain that adjustment in the H7 Final Decision. More particularly:

(a) The RAB adjustment was not reasonably necessary to secure that a notionally geared company (or indeed HAL) could finance its licensed activities.

(b) It did not incentivise HAL to make the necessary capex investment to secure that all reasonable demands for AOS at Heathrow Airport were met.

(c) The RAB adjustment has benefited HAL's shareholders at the expense of consumers and will continue to cause consumer harm over the period (currently approximately 20 years) the RAB is depreciated.

4.13.2 In consequence, and for the reasons set out above, the making (and maintenance) of a RAB adjustment was:

(a) contrary to the CAA's statutory duty to further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS (section 1(1) CAA2012);

(b) contrary to the CAA's statutory duty to have regard to the need to promote economy and efficiency on the part of HAL in its provision of AOS at Heathrow Airport (section 1(3)(c) CAA2012); and

(c) inconsistent with the CAA's statutory duty to have regard to the principles of better regulation, in particular that regulatory activities should be carried out in

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[164] CMA, *Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report*, 17 March 2021, paragraph 10.134, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_96/page 9224**.

ways that are transparent accountable, proportionate, consistent and targeted (sections (1)(3)(g) and 1(4) CAA2012).

4.14 Relief

4.14.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it implements the RAB adjustment and that the RAB adjustment be removed from HAL's licence.

4.14.2 To assist the CMA in providing the necessary directions for the CAA to give effect to this relief, Annex A1 to the RAB Report explains the changes required[165].

[165] RAB Report, 17 April 2023, Annex A1.

5. GROUND 3: WEIGHTED AVERAGE COST OF CAPITAL (WACC)

This ground concerns the errors in the CAA's decision to set the weighted average cost of capital (**WACC**) too high at 3.18%, within a broad range of 2.64 - 3.73%.

5.1 Key Documents

5.1.1 The key evidence that the Appellant requests the CMA reads when considering this ground is:

(a) the H7 Final Decision (paragraphs 51-53 of the Summary Document and Chapter 9 of Section 3 Financial Issues and Implementation entitled 'Weighted Average Cost of Capital' (pages 7-44));

(b) the H7 Final Proposals (paragraphs 58-64 of the Summary Document and Chapter 9 of Section 3 Financial Issues and Implementation entitled 'Weighted Average Cost of Capital' (pages 8-86));

(c) the WACC Report prepared by AlixPartners, which explains that the CAA has "*significantly overestimated the WACC*";[166]

(d) Paragraph 185 to 202 of AD1; and

(e) the CAA's summarised the WACC estimates in the H7 Final Decision and the H7 Final Proposals in Table 9.6 of Final Decision (replicated below).

H7 Final Decision: Extract from Table 9.6 Impact of market developments on the H7 Final Proposals WACC

	Final Decision		H7 Final Proposals	
	High	**Low**	**High**	**Low**
Gearing	60%	60%	60%	60%
RFR	0.59%	0.59%	-2.03%	-2.03%

[166] WACC Report, 17 April 2023, paragraph 3.

TMR	5.85%	5.85%	5.85%	5.85%
Asset beta	0.62	0.44	0.62	0.44
Debt beta	0.05	0.1	0.05	0.1
Equity beta	1.47	0.95	1.47	0.95
Post-tax cost of equity	**8.32%**	**5.59%**	**9.56%**	**5.45%**
Cost of new debt	4.22%	4.22%	0.89%	0.89%
Cost of embedded debt	-0.08%	-0.08%	0.17%	0.17%
Issuance and liquidity costs	0.25%	0.25%	0.18%	0.18%
Cost of debt	0.67%	0.67%	0.43%	0.43%
Vanilla WACC	3.73%	2.64%	4.08%	2.44%
Point estimate	**3.18%**		**3.26%**	

Source: Table 9.6, H7 Final Decision, Impact of market developments on the H7 Final Proposals WACC.

5.2 Summary of errors

5.2.1 Ground 3 concerns the CAA's decision to set the WACC at 3.18%, within a broad range of 2.64 - 3.73%. The Appellant contends that:

(a) **Asset Beta** errors: The CAA erred in its estimation of HAL's Asset Beta due to the following errors of fact, discretion and/or law:

(i) The asset beta is too high because the CAA has failed to rely on the most recent data when estimating the non-pandemic beta. The correct figure should be 0.44.

(ii) The CAA has overestimated the pandemic effect on the beta. First, because CAA (relying on Flint Global) used the wrong methodology in weighting the pandemic and non-pandemic betas. Second because CAA (relying on Flint Global) erred in its adjustment for gearing.

(iii) The CAA wrongly assumed that 50-90% of HAL's risk is traffic related when the only conclusion that could reasonably be supported by the available evidence is that it was in the range between 90-100%.

(b) **Index-linked Premium** errors: The CAA erred in its calculation of the appropriate WACC by:

(i) adding a material liquidity premium in respect of index-linked debt; and

(ii) having done so, misstating the magnitude of the adjustment.

(c) **Point Estimate** errors: The CAA erred by adopting the midpoint of the WACC range as the appropriate point estimate.

(i) The CAA misjudged or ignored factors that are relevant to its decision to set a WACC at the mid-point of the range, given the timing of H7 (including a severe cost of living crisis and no major capacity expansion) and factors specific to HAL- namely (i) asymmetry of costs and benefits; (ii) asymmetry of pandemic events; (iii) information asymmetries between HAL and the CAA; and (iv) effects of distortions created by the outer band of the TRS.

(d) **Allowance for Asymmetric Risk** error: The CAA erred in failing to take into account the latest data available to it demonstrating that the return of pandemic traffic was materially faster than expected. In doing so, the CAA failed to update the allowance for asymmetric risk for the higher outturn of traffic in 2022.

5.3 Consequence of errors and materiality

Table 1: Errors identified in the FD

Error	Estimated impact on WACC	Estimated impact on H7 aeronautical revenue requirement (2020 prices)[15]
Errors in estimation of beta		
Baseline beta	-0.40%	-£396m
Pandemic capacity constraint adjustment	-0.12%	-£119m
TRS adjustment	-0.10%	-£99m
Error in estimating the "premium" on index-linked debt	-0.04%	-£40m
Errors in assessing the balance of aiming up/down within the WACC range	-0.06%	-£59m
Updating asymmetric risk adjustment	n/a	-£7m
Total	**-0.72%**	**-£720m**

Source: AlixPartners

Source: AlixPartners, Table 1

5.3.1 As explained in paragraphs 10 to 12 of the WACC Report, in aggregate (including the correction of the asymmetric risk adjustment), the above errors imply that the WACC of the H7 Final Decision was over-estimated by a significant 0.72 percentage points, and an overstatement of £720 million in HAL's H7 aeronautical revenue requirement (in 2020 prices) – with a breakdown being shown the table above. This discrepancy (and the errors which lead to it) takes the WACC range in the H7 Final Decision outside the range which a reasonable regulator could properly arrive at.

5.3.2 The correct real vanilla WACC is 2.46%, compared the CAA's H7 Final Determination figure of 3.18%. The correct pre-tax WACC is 3.11%,[167] compared the CAA's H7 Final Decision figure of 4.04% from license condition C1.10(c).

5.3.3 The risk of harm to consumers is a material issue for H7 given the importance of the recovery from the impact of the Covid-19 pandemic, the cost of living crisis and the fact that HAL's airport charges are already among the highest in the world.[168]

5.4 Summary of Relief

5.4.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it sets the WACC at 3.18% and substitute the decision with a corrected WACC. The result of correcting the errors is to give a point WACC estimate of 2.46%, within a range of 2.34 - 2.71%.

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[167] The calculation from vanilla to pre-tax WACC assumes a rate of corporate tax of 19% to 5th April 2023 and 25% thereafter, with an average over H7 of 23.5%.

[168] Jacobs Report, 2022 Review of Airport Charges, page 3, as extracted in the Witness Statement of Alexander Dawe dated 18 April 2023 at page 7.

5.5 Overview of Ground 3

5.5.1 The CAA has erred in its methodology for setting the WACC for H7.

5.5.2 As the CAA observed in its H7 Final Decision, WACC is a "*key building block*" of the revenue HAL is permitted to earn under the price control[169]. The WACC is the weighted average of HAL's cost of equity and cost of debt finance. It represents a return on the RAB and acts as a payment to investors and creditors for the risk they incur by committing capital to the business. As the CAA acknowledges *"[s]etting an appropriate WACC furthers the interests of consumers*" by helping to secure not only that HAL is able to finance necessary investment, but also (critically) that efficient financing costs are reflected in the price control – i.e. those which are "*are no higher than necessary*" (emphasis added)[170].

5.5.3 As a result of a number of material errors in the CAA's methodology, the WACC is set at a higher level than can reasonably be supported. The Appellant does not raise this ground lightly. It acknowledges that there are inherent uncertainties in estimating the costs of equity and debt, such that the results are typically estimated as lying within a range. However, what the CAA has done is to adopt an approach which – in four critical respects – were simply wrong, and not matters which could be justified as a matter of regulatory judgement. The four errors are: 1. asset beta; 2. index linked-premium; 3. point estimate; and 4. allowance for asymmetric risk. The consequence is that these were material errors of discretion, which have resulted in material errors of fact which render the WACC calculation not reasonably supportable.

5.5.4 The materiality of these errors is such that the WACC has been set at an unsupportably high level. While a reduction of the WACC to a level which is reasonably supportable would be in the interests the Appellant and other airlines, more significant is that a failure to do so will cause significant harm the interest of consumers of air transport services. In particular, the WACC has been over-estimated by at least 0.72 percentage

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[169] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3),* paragraph 9.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 153**.

[170] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3),* paragraph 9.1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 153**.

points, which equates to a **£**713 million overstatement (**£**720 million when including the over-estimated asymmetric risk allowance) in HAL's aeronautical revenue requirement (in 2020 prices) This will result in passengers being over-charged,[171] with consequent consumer harm.

5.6 The CAA's Methodology

5.6.1 The Appellant does not take issue with the overall approach that the CAA adopts to estimate HAL's cost of capital. This follows that of other economic regulators (and, indeed, the CMA) of estimating WACC. While the CMA will be familiar with this mechanism, in the interests of comprehensibility in this appeal ground, a summary of this methodology is provided below.

5.6.2 In broad terms, the accepted methodology involves separately estimating:

(a) HAL's cost of equity;

(b) HAL's cost of debt; and

(c) Then weights these together using a notional gearing ratio, assuming that HAL is financed 60% by debt and 40% by equity.

5.6.3 In common with all other economic regulators in the UK and Europe, the CAA estimates the cost of equity through application of the Capital Asset Pricing Model

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[171] The CAA acknowledges that a WACC which is set too high leads to a higher per passenger charge resulting in "*consumers paying too much*" and the over-compensation of investors – see CAA, *CAP2365 Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Financial issues and implementation,* June 2022 paragraph 9.392, page 78, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1664**; CAA, *CAP2265C, Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Section 2: Financial issues, 22 October 2021,* paragraph 9.8, page 42. exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_22/page 973**.

("**CAPM**"). The CAPM calculates the post-tax cost of equity with the following formula:

Post-tax Cost of Equity

= Risk Free Rate + Equity Beta x (Total Market Return – Risk Free Rate, or Equity Risk Premium)

5.6.4 In this equation, the Risk Free Rate ("**RFR**") and Total Market Return ("**TMR**") are generic market-wide figures that capture the overall cost of market risk to investors. They measure, respectively, the return that an investor would expect on an asset that has virtually no risk and the return that an investor would expect on a "market portfolio" weighted to represent all assets available to investors.

5.6.5 By contrast to these generic, market-wide figures, the Equity Beta is company specific and measures the risk of the company relative to the market portfolio.[172] According to the CAPM, Equity Beta is captured through measuring the covariance between the expected return of the company and that of the market portfolio, so as to capture the extent to which the company's returns are more or less volatile than the market as a whole.

5.6.6 Equity Beta can be directly estimated for a company with publicly listed equity. However, for a private company, such as HAL, it needs to be inferred by:

(a) estimating the Beta for the underlying assets of the company – the "Asset Beta" - usually by reference to other similar assets where the beta is known; and

(b) performing a "*gearing adjustment*" to allow for the particular debt gearing of the company – requiring further data or assumptions on debt gearing and debt beta.

5.6.7 Assessing HAL's cost of equity thus turns on the analysis of its Asset Beta and to a lesser extent its "debt beta" and gearing. It is important to appreciate that the relevant Asset Beta is not the historical estimate (which will be influenced by the COVID-19

[172] A "beta" in this context is a measure of the volatility, or systematic risk, of a particular asset relative to the market for comparable assets.

pandemic and the impact of volume volatility on HAL's profit volatility under Q6 and previous price controls) but the expected value of the asset beta over the H7 period, including the impact of the TRS mechanism.

5.7 Asset Beta

5.7.1 The CAA's first error was in its estimation of HAL's Asset Beta. Here, the H7 Final Decision confirmed[173] the three-stage process for the estimation of the Asset Beta set out in the Final Proposals. This led to it estimating a beta range of 0.44-0.62. The building blocks were as follows:

5.7.2 **Stage one** - non-pandemic beta: this establishes the asset beta that would have applied in the absence of either a pandemic, or any change to the regulatory framework – most notably in the absence of the TRS. This had two components:

(a) First, HAL's pre-pandemic asset beta was taken to be the same as HAL's Q6 asset beta (0.5). The Q6 asset beta used Fraport (asset beta of 0.52-0.55) and ADP (asset beta of 0.59-0.60) as comparators since HAL's beta is not directly observable because it does not have publicly listed equity.[174] The CAA then adjusted these down to 0.5 due to Heathrow's lower risk as a result of excess demand.[175]

(b) Second, the effect of the pandemic in narrowing the difference between HAL's asset beta and that of other airports that the CAA uses as a "*comparator set*" to establish a benchmark asset beta for HAL. This gap has existed for a number of years whilst Heathrow has been operating at full capacity in respect of air traffic movements ("**ATM**"), cushioning HAL's passenger traffic volatility

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[173] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3),* paragraph 9.67, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 164**.

[174] CAA, *CAP 1115 Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences*, 2013, Figure 7.3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_38/page 2970.**

[175] CAA, *CAP 1115 Estimating the cost of capital: a technical appendix for the economic regulation of Heathrow and Gatwick from April 2014: Notices of the proposed licences*, 2013, paragraph 7.72, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_38/page 2989**.

compared to other airports. The CAA argues that the severity of the pandemic on air traffic reduced this "cushion", so as to expose HAL to passenger traffic volatility more in line with other airports. To allow for this the CAA added a 0.1 at the top end of the range, i.e. the range is 0.5-0.6. Accordingly, the CAA effectively assumes that, pre-pandemic and the TRS, the volatility in HAL's traffic has increased *relative* to comparator airports.

5.7.3 **Stage two** - pandemic beta adjustment: this was assumed to be the same as the effect of the pandemic on the "comparator set" determined from an analysis by Flint Global ("**Flint**");

5.7.4 **Stage three –** an adjustment reflecting the adoption of the TRS mechanism.[176] This was required because the TRS was designed to reduce the impact of traffic volatility on HAL's financial returns through adjustments to pricing, and reflects the (correct) principle that it is necessary to take account of the underlying risk of the HAL assets in light of both the risk of traffic volume volatility <u>and</u> the mitigations to that risk that are being put in place by the Determination as a whole.

5.7.5 The CAA has made critical errors at each stage of this analysis.

Pre-pandemic beta

5.7.6 As regards stage one, it was simply irrational for the CAA to rely on a Q6 finding when more recent (and more reliable) pre-pandemic asset beta data was available for the comparator set. As explained in paragraph 45 of the WACC Report[177], the reliance on outdated and unreliable data led to the adoption of an erroneous starting point for calculating HAL's pre-pandemic beta. Even taken alone this was an error of such gravity as to render the estimate as a whole unsupportable.[178]

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[176] CAP2524B *H7 Final Decision Section 1 on the regulatory framework (FD Section 1),* paragraphs 2.20 – 2.23, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 61-63**,

[177] WACC Report, 17 April 2023, paragraph 45.

[178] As the WACC Report at paragraph 46 explains, the non-pandemic asset beta range the CAA should have used was 0.44-0.50 (as opposed to 0.5-0.6), WACC Report, 17 April 2023, paragraph 46.

5.7.7 However, this was not the only material error made at this stage of the analysis. This is because the identified purpose of the adjustment is to capture the effect of the relaxation of HAL's capacity constraints "relative to" those of comparator airports.[179] What is therefore required is an assessment of whether there has – in fact – been a relaxation in HAL's capacity constraints since Q6 relative to those of comparator airports. The CAA failed to conduct that analysis, assuming (without any evidence at all, still yet evidence reasonably capable of supporting such a conclusion) that the capacity constraints at HAL *relative* to comparator airports have fallen.

5.7.8 The evidence which was *in fact* before the CAA tells in the opposite direction. In particular, the CAA's own forecasts of HAL's passenger numbers for 2023 which are not materially different to those which the CAA had forecast for 2018/19[180] (at which time the CAA considered that HAL was capacity constrained), and from 2024 onwards the CAA's passenger forecasts are at least 97.5% of HAL's 2019 peak passenger numbers.

5.7.9 That being so, the consequence is that the only conclusion that can reasonably be supported is that set out in paragraphs 46 and 51 of the WACC Report[181], resulting in a pre-pandemic beta of 0.44.

Pandemic adjustment

5.7.10 At stage two, the CAA's was entirely dependent on analysis conducted by external consultants, Flint.[182] The difficulty with Flint's analysis is that the methodology adopted

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[179] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.45, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/161**.

[180] See CAA, *CAP1103 Economic regulation at Heathrow from April 2014: final proposals,* October 2013, Figure 5.5, page 50, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2234**, which indicates that the CAA forecast that HAL would carry 73.2m passengers in 2018/19, which is only marginally higher than the CAA now forecasts HAL would carry in 2023; CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1), Table 1.7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_37/page 2607**.

[181] WACC Report, 17 April 2023, paragraph 45.

[182] Flint Global, *Support to the Civil Aviation Authority: H7 Updated Beta Assessment,* May 2022, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_9556**.

is so seriously flawed that it has resulted in a material error in the pandemic adjustment. Again, this is not a point which the Appellant raise lightly. As a general principle, the CAA is entitled to engage the assistance of external advisors who can be of great assistance. However, in this context their analysis is the subject of foundational analytical flaws, which means that it cannot support the weight which has been placed on it.

5.7.11 The first methodological error is that, as paragraph 53 of the WACC Report explains[183], Flint has departed from the standard economic practice by seeking to address the structural break in the share price time series caused by Covid-19 through a weighted least squares ("**WLS**") estimator. Whilst the use of weighting can validly be deployed in statistical analysis for producing descriptive statistics (e.g. the mean of a population), it is insufficiently precise to be deployed in this context. Indeed, the use of WLS in this context is a departure from current econometric best practice, and not a reasonable approach in circumstances where best practice offers a better, more accurate, approach.

5.7.12 The second (and more serious) error is that Flint's approach involves combining pandemic and non-pandemic periods, which paragraph 54 to 60 of the WACC Report explains[184], demonstrably and significantly distorts the subsequent calculations of asset beta. This is because:

(a) As explained at paragraphs 5.6.6-5.6.7 above, the difference between equity and asset betas is the result of a company's debt gearing.

(b) Debt gearing of most airports increased during the pandemic period due to a combination of falling shareholder equity value and increased debt. As paragraph 56 and Table 5 of the WACC Report explains[185], the evidence demonstrates beyond argument that gearing was higher during the pandemic period (by an average of 8% compared to the whole period). Gearing alone

[183] WACC Report, 17 April 2023, paragraph 53.

[184] WACC Report, 17 April 2023, paragraph 53.

[185] WACC Report, 17 April 2023, paragraph 54-60.

explains between 0.07 to 0.23 (average 0.15) of the difference in asset beta between the pandemic and whole period asset betas.

(c) Flint estimated that difference in asset beta between the pandemic and pre-pandemic period was 0.28. Therefore, roughly half of the increase in asset beta is due to the increase in comparator company gearing and not the pandemic *per se*.

5.7.13 The only reasonable approach (i.e. the only approach capable of accurately identifying the effect of the pandemic) was to estimate equity betas separately for pandemic and non-pandemic period. Unlike Flint's approach, this results in statistically unbiased and efficient estimates.

5.7.14 Using the correct approach one could reasonably estimate a difference in asset betas between pre-pandemic and pandemic periods of 0.16-0.38. Then, even accepting the questionable assumptions as to pandemic frequency and length adopted by the Flint report, a correct range for the pandemic adjustment would be 0.004- 0.061 (as opposed to the Flint estimate of 0.02-0.11). The adoption of Flint's estimate, in light of these methodological errors, was an error. This can be remedied by adopting an adjustment which falls within the defensible range of 0.004 – 0.061.

Risk adjustment

5.7.15 As regards stage three, the CAA was right to conclude that it was necessary to make an adjustment in light of the similarities between HAL and other UK regulated utilities for which empirical asset beta estimates are available. In the absence of risk-sharing mechanisms (as was the case in Q6 and all previous Heathrow price controls) HAL would be exposed to full volume risk, making it a riskier asset than a UK utility network. This was reflected in the asset beta of previous price controls. By introducing the risk sharing mechanism that it has in the H7 Final Decision, the CAA is able to place HAL on a risk spectrum between other comparable listed airports and other UK regulated utilities.

5.7.16 Where the CAA erred was in its approach to determining where HAL lay on this risk spectrum. In a nutshell, the CAA has failed reasonably to account for the significant mitigations to HAL's risk exposure contained in the H7 Final Decision as a whole.

These include the TRS, but also the new asymmetric risk allowance,[186] and the adoption of a "shock factor" to suppress passenger forecasts.[187] These mitigations will significantly reduce the impact of all traffic volatility. Indeed, The TRS *alone* reduces over half of HAL's systematic traffic risk, including both:

(a) Traffic volatility due to any future pandemic;

(b) Traffic volatility during "business as usual", such as typical fluctuations over the business cycle, through to any major economic recession.

5.7.17 While acknowledging that these mitigations needed to be accounted for, the adjustment which the CAA made to the cost of equity was so low as to be unsupportable. It does not provide an adjustment which is reasonably capable of capturing the magnitude of the risk mitigations which are contained in the Proposal, and the extent to which HAL has moved closer to the risk profile of other UK regulated utilities. In other words, the adjustment which was made falls outside the range of adjustments which the CAA could reasonably have made.

5.7.18 The source of this error is that the CAA has incorrectly assumed that, compared to UK energy and water networks, HAL is exposed to additional risks other than traffic variability that would affect its asset beta. This is not an assumption that the CAA could reasonably make on the evidence before it. Other than traffic volatility, where risk is in any case mitigated by the mechanisms described above, and potential forecast bias removed by the various shock and traffic adjustments, there is no reason why HAL is exposed to more systematic risk than the regulated water and energy networks. Nor does the CAA articulate any such reason.

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[186] CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3), chapter 11*, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 206.**

[187] See CAA, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraph 1.28, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 43**. For the reasons set out in 3.11.34 - 3.11.38 above, the existence of these risks has been used to justify other downwards adjustments to passenger forecasts, such that they are *already* double counted.

5.7.19 The CAA's precise methodology is set out at paragraph 9.158 of the H7 Final Proposals, and proceeds as follows:

(a) On the basis of an analysis of observable international airport betas undertaken by Flint, the CAA established an initial range of asset betas of 0.52-0.71.[188] This initial range:

(i) Includes the forward-looking impact of future pandemics by virtue of assumed weighting of the historical data between pandemic and non-pandemic periods[189]; but

(ii) does not yet take account of the TRS that is unique to the HAL H7, with no comparable mechanism in the regulatory regimes of the other airports analysed by Flint.

(b) The CAA then calculates the difference between the benchmark overseas airport asset beta and the average asset beta observed for UK regulated water and energy networks (of 0.342). This gives a difference of 0.178-0.368.

(c) The CAA then makes two critical assumptions.

(i) The first is that the CAA's did not consider it appropriate to assume that the entire difference above is due to traffic risk, although it considered it to be a principal factor. The CAA therefore assumed that between 50%-90% of the calculated asset beta difference is due to HAL's traffic risk. This low assumption was not one which the CAA could reasonably make on the basis of the evidence before it. The CAA does not identify <u>any</u> reason why, other than traffic risk, HAL is exposed to more systematic asset beta risk than the regulated water and energy networks. The CAA's reasoning on this point is limited to an unexplained reference to an instance where economic consultants CEPA "*noted*" that there

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188 CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.150 to 9.152, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1555**.

189 CAA, CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.151, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1555**.

might be "*other factors*" (which are not identified) which *could* account for this difference.[190] However, for the reasons explained in the WACC Report at paragraph 63 to 70[191] there is nothing reasonably capable of supporting the conclusion that HAL is exposed to more systematic risk than the regulated water and energy networks. That being so, the only conclusion reasonably open to the CAA was that a range of 90-100% should be used for comparing HAL with utility networks (once volume and pandemic risk are accounted for elsewhere in the calculation). To do otherwise would allow HAL an additional return with no associated risk, to the detriment of consumers.

(ii) The second is that the CAA assumes that 50% of the traffic risk is mitigated by the mechanisms set out in the H7 Final Decision.[192] The Appellant accepts that this was a conclusion that was reasonably open to the CAA, and acknowledge that it is consistent with the CAA's calculation for the protection offered by the TRS.

5.7.20 The consequence of the above is that the CAA's determination of HAL's Asset Beta cannot be supported, and ought to be quashed due to the following errors of fact, discretion and/or law:

(a) The asset beta is too high because the CAA has failed to rely on the most recent data when estimating the non-pandemic beta. The correct figure should be 0.44.

(b) The CAA has overestimated the pandemic effect on the beta. First, because CAA (relying on Flint) used the wrong methodology in weighting the pandemic and non-pandemic betas. Second because CAA (relying on Flint) erred in its adjustment for gearing.

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[190] CEPA, Response to CAA H7 Initial Proposals: Cost of Capital, 17 December 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_25/ page 1306**.

[191] WACC Report, 17 April 2023, Paragraphs 63-70.

[192] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.85, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/ page 168**

(c) The CAA wrongly assumed that 50-90% of HAL's total risk is traffic related when the only conclusion that could reasonably be supported by the available evidence is that the proportion of Heathrow's total risk that was traffic related was in the range between 90-100%.

5.7.21 The combined effect of these errors is addressed by the WACC Report at paragraph 75 and Table 8. The CMA ought to exercise its powers under section 27(2) of the CAA2012 to reduce the asset beta range to a level which can reasonably be supported (this would fall in the range 0.39-0.43). This requires the reduction of the overall WACC by 0.62%, with a consequential reduction in H7 aeronautical revenue requirements of **£**614 million (in 2020 prices) (see paragraph 75 of the WACC Report).

5.8 Index-linked Premium error

5.8.1 The CAA further erred the calculation of the appropriate WACC by:

(a) adding a material liquidity premium in respect of index-linked debt; and

(b) having done so, misstating the magnitude of the adjustment.

5.8.2 Specifically, in the H7 Final Decision, the CAA confirmed[193] that it had calculated the cost of HAL's index linked debt (both embedded[194] and new debt[195]) to include an index-linked *premium* of 15 bps. As the WACC Report explains at paragraph 81 this is a novel approach and not consistent with the approach adopted by other regulators. The CAA has sought to justify it by reference to what the WACC Report goes on to explain (later in the same paragraph) is a statistically invalid comparison between the spread of five of HAL's index-linked bonds as against recognised benchmarks. This has resulted in

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[193] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.142, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 177**.

[194] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.94, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 169**.

[195] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.98, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 169**.

an error of fact which (in and of itself) undermines the CAA's analysis, as the premium cannot be justified even on the CAA's own terms.

5.8.3 Furthermore, at a conceptual level the CAA's approach evidences a material misunderstanding of the nature of index linked debt. It is correct that the cost of index-linked debt can be derived by subtracting inflation expectations from a nominal yield. However, in order to derive a sufficiently accurate measure other factors specific to such debt need to be considered, principally the *lower* return required by investors as they no longer bear inflation risk.

5.8.4 This is the primary reason why the CAA's estimation and treatment of this adjustment cannot reasonably be supported. What the CAA has done is to add a positive indexed-linked premium of 15bps to the return from nominal gilts, with the CAA further assuming that 30% of debt was index-linked. This is entirely irrational. As the WACC Report explains at paragraph 83[196], index linked debt offers a lower return reflecting the absence of inflation risk. While it could reasonably be expected that this may, to some extent, be offset by a liquidity premium on index-linked gilts, it could not reasonably be expected that this liquidity premium would exceed the benefit of an absence of inflation risk.

5.8.5 Not only has CAA erred in the direction of the index-linked premium, it has misunderstood and misstated the magnitude of the premium. As the WACC Report explains at paragraph 85[197], the index-linked premium ought to be calculated by:

(a) Taking the 20-year nominal gilt yield from the Bank of England's yield curve calculations;

(b) Deducting the long term expected RPI-inflation of 2.9%;

(c) And then further deducting the 20-year ILG yield from the Bank of England's yield curve calculations.

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[196] WACC Report, 17 April 2023, Paragraph 83 and Table 8.

[197] WACC Report, 17 April 2023, Paragraph 85.

5.8.6 The CAA has not explained (in either its Initial Proposals and H7 Final Proposals or in the H7 Final Decision) why it has departed from the orthodox approach for calculating the magnitude of the premium. Nor is it possible for the Appellant – even with the benefit of expert assistance – to understand the approach that the CAA has taken - see WACC Report at paragraph 86[198]. The consequence is that the CAA's methodology is opaque, contrary to the orthodox practice, and not one which can reasonably be supported.

5.8.7 The consequences of this error are striking, and can be seen in Figure 5 in the WACC Report[199]. Whilst the index-linked premium has fluctuated, the nominal yield less expected inflation has (unsurprisingly) always been higher than the index linked-yield. In other words, as expected, because of the inflation risk implicit in nominal gilt yields (as inflation could be higher than expected) these have been significantly *higher* than index linked yields, even when any offsetting liquidity premiums are accounted for. As paragraph 88 of the WACC Report goes on to explain the appropriate index linked premium is a reduction of 0.15%[200].

5.8.8 These methodological errors are such that the premium calculation cannot be supported, and ought to be quashed. The CMA ought to exercise its powers under section 27(2) of the CAA 2012 to substitute this premium with one which reduces the cost of index-linked debt. Reducing the cost of index-linked debt by a range of 0 bps to -10 bps would reduce the cost of debt by 0.05-0.8% and the overall WACC by 0.03-0.05%% with a consequential reduction in H7 aeronautical revenue requirements of £40 million (in 2020 prices) (see paragraph 91 of the WACC Report)[201].

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[198] WACC Report, 17 April 2023, Paragraph 86.

[199] WACC Report, 17 April 2023, Figure 5.

[200] WACC Report, 17 April 2023, paragraph 88.

[201] WACC Report, 17 April 2023, paragraph 91.

5.9 Point Estimate error

5.9.1 The CAA's third error when setting the WACC was to adopt the midpoint of the WACC range as the appropriate point estimate.[202]

5.9.2 In the H7 Final Decision, the CAA explained that it had weighed up two considerations in adopting the point to be adopted within its estimated range of WACC, namely:

(a) Investment incentives, which may suggest aiming up - albeit the CAA emphasised that it "*has put in place other mechanisms to encourage investment, such as our capex incentive mechanism, which means that we do not need to rely exclusively on the WACC to ensure appropriate investment incentives*";[203] and

(b) Parameter uncertainty (as regards the TMR, such as whether the cost of equity is overstated), which may suggest aiming down (with recent market developments having mixed effects on any such bias).[204]

Balancing the considerations of the TMR bias and the incentivising investment, the CAA opted for the mid-point of the range.

5.9.3 At the outset, the Appellant should make clear that it does not consider that there is anything wrong *in principle* with adopting the midpoint. Rather, its case is that this approach was not one which is reasonably supportable in the particular circumstances of H7.

5.9.4 In particular, the CAA has erred in misjudging or ignoring factors that are relevant to its decision to set a WACC at the mid-point of the range, given the timing of H7

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[202] See CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3),* paragraph 9.207, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 188.**

[203] See CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.193, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 186**

[204] See CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraphs 9.193-9.205, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 186-188.**

(including a severe cost of living crisis and no major capacity expansion) and factors specific to HAL. These are:

(a) **Asymmetry of costs and benefits**. Here, for the reasons set out by the WACC Report at section 6.2.1, the only reasonably supportable conclusion is that, for the H7 regulatory period, the weight of the balance between investment and lower prices is reversed compared to previous Heathrow determinations (particularly Q5). In the balance of welfare consequences, the only reasonable approach was to prioritise lower prices and aim down within the WACC range.

(b) **Asymmetry of pandemic events.** Here, the CAA has erred by failing to take account of the asymmetry in probabilities of a pandemic event in the asset beta. Based on work by Flint, the CAA adjusted the asset beta by a range of 0.02 to 0.11, which in turn formed the assumptions for the top and bottom-end of the WACC range from which the central point was chosen. This approach is not one that can reasonably be supported for the reasons set out by the WACC Report at section 6.2.2.

(i) For the purposes of estimating the pandemic adjusted beta, the CAA (and Flint), assumed *ranges* for the likelihood of a future pandemic occurrence and the duration of any future pandemic occurrence. This produced four separate cases, with a probability spread (expressed as a percentage)[205] in an asymmetric distribution ranging from 2.8% to 16.3%. It is clear that there is an asymmetric distribution, in the sense that there are two extreme scenarios (with the upper band being a long lasting and frequently occurring pandemic).

(ii) In light of this asymmetry any valid analysis would assign an appropriate weighting to each of these four cases, and reflect this in the subsequent analysis. The CAA has entirely failed to do this, with the consequence that these cases are accorded equal weighting. In other words the CAA's analysis treats each of these four cases as though they

[205] That is, the probability of a pandemic at any given point in time.

are equally likely when they are anything but. This is a clear error of analysis.

(iii) The materiality of this error is clear from the WACC Report at paragraph 105[206]. The mid-point of the range of pandemic probability is 9.5% with the average being 8.2%, and the median 6.8%. By taking a WACC in the mid-point of the range, the CAA is effectively assigning 50% weight to the two extreme cases and zero weight to the two middle cases. On any reasonably supportable approach to asymmetric distributions of this kind, the correct measure of central tendency is the mean (8.2%) or the median (6.8%) and not the mid-point (9.5%). Whilst the median is generally a more robust measure of central tendency than the mean,[207] even if one were to take the mean as the appropriate value, the central point would be 40% within the range.[208] This would be tantamount to aiming down to 46% in the overall WACC range.[209]

(c) **Information asymmetries between HAL and the CAA.** The CAA further erred by failing to give appropriate weight to the challenges arising from the substantial asymmetry in information between HAL and itself. This a failure which cannot reasonably be supported as a matter of regulatory judgement, and has also been reached on the basis of a misdirection as to what the CAA refers to as "*regulatory precedent*".

(i) The starting point is that it is evident that significant information asymmetries clearly exist. The CAA had acknowledged this in the opening paragraphs of the H7 Final Decision which explain that:

"The H7 review has been particularly challenging for a number of reasons including...the relatively low quality of certain aspects of the

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206 WACC Report, 17 April 2023, paragraph 105.

207 This is because the median is not influenced by outlier data points.

208 40% = (Median – Bottom range) / (Top range – Bottom range) =(8.2-2.8)/(16.3-2.8).

209 The aiming-down narrows for the overall WACC range because the pandemic effect is only element of the overall WACC calculation.

business plan information provided by HAL [footnote: In particular the lack of detailed information on a number of its capital expenditure programmes as discussed in our Initial and Final Proposals.] and its opposition to the release of key information on issues such as its approach to passenger forecasting."[210]

(ii) The challenge for the CAA is further increased by the fact that, unlike other sectors, HAL has no close comparators against which to assess HAL's relative efficiency.

(iii) In the context of the H7 Final Decision, aiming down within the range is necessary to compensate for information asymmetries that exist between HAL and CAA and airlines in respect of:

(A) passenger forecasts (particularly the HAL model, for the reasons set out at section 3.8 above)

(B) Opex;

(C) Cost of debt, given the complexity of HALs debt structure that may well be the cause of the apparent "HAL-specific premium",[211] especially over A-/BBB+ rated bonds comparable to HAL's Class A debt;

(D) Commercial revenues; and

(E) Capital investment plans.

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[210] See CAA, *CAP2524C H7 Final Decision Section 2 on the key price control 'building blocks' (FD Section 2)*, paragraph 7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_3/page 121.**

[211] CAA, CAP2365D Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Financial issues and implementation, 28 June 2022, paragraph 9.307, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/pages 1620 and 1650.**

(iv) These information asymmetries were set out in a report from AlixPartners submitted by the Appellant in response to the H7 Final Proposals.[212]

(v) The CAA's sole reason for declining to aim down in the light of these asymmetries (as identified by AlixPartners) was because it considered itself constrained by "regulatory precedent,[213] specifically the CMA's decision in the RIIO-T2/GD2 cases. This was an erroneous direction, as the RIIO-T2/GD2 decisions reflect the entirely different factual position of those cases. In particular:

(A) In the RIIO-T2/GD2 cases, Ofgem benefited from information by benchmarking across very similar companies operating under exactly the same regulatory regime and with legally enforceable access to the information it reasonably required. This degree of benchmarking is not available to the CAA, which is wholly reliant on the information that HAL itself provides.

(B) In the context of H7, HAL has been repeatedly criticised by the CAA for providing poor quality information, which is likely to generate a systematic bias.[214] This is in contrast to the CMA's finding in relation to the which emphasised that "*GEMA had introduced a range of significant changes in RIIO-2 aimed at addressing its concerns over information asymmetry related to*

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[212] AlixPartners, *Analysis of the CAA's Final Proposals*, 9 August 2022, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_34/page 2094-2180.**

[213] CAP2524D *H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.199, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/page 187**.

[214] For example, see IP "Section1: Overall approach and building blocks", para 5.31: "The depth and quality of information provided by HAL meant it was not feasible for CEPA/Taylor Airey to undertake a full bottom-up assessment of HAL's forecasts across all elements of revenues" as referenced in AlixPartners, Analysis of the CAA's Final Proposals, 9 August 2022, page 68, exhibited to this Notice of Appeal and marked **Exhibit BA_NOA1_35/page 2164.**

these and other areas of totex assessment, and to Output Delivery Incentives (ODI)".[215]

(C) Unlike energy and water networks, HAL's opex and commercial revenues regulatory regime has no risk sharing, meaning it is highly incentivised to present forecasts that favour its interests.

(vi) In consequence, the CAA was not (as it concluded) restrained by the CMA's previous determination in the RIIO-T2/GD2 cases. Furthermore, in the circumstances of H7 it was both appropriate and necessary to aim down in recognition of the acknowledged and significant information asymmetries.[216]

(d) **Effect of distortions created by the outer band of the TRS.** The final reason why the CAA erred in setting the point estimate is that it fails to give appropriate weight to the fact that the design of the TRS, particularly the outer band, creates distortions that: (i) place an additional adverse asymmetric price risk on airlines using Heathrow; and (ii) potentially destroy incentives for HAL to initiate traffic recovery in times of severe recession. These distortions constitute errors by harming consumer interests through a higher passenger charge, including possibly at times when the market is recovering from challenging economic conditions. However, they can be addressed as part of the aiming down process within the WACC range.

(i) The first of these errors stems from the fact that, as the CAA recognises in the asymmetric traffic adjustment, there <u>are</u> asymmetries in shocks to Heathrow's traffic, i.e. downward shocks are more common than upward shocks; not least because in the short to medium term Heathrow will lack the capacity for higher traffic. Therefore, whilst it is possible that the lower 10% outer band will be breached around a central forecast (the

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[215] CMA, *RIIO-2 Energy Licence Modification Appeals Summary of final determination*, 28 October 2021, paragraph 27-28, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_65/page 5360**.

[216] CAA, *CAP2524D H7 Final Decision Section 3 on the financial framework (FD Section 3)*, paragraph 9.199, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_4/ page 187.**

CAA claims that prior to the pandemic HAL would have breached the lower 10% outer band twice in the last three price reviews[217]) a breach of the upper outer band is highly unlikely, largely due to HAL's capacity constraint, particularly from 2024 onwards (based on the CAA's own passenger forecasts). Once the lower outer band is breached, a further 1% fall in traffic results in a 1.05% increase in airport charges. Consumers are thereby exposed to an asymmetric upward risk on the airport charges they pay.

(ii) The second error is concerned with incentives once the lower outer bound of the TRS has been breached during a period of severe traffic downturn. The CAA's consultants – Deloitte – reviewed the TRS and noted:[218]

"*The elasticities (of costs and commercial income with respect to volumes) used by the CAA to calibrate the mechanism (especially the 90-100%* [219] *sharing proportion for deviations above 10%) are difficult to accurately estimate. It is therefore possible that the outcomes (e.g. in respect of HAL's revenue, EBITDA and airport charges) could be materially different to those currently forecast by the CAA (and potentially not as desired). This could result in HAL being over-compensated or under-compensated through the TRS, potentially significantly*." The consideration which Deloitte raised in this passage, was of such significance that the CAA could not simply ignore it. However, this is simply unaddressed by the CAA.

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[217] CAA, *CAP2365B Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework*, paragraph 2.39, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/page 1426.**

[218] CAA, *CAP2366E Review of the CAA's proposed traffic risk sharing mechanism (Deloitte), Final Report*, 23 June 2022, page 8, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_33/page 1977.**

[219] The figure confirmed in the Final Determination was 105%: *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, paragraphs 2.14 and 2.20, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2/page 59-62.**

(iii) The CAA's choice of a 105% factor for the outer band, according to the CAA's assumptions and calculations, will protect HAL from 91-94% of the EBITDA impact from the traffic deviation.[220] As the WACC Report explains at paragraph 116[221], when one considers the difficulties in estimating the opex and commercial revenue elasticities on which this calculation depends,[222] the CAA has failed to accord a reasonable margin for error. The consequence is that the CAA has created a situation whereby HAL is left with either limited incentive to promote traffic growth, or (perversely) a negative incentive to constrain traffic (particularly given the costs that may be incurred to increase traffic further – notwithstanding the benefits to consumers).

(iv) Any reasonable analysis would have avoided this situation. As paragraphs 185 to 202 of AD1 and the RAB Report explain,[223] even in the absence of the TRS outer band, the lack of HAL incentives to vigorously facilitate return of passenger traffic was seen during the Covid-19 recovery of 2022. This situation would be exacerbated were HAL to be fully compensated for any further loss of traffic during a severe downturn.

5.9.5 Each of these factors is individually sufficient to render the CAA's selection of the mid-point unsustainable. Taken together, it is unarguably the case that the only reasonable cause of action in the context of H7 is to aim down within the WACC range. Any other approach exposes airline passengers to unreasonable risks of consumer harm.

5.9.6 As to the *extent* to which the CAA ought to have aimed down, as the WACC Report at Table 11 and paragraphs 119 to 121[224] explains this requires an aggregation of the

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[220] CAP2365B *Economic Regulation of Heathrow Airport Limited H7 Final Proposals Section 1 Regulatory framework*, paragraph 2.44, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_27/page 1427**.

[221] WACC Report, 17 April 2023, paragraph 116.

[222] Not least because of the information asymmetries discussed at paragraph 5.9.4 above.

[223] RAB Report, 17 April 2023, paragraph 116.

[224] WACC Report, 17 April 2023, Table 11 and paragraphs 119-121.

factors set out above. When these factors are taken into account, the only reasonable conclusion is to aim-down in the order of the 33% point. In light of the above errors, the CMA ought to exercise its powers under section 27(2) of the CAA2012 to substitute such an approach.

5.9.7 This has the impact of reducing the WACC by 0.06% with a consequential reduction in H7 aeronautical revenue requirements of **£**59 million and charges by **£**0.16/passenger (in 2020 prices). It is worth noting that the correction of errors made in this report reduce the overall WACC range from 1.09% (2.64-3.73%) to a much narrower range of 0.357% (2.25-2.602.34-2.71%). This has the effect of reducing the impact of aiming-down (see paragraph 121 of the WACC Report)[225].

5.10 Allowance for asymmetric risk

5.10.1 The CAA's final error arises from a failure to update its allowance for asymmetric risk in light of the higher than estimated outturn of traffic in 2022. It would appear that this was an oversight, as earlier in the H7 Final Decision the CAA had explained why it was appropriate to use the actual 2022 passenger numbers (now that they were available) and not the materially lower numbers previously estimated.[226]

5.10.2 Whatever the reason for this, it is an error and means that the asymmetric risk allowance has been reckoned by reference (amongst other inputs) to a materially incorrect input. The consequence is that, as set out in more detail in section 8 of the WACC Report, the H7 Final Decision over-estimated the revenue requirement by around **£**7 million. This is because:

5.10.3 The CAA calibrated the adjustment by assuming that a future pandemic effect would depress passenger numbers by amounts based on the actual experience of the Covid-19 pandemic from 2020-2022 as against the actual numbers from 2019.

5.10.4 The actual 2022 passenger figures were significantly higher than the estimated figures assumed at the H7 Final Proposal stage. The consequence is that the actual 2022 figures

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[225] WACC Report, 17 April 2023, paragraph 121.

[226] CAA, *CAP2524B H7 Final Decision Section 1 on the regulatory framework (FD Section 1)*, Chapter 1, paragraphs 1.57, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_48.**

demonstrated that the return of pandemic traffic was materially faster than had been estimated in the H7 Final Proposals (and, indeed, in the H7 Final Decision). For the CAA's methodology (as set out in the previous sub-paragraph) to produce a valid estimate, the 2022 estimate would have to be replaced with the actual figures.

5.10.5 This error means the H7 revenue requirement was over-estimated by around £7 million. The CMA ought to make a consequential reduction in the WACC to reflect this.

5.11 Relief

5.11.1 The Appellant requests that the CMA quash the H7 Final Decision under section 27(2) of the CAA2012 insofar as it sets the WACC at 3.18% and substitute the decision with a corrected WACC. The result of correcting the errors is to give a point WACC estimate of 2.46%, within a range of 2.34 - 2.71%.

5.11.2 More specifically, in relation to the:

(a) **Asset Beta** errors, the CMA ought to exercise its powers under section 27(2) of the CAA2012 to reduce the asset beta range to a level which can reasonably be supported (this would fall in the range 0.39-0.43). This requires the reduction of the overall WACC by 0.62%, with a consequential reduction in H7 aeronautical revenue requirements of £614 million (in 2020 prices).

(b) **Index-linked Premium errors, t**he CMA ought to exercise its powers under section 27(2) of the CAA2012 to substitute this premium with one which reduces the cost of index-linked debt. Reducing the cost of index-linked debt by a range of 0bps to -10 bps would reduce the cost of debt by 0.05-0.8% and the overall WACC by 0.03-0.05% with a consequential reduction in H7 aeronautical revenue requirements of £40 million (in 2020 prices).

(c) **Point Estimate** errors, the CMA ought to exercise its powers under section 27(2) of the CAA2012 to aim down at the 33% point. This would have the impact of reducing the WACC by 0.06% with a consequential reduction in HAL's overall allowed revenue for H7 of £59 million.

(d) **Allowance for Asymmetric Risk** error, the CMA ought to make a consequential reduction in the WACC to reflect the **£**7m over-estimate of HAL's H7 revenue requirement.

SCHEDULE 1
BACKGROUND AND OVERVIEW

1.1 The Q6 price control

1.1.1 In February 2014, the CAA determined that HAL was the operator of a "dominant airport" and granted it a licence in relation to Heathrow Airport pursuant to its powers and duties under CAA2012 (hereafter, the **Licence**).[227] The CAA's market power assessment was based on HAL's position as the operator of the UK's only hub airport, airline network effects available at Heathrow Airport which limit the ability of airlines to switch capacity and to constrain HAL's charges, Heathrow Airport's good surface access options and the attractiveness of the London market to airlines.[228] The Licence came into force on 1 April 2014, and originally included a price control on airport charges for the period 1 April 2014 to 31 December 2018 inclusive (the **Q6 price control** or **Q6**).

1.1.2 The Q6 price control review took place after a period in which traffic volumes had been adversely affected by a number of downside events (e.g. the 2010 volcanic eruption in Iceland). HAL therefore asked the CAA to consider the regulatory treatment of traffic risks during the Q6 review.[229]

1.1.3 During the Constructive Engagement (**CE**) process, the CAA asked HAL and the airlines that used HAL's services if they thought there was merit in introducing a traffic risk sharing mechanism (similar to that introduced by the CAA in relation to its regulation of NATS En-route Limited (**NERL**).[230] The introduction of such a

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[227] CAA, *CAP 1133: Market power determination in relation to Heathrow Airport – statement of reasons, 10 January 2014,* exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_39/page 3009.**

[228] *Ibid*., paragraph 2.4.

[229] CAA, *CAP 2365D Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Financial issues and implementation*, 28 June 2022, paragraph 10.27, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1678.**

[230] See CAA, *CAP2279: Economic regulation of NATS (En Route) Plc: decision on licence modifications to implement exceptional measures', 18* November 2021, Chapter 1, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_47/page 4133.**

mechanism was not supported by HAL or any other stakeholders, and the preferred option was to consider and address traffic risk through traffic forecasts and the WACC instead.[231]

1.1.4 In the Q6 Final Proposals, the CAA included a shock factor in its Q6 passenger forecasts on the basis of evidence from the preceding two decades which indicated that HAL was exposed to risks relating to external downside shocks. The CAA stated that the financial consequences that could arise from differences between actual and forecast volumes would sit with HAL's shareholders, and that it had reflected this risk in the WACC:

"The allowances for demand shocks in the traffic forecasts and in the cost of capital are two different concepts. The CAA does not, therefore, consider that its proposals constituted double-counting. For example, the CAA may set the price control on the basis of a forecast level of shocks of 1% per annum. However, there could be a 10% chance that the out-turn level of shocks exceeds the forecast level by one percentage point of more. The risk that the out-turn is different is borne by the company and the shareholders. The CAA therefore allows a higher rate of return for the company than would otherwise be the case to compensate for this risk." (emphasis added).[232]

1.1.5 The Licence does not include any specific reopener mechanism or specific criteria by which a request to reopen the price control would be assessed. This was considered at the time of granting the Licence, and the CAA declined to do so (despite submissions from HAL requesting a prescribed trigger point with established consequences). Rather, the CAA stated: "*HAL may request that its price control be reopened at any time. The CAA would consider such a request in the light of its statutory duties under the circumstances prevailing at the time*".[233]

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[231] CAA, *CAP1138 Economic regulation at Heathrow from April 2014: Notice granting the licence*, February 2014, paragraph A57, page 177, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_2863.**

[232] CAA, *CAP1103 Economic regulation at Heathrow from April 2014: final proposals,* 2013, paragraph 3.14, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_37/page 2599.**

[233] *Ibid*., paragraph A12, page 167.

1.1.6 Following the Government's 2016 announcement that Heathrow Airport was its preferred location for the development of a new runway in the south-east of England[234] and an extensive period of regulatory development work by the CAA to determine how best to adapt the regulatory framework to accommodate this proposed expansion, the Q6 price control was extended by the CAA (following consultation) twice:

(a) first in December 2016 for one year, such that the Q6 price control would expire on 31 December 2019;[235] and

(b) subsequently in November 2019 for a two year period, up to 31 December 2021 (**iH7**).[236]

1.1.7 These extensions were intended to align the start of the H7 regulatory period with the period during which it was anticipated that construction work for the third runway at Heathrow Airport would take place.

1.2 The H7 price control and the Covid-19 pandemic

1.2.1 On 31 December 2019 – consistent with this revised timing – HAL submitted its Initial Business Plan (**IBP**) to the CAA[237] in respect of the years 2022-2036 and on the basis that the expansion of Heathrow Airport was proceeding.

1.2.2 However, in February 2020, the Court of Appeal held that the Airports National Policy Statement – which set out the Government's plans in relation to developing the third

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[234] Department for Transport, *Increasing airport capacity in the south-east of England, webpage https://www.gov.uk/government/collections/heathrow-airport-expansion*, 25 October 2016, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_86/page 6517-6525.**

[235] CAA Civil Aviation Authority, '*Notice in relation to a modification of Heathrow Airport Limited's Licence made under section 22(6) of the Civil Aviation Act 2012*,' 21 December 2016, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_42/page 3824-3833.**

[236] CAA, CAP1852, *Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications*,5 November 2019, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_43/page 3834-3899.**

[237] Heathrow Airport Limited, *Heathrow's Initial Business Plan Detailed Plan*, December 2019, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_89/page 6606-7004.**

runway at Heathrow Airport – was unlawful.[238] In light of that decision, HAL paused its plans for expansion.[239] Although the Supreme Court subsequently overturned the Court of Appeal's judgment in December 2020,[240] by that point HAL's expansion plans had already been overtaken by the impact of the Covid-19 pandemic. Plans for the construction of a third runway at Heathrow Airport remain paused to date (although it is expected that HAL's expansion programme will remobilise again in the future[241]).

1.2.3 In April 2020, the CAA published an update on its programme for the development of economic regulation at HAL (the **April 2020 Update**),[242] outlining the fundamental impact of the Covid-19 pandemic on Heathrow Airport and the aviation sector more widely. The April 2020 Update confirmed that the CAA would focus its H7 price control review on the operation of a two-runway airport at Heathrow Airport, with the intention of having a new price control in place with effect from 1 January 2022. In its response to the April 2020 Update, HAL noted that passenger numbers at Heathrow Airport had, at that point, fallen by c.97% as a result of the Covid-19 pandemic.[243]

1.2.4 On 5 June 2020, Lord Paul Deighton (the Chairman of HAL) wrote to Dame Deirdre Hutton (the Chair of the CAA)[244] requesting that the CAA reopen the Q6 price control "*to recalibrate Heathrow's incentives*" on the basis that the current settlement was

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238 *R. (on the application of Plan B Earth) and others v Secretary of State for Transport* [2020] EWCA Civ 214.

239 Heathrow Airport, *H7 Revised Business Plan (Detailed)*, December 2020, paragraph 7.2.1.2, page 269 – 270, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_6643.**

240 See *R. (on the application of Friends of the Earth Ltd) v Heathrow Airport Ltd* [2020] UKSC 52.

241 See, for example, Heathrow Airport Limited, *Heathrow Expansion* webpage, https://www.heathrow.com/company/about-heathrow/expansion, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_107/page 10031-10033.**

242 CAA, CAP1914: *Economic regulation of Heathrow: programme update,* 22 May 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_44/page 3900-3924.**

243 CAP1914: Heathrow Airport Limited *Economic regulation of Heathrow: programme update*, 22 May 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_44/page 3900-3924.**

244 *Letter from Lord Paul Deighton (HAL Chairman) to Dame Deirdre Hutton (CAA Chair) requesting reopening of Q6 price control*, 5 June 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_78/page 6146-6148.**

"*unsustainable*". Lord Paul Deighton referred to the "*unprecedented challenges*" the aviation industry was experiencing as a result of the Covid-19 pandemic, and concluded that HAL would "*separately set out more details of [its] request and potential mechanisms for a reopener to [the CAA's] Chief Executive*" and it was seeking "*discussions on how we can urgently move to implementation as delay is not in the interests of consumers or other stakeholders*."

1.2.5 On 23 June 2020, the CAA published a consultation entitled 'Economic regulation of Heathrow: policy update and consultation' (the **June 2020 Consultation**).[245] The CAA noted that HAL's IBP had been published in December 2019 on the basis that the construction of a third runway at Heathrow Airport was proceeding. However, on account of Heathrow Airport's expansion now being paused, and given the changed circumstances in light of the outbreak of Covid-19, the CAA concluded that the IBP was substantially out of date, and set out its expectation and guidance for HAL to produce a revised business plan towards the end of 2020. More specifically, the CAA stated:

"We do not currently expect construction for expansion to restart during H7. If expansion restarts, we will treat it as an add-on to the price control. This, and the impact of the covid-19 pandemic on traffic volumes, means that several key assumptions used to construct the IBP are no longer appropriate. These include assumptions on traffic forecasts, the capex plan, financing and financeability and several other key building blocks."[246]

1.2.6 The CAA stated that HAL's revised business plan should capture, among other things: (i) the outcomes of CE; (ii) HAL's latest thinking on traffic scenarios and efficient levels of cost; and (iii) HAL's views on the form and duration of price control arrangements best suited to dealing with any remaining uncertainty.

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[245] CAA, CAP 1940 *Economic regulation of Heathrow: policy update and consultation,* 23 June 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_45/page 3925-4041.**

[246] *Ibid*., paragraph 2.7.

1.2.7 In response to the June 2020 Consultation, HAL issued a revised financial forecast and accompanying narrative in July 2020 (referred to as its building block update (**BBU**))[247]. Following HAL's BBU, a period of CE between HAL and its airline customers began, running between August and October 2020. HAL issued its revised business plan (**RBP**) on 18 December 2020.[248] HAL's RBP "*base case*" implied a substantial increase in airport charges compared to the iH7 charge (c.£30 per passenger (in 2018 prices) compared to an average of c.£22 for 2020 (in nominal prices)).

1.2.8 Meanwhile, in July 2020, HAL had also sent the CAA a request that it should reopen the Q6 price control by making an upward adjustment to HAL's RAB of £1.7 billion to address the shortfall in revenue it expected to recover in 2020 and 2021 due to the impact of the Covid-19 pandemic (**HAL's Application**).[249]

1.2.9 Specifically, HAL requested:

(a) a depreciation holiday for 2020 and 2021;

(b) an upward adjustment to the starting RAB in the H7 determination of £1.7 billion (based on actual revenue outturn for 2020 and the forecast revenue for 2021 to correct for any difference between the RAB change and that implemented through the depreciation holiday);

(c) no depreciation to be applied to this element of the RAB for H7, but return to be included in prices from 2022 in H7; and

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[247] CAA, *CAP 2265A Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Summary*, October 2021, paragraph 16, page 9, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/page 845.**

[248] Heathrow Airport, *H7 Revised Business Plan (Detailed)*, December 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_91/page 7016-7615.**

[249] Heathrow Airport Limited, *Application for Covid-related RAB adjustments*, July 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_12/page 462-504**

(d) a final adjustment to the RAB to be made at the end of 2022, reflecting actual outturn revenue for 2021 and prices for 2023 onwards adjusted accordingly.[250]

1.2.10 Both HAL's BBU and the RBP were based on the assumption that HAL could recover the full Covid-19 related RAB adjustment that it had requested (£1.7 billion).

1.2.11 The CAA consulted on HAL's Application in October 2020 under the identifier (the **October 2020 Consultation**)[251] and February 2021 under the identifier CAP2098 (the **February 2021 Consultation**)[252] before issuing a decision to make an upward adjustment of £300 million (in 2018 prices) to HAL's RAB in CAP2140 dated April 2021 (the **April 2021 RAB Adjustment Decision**).

1.2.12 On 5 May 2021, Helen Stokes (Head of Legal, Regulation and Operations at HAL) wrote to the CAA, seeking to clarify the formal status and effect of the April 2021 RAB Adjustment Decision.[253] More specifically, HAL sought clarification as to whether the April 2021 RAB Adjustment Decision was a H7 Final Decision as to any aspect of the regulatory package that would apply during the H7 Price Control. In its response dated

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[250] Heathrow Airport Limited, *Application for Covid-related RAB adjustments*, July 2020, pages 4 – 5, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_12/page 465-466.**

[251] CAA, CAP1966 *Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment*, 9 October 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_13/page 505-540.**

CAA, CAP 1966A Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment, 9 October 2020, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_14/page 541-579.**

[252] CAA, CAP2098 *Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment*, 5 February 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_16/page 603-651.** CAA, CAP2098A Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment: Appendices, 5 February 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_17/page 652-706.**

[253] Heathrow Airport Limited, *Letter from Helen Stokes (Head of Legal, Regulation and Operations at HAL) to the CAA entitled 'CAP2140: Status of the CAA's document'*, 5 May 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_80/page 6153-6154**

11 May 2021,[254] the CAA clarified that the April 2021 RAB Adjustment Decision was a decision by the CAA only on the package of measures that would apply pending the start of the H7 Price Control, and that the appropriate forum for oversight of the April 2021 RAB Adjustment Decision would be as part of any appeal to the CMA. The CAA noted that, in the event of such appeal, the CAA "*will not seek to argue that HAL (or airlines) should be precluded from challenging any aspect of the CAA's H7 licence modifications on the basis that it reflects a decision already taken in the [April 2021 RAB Adjustment Decision] that ought to have been challenged by way of judicial review.*"[255] [256]

1.2.13 On 27 April 2021, the CAA published a consultation entitled 'Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward (the **April 2021 Way Forward Document**).[257] In the April 2021 Way Forward Document, the CAA: (i) recognised the ongoing difficulties associated with traffic forecasting in uncertain circumstances, (ii) set out its initial assessment of HAL's RBP, and (iii) outlined the CAA's proposed next steps.

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[254] CAA, *Letter from CAA to Helen Stokes entitled 'Status of CAP2041 "Economic regulation of Heathrow Airport Limited: "Response to its request for a covid-19 related RAB adjustment" (the "Response")'*, 11 May 2021., exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_80 - 81.**

[255] *Ibid.*

[256] also CAA, *CAP2365D Economic regulation of Heathrow Airport Limited: H7 Final Proposals Section 3: Financial issues and implementation*, 28 June 2022, paragraphs 10.61-10.62 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_29/page 1686-1687**, which states: "*For the avoidance of doubt, the April 2021 RAB Adjustment Decision was intended to be our H7 Final Decision to give effect to the inclusion of the £300m in HAL's opening RAB for H7 RAB. ... Nonetheless, this change will be put into effect through the same licence modifications that will introduce the H7 price control. As such, airline stakeholders will be able to appeal this decision to the CMA if they disagree with our reasoning and approach to these matters.*" In addition, the Holding Price Cap 2023 Decision states: "*In due course, this process will provide key stakeholders with the right to appeal the licence modification, which will encompass our decisions on HAL's regulatory asset base (including in relation to the interim RAB adjustment).*"

[257] CAA, *CAP 2139 Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward*', 27 April 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_46/page 4042-4125.**

1.2.14 HAL subsequently issued an updated revised business plan (**RBP Update 1**) at the end of June 2021.[258] HAL's RBP Update 1 stated that the lower passenger numbers expected over the H7 period (due to the impact of the Covid-19 pandemic) meant airport charges would need to be increased beyond the level HAL had previously set out. It included two scenarios: one implying average charges over H7 of c.£32 per passenger and the other implying average charges over H7 of £43 per passenger (both in 2018 prices).

1.2.15 During the period June 2021 – January 2022, HAL submitted evidence critical of the CAA and its RAB Adjustment Decision to the House of Commons Committee of Public Accounts 'Principles of Effective Regulation' inquiry[259] and to the House of Commons Transport Committee inquiry to plot the aviation sector's route to recovery following the Covid-19 pandemic.[260]

1.2.16 The CAA issued its initial proposals in respect of the H7 price control period in October 2021, which was marked CAP2265 (**the Initial Proposals**). These set a wide range for the regulated airport charge (£24.50 to £34.40 per passenger, in 2020 prices) to reflect the uncertain circumstances prevailing at that time due to the ongoing Covid-19 pandemic.[261] The CAA set out its views on the way forward for dealing with HAL's airport charges from 31 December 2021 (when the Q6 price control expired) until the H7 price control arrangements were due to come into effect (at that time, predicted to be early 2022). The CAA proposed to put in place a licence condition to regulate HAL's

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[258] Heathrow Airport, *H7 Revised Business Plan – Update 1*, June 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_97/page 9328-9610.**

[259] See Public Accounts Committee, *Principles of effective regulation* webpage https://committees.parliament.uk/work/1262/principles-of-effective-regulation/, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_106/page 10029-10030**; and Heathrow Airport Limited, *PER0006 Written evidence submitted by Heathrow Airport*, June 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_98/page 9611-9615**.

[260] See Transport Committee, *Airlines and airports: supporting recovery in the UK aviation sector, webpage https://committees.parliament.uk/work/1473/airlines-and-airports-supporting-recovery-in-the-uk-aviation-sector/publications/,* exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1**_6153

[261] *CAA, CAP2265A Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Summary*, 19 October 2021, Table 3, pages 21 – 22, Table 3, pages 21 – 22, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/page 857-858.**

prices in 2022 – a £29.50 "*interim price cap*" – and it published a notice of such licence modification in Appendix C to the Initial Proposals. The indicative timetable published in the Initial Proposals provided for responses to the proposed licence modification in November 2021 and to the Initial Proposals by December 2021, followed by the CAA's final proposal (March/April 2022) and H7 Final Decision (May/June 2022), with the licence modification taking effect in July/August 2022.[262]

1.2.17 The CAA received "*detailed responses*" to the Initial Proposals, including from HAL and BA,[263]. In their joint response to the CAA's consultation on the Initial Proposals, BA stated that "*the H7 Initial Proposals are not in consumer interest, and it is not evident that the CAA has sufficiently considered many issues that sit at the heart of the Heathrow monopoly problem; the regulatory toolkit is out of date and does not appear an appropriate solution for the challenges presented by Heathrow's substantial market power.*"[264]

1.2.18 The Initial Proposals acknowledged that an H7 final decision was unlikely to be finalised before the iH7 price control expired on 31 December 2021 (the Holding Price Cap 2022).[265] Therefore, it proposed a holding price cap at the mid-point of the range set out in its Initial Proposals for 2022. This resulted in a proposed price cap of £29.50.266 BA responded this proposal by saying that, in principle, it supported a "*holding cap*" but believed that the most up to date data confirmed that a more appropriate range for a holding cap fell somewhere between £16.87 to £21.91 in 2020

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262 CAA, *CAP2265A Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Summary*, paragraph 77, 19 October 2021, page 23, and Table 4: Timetable for the remainder of the H7 review, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/ page 859**.

263 CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*, 28 June 2022, paragraph 44, page 12, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1297**

264 BA, *British Airways Response to CAP2265 Economic regulation of Heathrow Airport Ltd H7 Initial Proposals*, 17 December 2021, page 3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_24/page 1104.**

265 CAA , *Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Summary*, 19 October 2021, paragraph 78, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/page 859.**

266 CAA , *Economic regulation of Heathrow Airport Limited: H7 Initial Proposals Summary*, 19 October 2021, paragraph 82, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/ page 860**.

prices.267 In December 2021, the CAA issued its decision to impose a holding price cap for 2022 at £29.50 per passenger (in 2020 prices).[268] The Holding Price Cap 2022 (£30.19 in 2022 prices) was in effect between 1 January 2022 and 31 December 2022. The CAA stated that it intended the Holding Price Cap 2022 to be 'trued up/down' in the light of its H7 Final Decision for the H7 period.

1.2.19 Alongside its response to the Initial Proposals in December 2021, HAL submitted a second update to its RBP (**RBP Update 2**)[269] which was stated to provide key updates to its H7 building block forecasts to reflect new market data and evidence that had become available since the publication of RBP Update 1 in June 2021.

1.2.20 Although the final proposals were timetabled for March/April 2022 (see paragraph 1.2.16),[270] the CAA published its final proposals for H7 on 28 June 2022 (the **H7 Final Proposals**).[271] This consultation was titled CAP2365. The CAA's H7 Final Proposals were based on retaining the Holding Price Cap 2022 for 2022, with the price cap for subsequent years reducing each year over the H7 period to £21.75 in 2026 (2020 prices). The CAA confirmed its £300 million ex post RAB adjustment in the H7 Final

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[267] BA, *British Airways Response to CAP2265 Economic regulation of Heathrow Airport Ltd Holding Cap for 2022,* 17 November 2021, pages 1 – 2, exhibited to this Notice of Appeal and marked **Exhibit BA_NOA1_24.**

[268] *CAA, CAP2305 Economic regulation of Heathrow Airport Limited from January 2022: notice of licence modifications*, 22 December 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1__3803.**

[269] Heathrow Airport Limited, *A20. RBP Update 2*, December 2021, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_9305.**

[270] CAA, *CAP2265A Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Summary*, October 2021, paragraph 77, page 23, and Table 4: Timetable for the remainder of the H7 review, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_837.**

[271] CAA, *Economic Regulation of Heathrow Airport Limited: H7 Final Proposals* 28 June 2022 comprising: CAP2365A (Summary) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1286**, CAP2365B (Section 1: Regulatory framework) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1318**, CAP2365C (Section 2: Building blocks) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1390**, CAP2365D (Section 3: Financial issues and implementation) exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1519** and Appendices at CAP2365E1 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1699**, CAP2365E2 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1713** and CAP2365E3 exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1817.**

Proposals, but concluded that any further RAB adjustment would not further the interest of consumers regarding the range, availability, continuity, cost and quality of AOS, nor be necessary to support the efficient financing of HAL. The H7 Final Proposal stated that the H7 Final Decision, originally timetabled for July/August 2022, was intended to be published "*in the Autumn of 2022*".[272]

1.2.21 After publication of the H7 Final Proposals, the CAA received "*a large number of detailed responses*",[273] including consultation responses from HAL, eleven airlines (including BA), three airline associations, and an airport hotel operator. The H7 Final Decision records that the airlines "*repeated many of the concerns they had raised at earlier stages of the process, suggesting that the proposed charge was too high and should be no more than around £18.50 on average across the H7 period*" and that they "*considered that the Final Proposals included a number of fundamental errors in relation to areas such as the passenger forecast, the cost of capital and the RAB adjustment*".[274] HAL was also critical of the H7 Final Proposals, and raised a wide range of challenges on all key areas of the building and the price control as a whole. HAL considered that the proposed charge was too low.[275]

1.2.22 The H7 Final Proposals stated the CAA would consider adopting a new passenger forecast and revising its proposals for the H7 price control if "*strong evidence*" were to emerge during the period of consultation that indicated the CAA's "mid" case was not an appropriate average forecast for 2022 and beyond, and that retaining it would create

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[272] CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*, 28 June 2022, paragraph 117, page 31, exhibited to this Notice of Appeal and marked Exhibit BA_NOA1_**1316**.

[273] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph [10], page 6, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_3845.**

[274] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, paragraph 20, page 8, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 17**.

[275] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, paragraph 20, page 8, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 17**.

significant bias.[276] As outlined in section 3.9 below, as the Covid-19 pandemic restrictions were gradually lifted in the spring and early summer 2022,[277] passenger numbers at Heathrow did increase significantly in 2022 beyond the 45.4 million which had been predicted by HAL,[278] and 54.9 million as predicted by the CAA,[279] to 61.6 million.[280] This upward trajectory exceed the projections by HAL and the CAA by 36% and 12%, respectively.

1.2.23 Developments in the economy after the H7 Final Proposals, namely the high degree of volatility in forecasts of inflation and interests rates in autumn 2022,[281] led the CAA to extend the period to consider (i) the responses to its H7 Final Proposals and (ii) whether a further consultation would be likely to help the CAA to discharge its duties in making the H7 Final Decision on the H7 price control.[282] The CAA considered that it was "*no longer possible to reach and implement a H7 Final Decision on all aspects of the H7 settlement in a timely way to come into effect when the current holding price cap expires*

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[276] CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*, 28 June 2022, paragraph 108, page 30, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1315**

[277] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph 10, page 6, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_26/page 1383.**

[278] CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*, 28 June 2022, paragraph 48, page 14, and Table 1: CAA Final Proposals passenger forecast compared with HAL & AOC/LACC forecasts, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1299.**

[279] CAA, *CAP2365A Economic regulation of Heathrow Airport: H7 Final Proposals – Summary*, 28 June 2022, paragraph 48, page 14, and Table 1: CAA Final Proposals passenger forecast compared with HAL & AOC/LACC forecasts, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_49/page 4218**.

[280] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* paragraph 40, page 12, Table 1: Passenger forecasts for H7, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_26/page 1366-1367.**

[281] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph 13, page [6], exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_26/page 1366-1367.**

[282] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph 11, page 6, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 21**.

on 31 December 2022".[283] As it had done in December 2021, the CAA decided to introduce a further holding price for 2023, on a similar basis to the interim arrangements which the CAA had introduced a year earlier through the Holding Price Cap 2022.

1.2.24 On 8 December 2022, the CAA published 'CAP2488: Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023' (the **Holding Price Cap 2023 Consultation Document**).[284] The CAA stated that the proposed interim cap (£31.57 in nominal prices) would replace the Holding Price Cap 2022 which was due to expire on 31 December 2022, and its value was in line with the price cap in the H7 Final Proposals. As with the Holding Price Cap 2022, the CAA committed to 'true up' or 'true down' the interim price cap for 2023 to account for any difference between it and the final price cap for the H7 period. The consultation period closed on 22 December 2022 (two weeks following the publication of the Holding Price Cap 2023 Consultation Document), with the new holding price cap expected to come into effect during February 2023.[285]

1.2.25 The Holding Price Cap 2023 Consultation Document did not specify a month for the CAA's H7 Final Decision in respect of the H7 price control, but did indicate that the "*wider H7 price review programme will continue at an appropriate pace with the aim of allowing both the CAA's H7 Final Decision and any appeal to the CMA to be concluded during 2023*".[286] In response to the Holding Price Cap 2023 Consultation Document, HAL stated that it was "*unacceptable to have no clear complete timeline*

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[283] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph 1.5, page 8, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_49/page 4218**.

[284] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_49/page 4218**.

[285] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraphs 2.19-2.20, pages 14-15, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_49/page 4220.**

[286] CAA, *CAP2488 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023: Consultation and notice under section 22(2) of the Civil Aviation Act 2012*, 8 December 2022, paragraph 2.18, page 14, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_49/page 4213-4231**.

for the regulatory process and to rely on last minute publications to ensure the right provisions are in place",[287] and criticised the CAA's Final Proposals, published in June 2022, as "*materially out of date*".[288] It pointed out that the delays to the price control "*also mean that 2022 performance*" – which respondents to the CAA's consultation had undertaken to forecast – "*is now available and does not need to be forecast*".[289]

1.2.26 BA submitted that while it recognised "*the need for an interim price cap in 2023, the CAA's decision will exacerbate the trend of Heathrow meaningfully over collecting revenues in the period 2020-2022 as a direct result of delays to the H7 process. This is exacerbated by the CAA's unwillingness to require Heathrow to return the over collected revenues*." BA expressed concern that the CAA "*will not have an opportunity to give due consideration to the submissions it receives given the ambitious timeline for review and implementation set out in CAP2488.*"[290]

1.2.27 On 1 February 2023, the CAA published 'CAP2515 - Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023' (the **Holding Price Cap 2023 Decision**).[291] The Holding Price Cap 2023 Decision gave notice under section 22(6) of CAA2012 of the CAA's decision to modify HAL's licence in order to set an interim price cap for 2023 of £31.57 (the **Holding Price Cap 2023**), with effect from 15 March

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[287] Heathrow Airport Limited, *Response to Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023* (CAP2488), 22 December 2022, paragraph 1.2.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_50/page 4233**.

[288] Heathrow Airport Limited, *Response to Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488)*, 22 December 2022, paragraph 2.1.2, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_50/page 4233**.

[289] Heathrow Airport Limited, *Response to Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 (CAP2488),* 22 December 2022, paragraph 2.1.3, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1__50/page 4234**.

[290] BA, *British Airway's ("BA") Response to CAP2488 Economic regulation of Heathrow Airport ("Heathrow") : setting an interim price cap for 2023*, 22 December 2022, exhibited to this **BA_NOA1 at Tab 51/page 4238-4244**.

[291] CAA, *CAP2515 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 Notice of Licence Modifications under section 22(6) of the Civil Aviation Act 2012*, January 2023, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_52/page 4245-4269**.

2023. The CAA stated that it was aiming to publish its H7 Final Decision on the H7 price control in March 2023. As discussed in paragraph 1.2.28 below, the CAA did so on 8 March 2023 and identified as CAP2524. Consequently, the CAA's Holding Price Cap 2023 came into effect only after the CAA had already published the H7 Final Decision.

1.2.28 Although initially timetabled by the CAA for May/June 2022,[292] the CAA's H7 Final Decision was published on 8 March 2023. The H7 Final Decision set a price cap of £23.06 (2020 real prices) for the H7 price control period,[293] and again confirmed the CAA's April 2021 RAB Adjustment Decision to make an upward adjustment of £300 million to HAL's RAB.[294] A notice under section 22(6) of CAA2012 specifying the necessary modifications to HAL's Licence accompanied the H7 Final Decision and those modifications are due to come into effect on 1 May 2023.[295] Although the Holding Price Cap 2023 Decision had stated that the Holding Price Cap 2023 would "*remain in place up until it is replaced by the main H7 price control by our H7 Final Decision in March 2023*",[296] the CAA concluded in the H7 Final Decision, published during the following month, that the Holding Price Cap 2023 would not be changed for 2023.[297]

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[292] CAA, *CAP2265A Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Summary*, paragraph 77, October 2021, page 23, and Table 4: Timetable for the remainder of the H7 review, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_20/page 859.**

[293] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023 paragraph 64, page 17 and Table 7: H7 Final Decision revenue requirement and unprofiled yield per pax, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 26.**

[294] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, paragraph 54, page 15, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 24**.

[295] CAA, *CAP2524E2 Economic regulation of Heathrow Airport Limited: H7 Final Decision, Appendix C: Notice of the CAA's decision to modify HAL's licence*, 8 March 2023, paragraph C9, page 2 , exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_6/page 267**.

[296] CAA, *CAP2515 Economic Regulation of Heathrow Airport Limited: setting a holding price cap for 2023 Notice of Licence Modifications under section 22(6) of the Civil Aviation Act*, January 2023, page [9], paragraph 20, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_52/page 4253.**

[297] CAA, *CAP2524A Economic regulation of Heathrow Airport: H7 Final Decision – Summary,* 8 March 2023, paragraph 65, page 17, exhibited to this Notice of Appeal and marked Exhibit **BA_NOA1_1/page 26-27.**

SCHEDULE 2

KEY DOCUMENTS

BA has provided a list of the key CAA documents exhibited to this Notice of Appeal below. To assist the CMA has also indicated which sections of the documents BA considers are particularly relevant for the purposes of its appeal.

No.	Document	Date	Relevant section(s)
1.	H7 Final Decision	8 March 2023	• Summary **BA_NOA1_1/page 10** • Section 1, Chapter 1 Passenger forecasts **BA_NOA1_2/page 46-55** • Section 1, Chapter 2 Regulatory Framework **BA_NOA1_2/page 55-64** • Section 3, Chapter 9 Weighted Average Cost of Capital **BA_NOA1_4/page 153-191** • Section 3, Chapter 10, The H7 Regulatory Asset Base **BA_NOA1_4/page 191-205** • Appendix A, Our duties **BA_NOA1_5/page 255-256** • Appendix B, Glossary **BA_NOA1_5/page 257-265** • Appendix C, Notice of the CAA's decision to modify HAL's licence **BA_NOA1_6/pages 266-309** • Appendix H, Rolling forward the RAB **BA_NOA1_7/pages 389-392** • H7 Forecast Update Review, Final Report, Skylark **BA_NOA1_8/pages 393-410**
2.	Interim charge decision for 2023	1 February 2023	• Summary **BA_NOA1_52/pages 4245-4269** • Chapter 2, The level and other aspects of the holding price cap for 2023

No.	Document	Date	Relevant section(s)
3.	H7 Final Proposals	28 June 2022	• Summary **BA_NOA1_26/pages 1354-1385** • Section 1, Chapter 1 Passenger forecasts **BA_NOA1_27/pages 1322-1347** • Section 3, Chapter 9 Weighted Average Cost of Capital **BA_NOA1_29/pages 1526-1604** • Section 3, Chapter 10, The H7 Regulatory Asset Base **BA_NOA1_29/pages 1605-1627** • Appendix A, Our Duties **BA_NOA1_30/pages 1770-1771** Appendix B, Glossary **BA_NOA1_30/pages 1772-1771** • Appendix C Notice of the CAA's proposal to modify HAL's licence **BA_NOA1_31/pages 1885-1969** • Appendix K: Rolling forward the RAB **BA_NOA1_32/pages 1885-1969**
4.	Interim charge decision for 2022	22 December 2021	• **BA_NOA1_48/pages 4176-4212**
5.	H7 Initial Proposals	22 October 2021	• Summary **BA_NOA1_20/pages 837-863** • Section 2, Chapter 6 The H7 Regulatory Asset Base and HAL's request for a RAB adjustment **BA_NOA1_22/pages 936-954** • Section 2, Chapter 9, Weighted Average Cost of Capital **BA_NOA1_22/pages 972-1018**
6.	April 2021 RAB Adjustment Decision	May 2021	• Summary and introduction (page 6) **BA_NOA1_19/pages 753-762** • Chapter 4, Details on early intervention **BA_NOA1_19/pages 788-795**

SCHEDULE 3

CHRONOLOGY

Date	Event
February 2014	The CAA Grants HAL an Economic Licence The CAA publishes CAP1151 - Economic regulation at Heathrow from April 2014: Notice granting the licence, in which it gives notice that the CAA is granting a licence to Heathrow Airport Limited and outlines the conditions in that licence ("Hal's Licence").
21 December 2016	HAL's Licence Modified to Extend Q6 Period The CAA modifies condition C1 of HAL's Licence to extend the Q6 Settlement by 1 year to 31 December 2019.
28 February 2019	Economic regulation at Heathrow airport from January 2020 Published The CAA publishes CAP1769 - Economic regulation at Heathrow from January 2020: proposals for the interim H7 price control.
1 August 2019	iH7 Consultation Commences The CAA publishes CAP1825 - Economic regulation of Heathrow Airport Limited from January 2020: notice of proposed licence modifications, in which the CAA proposes to set an is interim price control ("**iH7**") and extend the Q6 price control by two years.
5 November 2019	iH7 Decision Published The CAA publishes CAP1852 - Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications, in which the CAA sets an is interim price control ("**iH7**") and extends the Q6 Settlement by 2 years to 31 December 2021).
27 July 2020	HAL Requests a RAB Adjustment

	HAL applies for Covid-related RAB adjustments.
9 October 2020	The October 2020 RAB Adjustment Consultation The CAA publishes CAP1966 - Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment, which seeks comment on HAL's request for a RAB adjustment.
5 November 2020	BA and IAG Respond to the October 2020 RAB Adjustment Consultation BA and IAG provide separate responses to CAP1966 - Heathrow RAB adjustment.
18 December 2020	HAL's Revised Business Plan Published HAL releases its H7 Revised Business Plan, in which it says that its prices have increased due to a downturn in passenger numbers brought on by the Covid-19 pandemic.
5 February 2021	The February 2021 RAB Adjustment Consultation Published The CAA publishes CAP2098 - Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment.
5 March 2021	BA Responds to the February 2021 RAB Adjustment Consultation BA responds to CAP2098 - Heathrow's request for a Covid-19 related RAB adjustment.
April 2021 (amended 4 May 2021)	The April 2021 RAB Adjustment Decision Published The CAA publishes CAP2140 Economic regulation of Heathrow Airport Limited: response to its request for a Covid-19 related RAB adjustment.

May 2021	Letters Exchanged that Clarify the Nature of the April 2021 RAB Adjustment Decision Letter from HAL to the CAA seeking to clarify whether the April 2021 Decision is a final decision as to any aspect of the regulatory package that will apply during the H7 Price Control. Letter from the CAA to HAL clarifying that the April 2021 Decision is a decision by the CAA only on the package of measures that will apply pending the start of the H7 Price Control, and that the appropriate forum for oversight of the April 2021 Decision would be as part of any appeal to the CMA.
End of June 2021	HAL Releases its H7 Revised Business Plan – Update 1 HAL publishes an update to its revised business plan in which it said that its price cap needed to be further revised beyond what was in its revised business plan due to a deflated passenger forecasts over H7.
19 October 2021	H7 Initial Proposals Published The CAA publishes CAP2265 Economic Regulation of Heathrow Airport Limited: H7 Initial Proposals. The CAA proposed a wide range of airport charges for the period 2022 to 2026 ranging from £24.60 to £34.40 per passenger in 2020 prices.
17 November 2021	Draft Licence Consultation The CAA publishes CAP2275 Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – draft licence modifications.
19 November 2021	OBR Working Paper Published The CAA publishes CAP2274 - Economic regulation of Heathrow Airport Limited: H7 Initial Proposals – Working paper on outcome-based regulation. This working paper follows on from the October 2021 Initial Proposals consultation and provides further details of the

	CAA's proposed approach to implementing outcome based regulation (OBR).
22 December 2021	Holding Price Cap for 2022 Published The CAA publishes CAP2305 - Economic Regulation of Heathrow Airport Limited from January 2022: notice of licence modifications (implementing the holding price cap). The interim holding cap is set for 2022 at the mid-point of the range in the Initial Proposals: £29.50 per passenger in 2020 prices or £30.19 per passenger in nominal prices.
17 December 2021	BA and IAG Comment on the Initial Proposals BA and IAG respond to the Initial Proposals and consider the proposals set too high a price cap.
18 January 2022	BA's Comments on OBR Working Paper BA responds to CAP2274 Economic regulation of Heathrow Airport Ltd Working paper on outcome-based regulation.
28 June 2022	H7 Final Proposals Published The CAA publishes CAP2365 - Economic regulation of Heathrow Airport Limited: H7 Final Proposals. CAP2365A outlines the CAA's Final Proposals for HAL's H7 price control review. Under the Final Proposals, the price cap starts at the level envisaged by the holding cap in 2022 of £27.39 in 2020 prices (£29.50 in nominal terms) and then reducing in real terms in each year until reaching a level of £24.50 in (in 2020 prices) in 2026.
9 August 2022	BA Comments on Final Proposals BA submits a response to the H7 Final Proposals.
8 December 2022	Holding Price Cap 2023 Consultation Published

	The CAA publishes CAP2488 - Economic regulation of Heathrow Airport Limited: setting a holding price cap for 2023. CAP2488 seeks consultation on an interim price cap for 2023.
22 December 2022	BA Comments on Holding Price Cap 2023 Consultation BA submits a response to the Holding Price Cap 2023 consultation.
1 February 2023	Holding Price Cap 2023 Decision Published The CAA publishes CAP2515 - Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023. This decision follows the Holding Price Cap 2023 Consultation on setting the interim price cap for 2023 and replaces the holding cap that was put in place by CAA in 2022. The interim holding cap is set for 2023 at £31.57 per passenger in nominal prices.
8 March 2023	H7 Final Decision Published The CAA makes its Final Decision for HAL's H7 price control review and publishes the corresponding amendments to the conditions of HAL's Licence.
1 May 2023	H7 Final Decision Takes Effect

SCHEDULE 4

GLOSSARY

Abbreviation	Meaning
AD1	The Witness Statement of Alexander James Dawe Group Head of Economics and Regulation at International Airlines Group, dated 18 April 2023
AOS*	Airport Operation Services as defined in section 68 of CAA2012
ATM	Air Traffic Movements
Appellant	British Airways plc
April 2020 Update*	CAP1914 "Economic regulation of Heathrow: programme update", dated April 2020.
April 2021 RAB Adjustment Decision*	CAP2140 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", dated April 2021 (updated 4 May 2021).
April 2021 Way Forward Document*	CAP2139 "Economic regulation of Heathrow Airport Limited: Consultation on the Way Forward", dated 27 April 2021.
BA/IAG*	British Airways plc/International Airlines Group (owner of British Airways)
BBU	The building block update in the Initial Proposals
Better Regulation Principles*	The principles to which the CAA (and the CMA) must have regard under section 1(3)(g) of CAA2012 and set out in subsection 1(4) of CAA2012

Building blocks*	Price control building blocks, including passenger numbers, operating costs, capital expenditure and commercial revenues
CAA*	The Civil Aviation Authority
CAA2012*	The Civil Aviation Act 2012
Capex*	Capital Expenditure
CAPM*	Capital Asset Pricing Model
CC	Competition Commission
CE*	Constructive Engagement: a CAA-mandated process that requires the airport operator to discuss its business plan with the airlines before the CAA develops its proposals for the relevant price control. For H7, CE took place between August 2020 and October 2020
CMA*	The Competition and Markets Authority
CMA Guide	Airport Licence Condition Appeals: Competition and Markets Authority Guide (CMA173) dated 27 October 2022
CMA Rules	Airport Licence Condition Appeals: Competition and Markets Authority Rules (CMA172) dated 27 October 2022
Consumers*	"Users" are defined in section 69 of CAA2012 as passengers and those with "a right in property" (cargo) carried by air transport services and include future users
Delta	Delta Air Lines, Inc.
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
Equity Beta*	Company specific estimate of risk relative to the whole market

February 2021 Consultation*	CAP2098 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", dated 5 February 2021
Final Decision Skylark Report	A report by Skylark entitled "H7 Forecast Update Review" dated February 2023 which was commissioned by the CAA
Flint	Flint Global, who were commissioned by the CAA to provide an opinion of the future assessment of beta for Heathrow Airport and at H7
GM1	The Witness Statement of Gavin Molloy, Director of Airport Regulation and Infrastructure at British Airways, dated 18 April 2023
H7	The price control period for Heathrow from 1 January 2022 until 31 December 2026
H7 Final Decision	H7 Final Decision made by the CAA to modify the conditions of HAL's Licence to give effect to the H7 Final Proposals which will operate from 1 January 2022 to 31 December 2026, contained in a notice under section 22(6) of CAA2012 dated 8 March 2023
H7 Final Proposals / FPs	CAA's Final Proposals for the H7 price control review dated 28 June 2022
HAL*	Heathrow Airport Limited, the licence holder and operator of Heathrow Airport
HAL's Application	HAL's Application for Covid-related RAB adjustments, dated July 2020
HAL's Licence	Airport Licence granted to HAL by the CAA under section 15 of the Act on 13 February 2014

Heathrow Airport	London Heathrow Airport
Holding Price Cap 2022	Holding Price Cap for 2022 set at £30.19 per passenger in 2022 prices (expired 31 December 2022)
Holding Price Cap 2023	Holding Price Cap for 2023 set at £31.57 (nominal prices) per passenger
Holding Price Cap 2023 Consultation Document	The document titled "CAP2488 'Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023", dated 8 December 2022
Holding Price Cap 2023 Decision	The document titled "*CAP2515 Economic regulation of Heathrow Airport Limited: setting an interim price cap for 2023*", dated 1 February 2023
iBoxx indices*	The Markit iBoxx Corporates Indices represent investment grade fixed-income bonds issued by public or private corporations and are produced by public or private corporations and are produced by HIS Markit.
iH7*	The interim H7 price control, running from 1 January 2020 until 31 December 2021
IBP*	HAL's publication, Initial Business Plan submitted to the CAA in December 2019 in response to the Updated Business Plan Guidance,
ILG*	Index-Linked Gilt
Initial Proposals*	CAP2265 "Economic regulation of Heathrow Airport Limited: H7 Initial Proposals", dated October 2021

June 2020 Consultation*	CAP1940 "Economic regulation of Heathrow: policy update and consultation", dated 23 June 2020
NOA	Notice of Appeal
NERL*	NATS En Route plc.
NPV*	Net Present Value
OAV	Opening Asset Value
OBR*	Outcome Based Regulation
October 2020 Consultation*	CAP1966 "Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment", dated 9 October 2020
Opex*	Operational Expenditure
PAX	Passengers
Phoenix Gas/PNGL	CC price redetermination in Phoenix Natural Gas Limited dated 2012
Price Control Model*	The financial model developed by the CAA to calculate HAL's revenue requirements for H7
Q6 / Q6 price control*	Q6 was the price control for the period from 2014 to 2018, the approach to which was successively extended to cover 2019 and 2020 to 2021
Q6 Final Proposals	CAA's Final Proposals for the Q6 price control review dated October 2013
RAB*	Regulatory Asset Base

RAB Report	'Assessment of the CAA's H7 RAB Adjustment': an Expert Report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023
RAR	Regulated Asset Ratio
RBP	HAL's H7 revised business plan, dated December 2020
RBP update / Updated RBP *	HAL's publication, Revised Business Plan updated to take the 2021 situation into account and submitted to the CAA in July 2021
RBP Update 2*	HAL's publication, Updated Revised Business Plan submitted to the CAA in December 2021.
RFR	Risk Free Rate
SQRB	Service Quality Rebate and Bonus scheme
TMR*	Total Market Return
TRS*	Traffic Risk Sharing
UR	Utility Regulator
VAA*	Virgin Atlantic Airways
WACC*	Weighted Average Cost of Capital
WACC Report	'Cost of capital issues raised by the Heathrow Airport H7 price control': an Expert Report prepared for British Airways, Virgin Atlantic Airways and Delta Airlines by AlixPartners dated 17 April 2023
WLS	Weighted Least Squares

STATEMENT OF TRUTH

British Airways believes that the facts stated in this Application are true.

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Signature of Authorised Representative

Name of Authorised Representative

Date 18 April 2023

for and on behalf of British Airways plc