NON-CONFIDENTIAL VERSION

BEFORE THE COMPETITION AND MARKETS AUTHORITY

IN THE MASTER OF AN APPEAL

UNDER SECTION 25 OF THE CIVIL AVIATION ACT 2012

BETWEEN

HEATHROW AIRPORT LIMITED ("HAL")

BRITISH AIRWAYS PLC ("BA")

VIRGIN ATLANTIC AIRWAYS LIMITED ("VIRGIN")

DELTA AIR LINES, INC. ("DELTA")

Appellants

-and-

THE CIVIL AVIATION AUTHORITY (THE "CAA")

Respondent

RESPONSE TO APPEAL

Contents

I. INTRODUCTION & SUMMARY

1 This is the Response of the Civil Aviation Authority (**"CAA"**) to the Appellants' appeals against the modifications made to the Licence that implemented the CAA's decision on the price control applicable to Heathrow Airport Limited (**"HAL"**) for the "H7" period from 1 January 2022 to 31 December 2026 (**"the Final Decision"**).

2 The H7 price control has been given effect by modifying HAL's licence. The modifications to which the appeal relates were set out in a Notice under s.22(6) of the Civil Aviation Act 2012 (the **"CAA12"**) published by the CAA on 8 March 2023 (**"the Notice"**) as part of the Final Decision **[Core/2052-2075]**. The Appellants appeal against those modifications pursuant to s. 25 CAA12 on a number of different grounds, summarised below.

3 For reasons of procedural efficiency and in light of the importance of the matters raised only, the CAA did not contest permission to appeal, which was granted on 11 May 2023 on the condition that the grounds be joined and heard together. The CAA notes that on Monday 22 May 2023, HAL, Delta and BA each applied for permission to intervene in their respective appeals and filed additional substantial submissions and evidence. Given the time, and the receipt of these materials shortly before the filing of the CAA's Response, the CAA does not address them and reserves all of its rights in relation to the same.

4 The H7 review and, indeed, the current appeals have been characterised by HAL and airline stakeholders putting forward diametrically opposed positions on each of the key issues discussed, such as operating and capital costs,

passenger forecasts and the cost of capital. Although the CAA readily accepts that any party is entitled to argue in a way that suits its commercial interests, the extent to which these divergent positions match the parties' respective commercial interests is nonetheless striking, with HAL suggesting airport charges should increase significantly and airlines saying they should be significantly lower. To place this clash of commercial interests in some context the table below shows HAL and airlines proposed calculation of airport charges following the CAA's Final Proposals compared to the CAA's Final Decision.

£/pax (CPI-2020)	2022	2023	2024	2025	2026	Average
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
HAL Revised Business Plan Update 2 (Dec-22)	34	46	46	47	47	44
CAA Final Decision (Mar-23)	27	26	21	21	21	23

5 The table is striking for a number of reasons, including that HAL's most recent business plan update, provided shortly before the Final Decision, calls for airport charges on average to be almost double the level included in the Final Decision. Airlines, by contrast, have called for charges to be nearly [redacted] lower than the Final Decision and nearly [redacted] lower than HAL's Business Plan projection.

6 As to the grounds of appeal, the CAA denies that they disclose any error. The CAA's determination of the new price control arrangements was lawful and

not vitiated by any error in the exercise of its discretion or of fact and law. There is no basis for the CMA to disturb it. Following an extensive and detailed consultation process, in which each of these Appellants made representations which were considered and taken into account by the CAA, the CAA issued the Final Decision in accordance with its core statutory duties. The CAA had regard to all relevant evidence and material and to its statutory obligations, gave those matters appropriate weight, and reached decisions based on its own expert regulatory judgement and in accordance with the legal framework applicable to the development and determination of the H7 price control.

7 The Appellants raise the following complaints, each of which is without merit for the following summary reasons:

7.1 All the Appellants raise complaints about the **CAA's adjustment to HAL's RAB** (**Joined Ground A**):

(a) **HAL** says that it should have received a substantial further upwards increase in its RAB for three reasons, each of which is misguided. First, it submits that the CAA failed to act consistently with the terms of the previous price control settlement. This ground is based upon a misreading of what was previously decided. Secondly, HAL submits that the CAA was *required*, by virtue of its statutory duties, to make such an adjustment. This is a complaint about how the CAA weighed current prices and future consumer benefit in the exercise of its regulatory judgement. It discloses no error. Thirdly, HAL argues

that the CAA erred when it failed to make a RAB adjustment which guaranteed that HAL would recover regulatory depreciation on its RAB over the pandemic. There was no entitlement to this, and so the CAA did not err by refusing to guarantee it.

(b) **The Airlines** submit that the CAA should have reviewed the RAB adjustment made in 2021, in light of Heathrow's subsequent poor performance. There is no merit in this either: there is no evidence of poor performance sufficient to justify such a review, and the CAA was entitled to consider the perceptions of regulatory risk which might arise were it to reverse the adjustment. The Airlines also submit that the overall conclusion that the adjustment should be made at all is unsupportable. This limb of this Ground amounts to little more than a number of policy disagreements with the CAA's exercise of its regulatory judgement, and discloses no error.

7.2 All the Appellants raise complaints about the CAA's estimation of HAL's cost of capital (**Joined Ground B**). As to that:

(a) **Joined Ground B(i)** concerns **the estimation of the asset beta**. In short, the complaints are that the CAA relied on out-of-date information and (according to HAL) underestimated HAL's systemic risk in calculating the pre-pandemic asset beta estimate; wrongly over-estimated (Airlines) or under-estimated (HAL) the effect of the pandemic on asset beta; and either

should not have adjusted the asset beta to take account of the forward-looking Traffic Risk Sharing ("**TRS**") mechanism that the CAA introduced as part of the H7 price control (HAL), or should have made a greater adjustment for the TRS mechanism (Airlines). The CAA joins issue with each allegation. It used up-to-date information to assess the pre-pandemic asset beta, and, taken in the round, made permissible regulatory judgements about HAL's systemic risk and the impact of the TRS on asset beta. In challenging circumstances (see paragraph 36 below), the CAA's assessment of the impact of the pandemic on HAL's asset beta fell within its margin of appreciation, and cannot be said to be wrong. The Appellants disagree with the adjustment for opposite reasons (in each case consistently with their commercial objectives): but this too was an exercise of regulatory judgement underpinned by analysis, which discloses no error.

(b) **Joined Ground B(ii)** concerns **the cost of debt**. HAL argues that the CAA should have used a different measure of inflation, assessed HAL's cost of debt premium differently, and used a different averaging period. By contrast, the Airlines argue that the CAA was wrong to apply an uplift to reflect the higher cost of index-linked debt relative to fixed-rate debt. These submissions all amount to a series of proposals for how the CAA might have gone about things differently. None of them provide a basis for

concluding that the CAA was wrong to assess the cost of debt in the way it did.

(c) **Joined Ground B(iii)** concerns **the point estimate**. HAL says the CAA should have picked a point estimate higher in the range; while the Airlines say the opposite. The arguments put forward have varying degrees of cogency, and insofar as relevant, were taken into account – but none of them provide a basis for concluding that the CAA was wrong to pick the midpoint. It is telling that each side was able to identify factors which supported a shift up or down. That in itself suggests that the CAA's approach of taking the middle point was a reasonable exercise of regulatory judgement and cannot be said to be wrong.

7.3 The Airlines appeal against the CAA's determination of **passenger forecasts** (**Joined Ground C**). They first submit that it was procedurally unfair for the CAA to adopt HAL's model as a starting point. HAL refused to permit the CAA to disclose the version of HAL's model that it had amended for use in its forecasting work. However, the CAA was justified in taking HAL's model as a first reference point and amending, testing and benchmarking it as part of its work to satisfy itself of the Final Decision's correctness. The CAA did so in a fair, transparent, and consultative way. There was therefore no overall procedural deficiency, and certainly none serious enough to call into question the correctness of the CAA's decision. The Airlines further

complain about the *"Steps"* which the CAA adopted to adjust the output of HAL's model (as amended). Each such complaint is a disagreement as to how to forecast passenger numbers in conditions of imperfect information. None of these complaints shows the CAA to have exceeded its margin of appreciation in making that necessarily imprecise assessment on the basis of incomplete and developing information. Nor have the Airlines identified a clearly superior alternative approach that the CAA could sensibly be described as *"wrong"* not to have taken.

7.4 HAL appeals against the application of **the AK factor** (**Ground D**). This is a wholly unmeritorious ground, by which HAL argues that the CAA should not have imposed a correction factor to give effect to the iH7 price cap. The CAA was clearly (at the very least) entitled to hold HAL to a previously settled price cap, and its decision to do so discloses no error. To the extent that there are issues to consider in relation to HAL's financial losses in 2020 and 2021, these are dealt with by the CAA's approach to RAB adjustment and in response to HAL's complaint in relation to the RAB adjustment.

7.5 Finally, HAL appeals against the **capex incentives framework** (**Ground E**). HAL's appeal against the capex incentives framework is nothing more than disagreement with the CAA about the exercise of its regulatory judgement. Its grounds of appeal identify what HAL considers to be a number of arguments against the Final Decision the CAA eventually made (many of which had been previously aired, as

described above). In fact, the CAA is continuing to consult on important details of the new framework. None of this comes close to showing that the decision was *"wrong"*, rather than an exercise of regulatory judgement with which HAL disagrees.

8 A number of general observations arise from the Appeals, which the CAA invites the CMA to take into account in its decision:

8.1 The nature of the Appellants' Grounds: As even the short summary above indicates, the Appellants' real complaints are that they would have preferred the CAA to have exercised its regulatory judgement *differently*. That is not the relevant test on appeal, nor does it reflect the well-established principles of law set out by the Appellants themselves. As is often the case in regulatory appeals, the CMA is faced with opposing positions from HAL and the Airlines which, consistently with their respective commercial interests, are diametrically opposed to each other. The CAA considered and balanced the various factors raised by the parties, alongside its statutory objectives, and reached a Final Decision which was reasonable in the interests of consumers[1] in all of the circumstances.

8.2 Complexity of the exercise: The Final Decision was unusual in that it incorporates adjustments to reflect the impact of the covid-19 pandemic. The period leading up to the CAA's decision was characterised by very significant uncertainties both as to the future

[1] That is "users of air transport services": see para. 15 below.

course of that pandemic - and as to its medium and long-term impact on the aviation industry (as to which there remains substantial uncertainty). It is obvious, and accepted by everyone, that the pandemic had a profound effect on the aviation industry generally, including on HAL. The need to take account of that impact across almost all the issues being considered, combined with the difficulties in predicting the level and speed of recovery from the pandemic and its impact over the period of the CAA's review, inevitably both delayed and complicated the CAA's review process. This required the CAA to strike the right balance between allowing time to obtain further information that would improve the accuracy of its assessment[2] and the need to avoid undue delay to its Final Decision and consequent regulatory uncertainty. In the meantime, the advantages of supporting HAL's financeability and ensuring that it had the resources and incentives to maintain a high quality of customer service and reopen terminal capacity in a timely manner in 2021 led to the CAA's decision in April 2021 to make a targeted and focused adjustment to HAL's RAB of £300 million in order to support it in achieving those objectives.

8.3 Consumer interests vs commercial interests: It is notable that, in the view of each Appellant, the decision that the CAA should have reached is the one that best aligns with its commercial interests. The CAA,

[2] As noted at paragraph 31 below, the CAT has previously emphasised the need for regulators to base their conclusions as to the impact of the pandemic on adequate evidence, even in the context of a strict administrative timetable.

however, is required to put the interests of the consumer first (see the detailed discussion at paragraph 19 below).

8.4 Repetition of the consultation: Certain procedural complaints are made by the parties about the CAA's decision-making. However, as noted above, the pandemic and its uncertain course and impact on the aviation sector inevitably meant that the consultation in this case was unusually long. The process was also complicated by the decision in 2020 not to proceed with the third runway proposal (a proposal that had until then played a very large part in the development of the CAA's proposals). The process was also extremely detailed, with more iterations than would have occurred in normal circumstances. The CAA is confident that the lengthy and intensive process that it has followed (described in Section III below and the First Witness Statement of Robert Toal ("**Toal 1**")) has delivered a result that is well-founded and that effectively and appropriately discharges its primary duty to further the interests of present and future consumers at Heathrow airport. The CAA has appropriately balanced those interests and has had appropriate regard to the matters it is required to consider under CAA12. It is notable that a number of the detailed issues now raised, including some of points made in relation to the cost of capital (Ground B) and the AK factor (Ground D) were never raised until the appeals, and so could not have been taken into account in the Final Decision, while many others around the RAB adjustment (Ground A), cost of capital (Ground B) and capex incentives framework (Ground E) are simply re-runs of matters raised, considered and dealt with

appropriately in the consultation process. In those circumstances, the only real question for the CMA is whether there is anything of substance calling into question the correctness of the Final Decision, in order to ensure that the most up-to-date information is taken into account: complaints about process, which are in any event without merit, are relevant only to the limited extent set out in paragraph 27 below.

8.5 Allegation that judgements are *"arbitrary"*: On a number of occasions (discussed in detail at various points below) HAL accuses the CAA of making *"arbitrary"* judgements. However, in evaluating those accusations, it is important to bear in mind that in all sorts of contexts regulators (and indeed courts) have to fix values (or thresholds) against a background where the available, and often limited, material before the decision maker could easily support a range, and sometimes a very wide range, of reasonable values (or thresholds). Regulators have to set safety limits for a new chemical about which little is known. Courts have to assess damages for loss of future earnings for a promising footballer disabled in a car accident at the start of their career (and do so by applying a *"broad axe"*). In neither of those cases does (or can) the decision-maker throw up their hands and say *"because the uncertainties are so great and because there are so many reasonable estimates, I cannot fix any figure at all"*. And in none of those cases can the choice of a figure within an (often very wide) range of reasonable figures be sensibly criticised as *"arbitrary"*. Yet, as

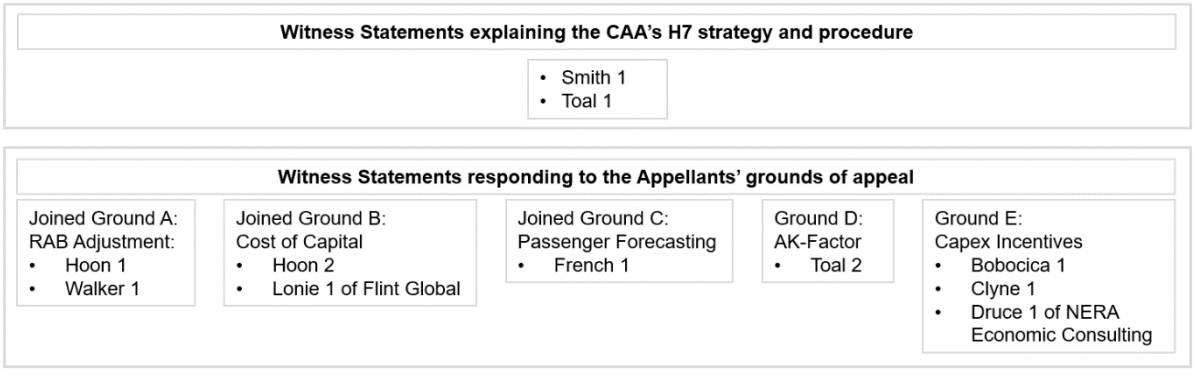
explained in detail on various occasions below, HAL consistently misuses the word *"arbitrary"* in that way.

9 The CAA accordingly resists the appeals on all grounds and invites the CMA to dismiss each of them. Where the CAA does not expressly respond to a particular paragraph of any Notice of Appeal, it should not be taken to be accepting the relevant submission. Since it is the CAA's position that its decision should be upheld in full, it respectfully suggests that submissions on any suitable remedies and/or costs should only be made following the CMA's Provisional Determinations (should such submissions be needed).

10 In this Response, the CAA refers to each Notice of Appeal in the forms ***"HAL §[paragraph]"***, ***"BA §[paragraph]"***, ***"Virgin §[paragraph]"***, and ***"Delta §[paragraph]"*.** The latter three Appellants are referred to collectively as **"the Airlines"** in this Response, where appropriate. To the extent that this Response refers to other defined terms, these are consistent with the use of those terms in the Glossary set out at Appendix B to the Final Decision.

Overview of evidence provided with this Response

11 The CAA files, alongside this Response and in support of the points made within it, the following evidence:



II. LEGAL FRAMEWORK

A. Power to Impose Price Control Conditions

12 The CAA imposed the H7 price control pursuant to its power under ss. 18-19 CAA12. Section 18(1) provides (emphasis added):

> *A licence may include—*
>
> *(a) such conditions as the CAA considers necessary or expedient having regard to 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 airport operation services (or for services that include airport operation services), and*
>
> *(b) such other conditions as the CAA considers necessary or expedient having regard to the CAA's duties under section 1.*

13 Section 19(2) provides (emphasis added):

> *A licence must include such price control conditions as the CAA considers necessary or expedient having regard to the risk referred to in section 18(1)(a).*

14 Section 19(6)-(7) provides:

> *(6) A price control condition may make provision—*
>
> *(a) by reference to the amount charged for particular goods or services;*
>
> *(b) by reference to the overall amount charged for a range of goods or services.*
>
> *(7) A licence that includes a price control condition must include conditions specifying a period or periods for which the price control condition has effect.*

B. Statutory Duties

15 The CAA's work on the H7 price control has been conducted as part of its functions under CAA12. Section 1(1) provides that (emphasis added):

> *"The CAA must carry out its functions under this Chapter 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 airport operation services."*

16 In this context, *"users of air transport services"* are defined in s. 69 as persons who are either passengers, or persons with a right in property carried by an air transport service and include both present future users of such services. The CAA refers to these collectively as *"consumers"*.

17 Section 1(2) imposes a further qualified duty on the CAA in respect of the general duty by providing that:

"The CAA must do so, where appropriate, by carrying out the functions in a manner which it considers will promote competition in the provision of airport operation services."

18 When performing these duties, the CAA must have regard to the matters set out in s. 1(3), which provides that (emphasis added):

"In performing its duties under subsections (1) and (2) the CAA must have regard to--

(a) the need to secure that each holder of a licence under this Chapter is able to finance its provision of airport operation services in the area for which the licence is granted,

(b) the need to secure that all reasonable demands for airport operation services are met,

(c) the need to promote economy and efficiency on the part of each holder of a licence under this Chapter in its provision of airport operation services at the airport to which the licence relates,

(d) the need to secure that each holder of a licence under this Chapter 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 with that airport ("associated facilities") and aircraft using that airport,

e) any guidance issued to the CAA by the Secretary of State for the purposes of this Chapter,[3]

(f) any international obligation of the United Kingdom notified to the CAA by the Secretary of State for the purposes of this Chapter, and

(g) the principles in subsection (4)."

19 Section 1(4) provides that those principles are that (emphasis added):

(a) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent, and

(b) regulatory activities should be targeted only at cases in which action is needed."

20 The matters set out in section 1(3) must be properly and conscientiously taken into account in assessing how best to further the interests of users. However, they do not, individually or collectively, override the duties in section 1(1) and (2) (*Explanatory Notes to CAA12*, §36). Accordingly, the CAA's primary focus in setting the price control must be on furthering the interests of consumers: *R (British Gas Limited) v The Gas and Electricity Markets*

[3] BAA, Delta and Virgin make reference in this regard to a letter dated 1 December 2020 issued by the Secretary of State to the CAA. It is not clear whether anything turns on this, but, insofar as it does, then (a) that letter was not *"guidance issued…for the purposes of this Chapter"* and so does not fall within the material to which s. 1(3)(g) required the CAA to have regard; and in any event (b) it cannot override the primary duty and/or replace it with a direct duty to support *"the recovery and growth of the aviation industry"*.

Authority [2019] EWHC 3048 (Admin) at §14 per Mrs Justice Andrews. The CAA is not obliged to ensure the financing of a particular operator of a regulated airport in all circumstances, and is not required to adjust regulatory decisions in order to take account of such 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.

21 Section 1(5) confers a discretion on the CAA as to how it should manage conflicts arising from its duties by providing that:

> *"If, in a particular case, the CAA considers that there is a conflict –*
>
> *(a) between the interests of different classes of user of air transport services, or*
>
> *(b) between the interests of users of air transport services in different matters mentioned in subsection (1),*
>
> *its duty under subsection (1) is to carry out the functions in a manner which it considers will further such of those interests as it thinks best."*

22 Thus, where there is a conflict between the interests of different classes of consumer or different elements of consumer interest, the CAA must consider the specific elements of the consumer interest set out in s. 1(1) and decide what weight to give each of them.

23 The CAA, as a public body, is also bound by the ordinary requirements of public law, including as to its standards of consultation, the duty of enquiry, and the taking into account of relevant considerations.

C. The CMA's Jurisdiction

24 The CMA has jurisdiction to hear the Appellant's appeals pursuant to s. 25 CAA12, which provides (so far as relevant):

> *(1) An appeal lies to the Competition and Markets Authority against a decision by the CAA to modify a licence condition under section 22.*
>
> *(2) An appeal may be brought under this section only by—*
>
> *(a) the holder of the licence, or*
>
> *(b) a provider of air transport services whose interests are materially affected by the decision.*

25 Section 27 provides (so far as relevant, emphasis added):

> *(1) Where it does not allow an appeal under section 24 or 25, the Competition and Markets Authority must confirm the decision appealed against.*
>
> *(2) Where it allows an appeal under section 24 or 25, the Competition and Markets Authority must do one or more of the following—*
>
> *(a) quash the decision appealed against;*
>
> *(b) remit the matter that is the subject of the decision appealed against to the CAA for reconsideration and decision in accordance with this Chapter and any directions given by the Competition and Markets Authority;*
>
> *(c) substitute its own decision for that of the CAA.*

(3) Where it allows only part of an appeal under section 24 or 25—

(a) subsection (2) applies in relation to the part of the decision appealed against in respect of which the appeal is allowed, and

(b) subsection (1) applies in relation to the rest of that decision.

(4) Where the Competition and Markets Authority substitutes its own decision for that of the CAA, the Competition and Markets Authority may give directions to—

(a) the CAA, and

(b) the holder of the licence.

26 Section 30 CAA12 provides that in determining an appeal under section 25, the CMA itself must have regard to the matters in respect of which duties are imposed on the CAA by section 1.

27 Schedule 2, paragraph 23 deals with the powers of the CMA to consider matters which are only raised at the appeal stage. Paragraph 23(3) provides that (emphasis added):

The member or group must not have regard to any matter, information or evidence raised or provided by a person other than the CAA if it was not considered by the CAA in making the decision that is the subject of the application or appeal, unless the member or group considers that—

(a) the person or a relevant connected 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 application or appeal, either by itself or taken together with other matters, information or evidence.

D. Standard of Review

28 Section 26 provides (emphasis added):

The Competition and Markets Authority may allow an appeal under section 24 or 25 only to the extent that 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;

(b) that the decision was wrong in law;

(c) that an error was made in the exercise of a discretion.

29 Accordingly, the question for the CMA is whether the decision is *"wrong"*. Although the parties (naturally) differ in emphasis, the legal principles (or at least their effect) appear to the CAA to be largely common ground.

30 In particular, it is common ground that applying that standard, the CMA is not limited to reviewing the decision on traditional judicial review grounds. However, conversely, it is not a full rehearing of the merits of the decision, or a *"second bite of the cherry"*: *BT v. Ofcom* [2010] CAT 17 at §76 **[CAA/422];** *Energy Licence Modification Appeals 2021* **("RIIO-2")** §3.29 **[CAA/3788]**.

31 Critically, while the CMA can decide whether a fact or inference is *"wrong"*, it cannot substitute its judgement for that of the regulator simply because it would have taken a different view: *RIIO-2* §3.36 **[CAA/3790]**. Further:

31.1 It is not in itself sufficient that the CMA or a party is able to identify an alternative approach, unless that approach is *"clearly superior"*: *RIIO-2* §§3.40-3.43, and §3.77 **[CAA/3791, 3799]**. Insofar as BA seek to suggest that some lower standard applies by its suggestion that the CAA may not intervene *"where less intrusive alternatives are available"* that is wrong (BA §2.5.3), and it is trite that the proportionality analysis from which this principle is lifted involves generous respect for the decision-maker's margin of appreciation: see, in relation to the necessity limb of the proportionality test, *Bank Mellat v HM Treasury (No 2)* [2014] A.C. 700, p.791C-E at §75 per Lord Reed JSC **[CAA/745]**.

31.2 It is not sufficient to identify some defect in reasoning. It is only if the decision cannot be supported on any basis (whether or not relied upon by the CAA) that it will be *"wrong"*: *RIIO-2* §3.51 **[CAA/3792]**.

31.3 It is not sufficient to identify some procedural deficiency. Such a deficiency will render the decision *"wrong"* only if it is *"so serious that* [the CMA] *cannot be assured that the Decision was not wrong"*: *RIIO-2* §3.54 **[CAA/3793]**.

32 A decision will be *"wrong"* if it is based on unreliable data or fails to take account of the relevant evidence: *RIIO-2* §3.47 **[CAA/3793]**.

33 The CMA's RIIO-2 decision recognised the importance of the *"margin of appreciation"* in deciding whether a decision is *"wrong"* (save that no such margin is available in respect of alleged errors of law). It is respectfully submitted that the CMA should adopt the same approach to its determination of appeals under CAA12 as it did in *RIIO-2*, not least because many decisions taken by any regulator, or decisions on elements which go to make up those overall decisions, involve the exercise of judgement and estimation of what might happen in an uncertain context. Further, that approach preserves the institutional balance between the CAA as the body tasked by Parliament with taking the relevant regulatory decisions, and the CMA as the appellate body.

34 Thus, the CMA should allow the CAA a margin of appreciation and in particular:

34.1 Should be slow to impugn the CAA's findings of fact, unless it concludes that the CAA has based its decision on a *"plain"* error of fact: *RIIO-2* §3.69 **[CAA/3797]**.[4]

34.2 Should have regard to the CAA's expert regulatory judgement where it is required to reach an overall value judgement based on competing considerations in the context of a public policy decision and should apply appropriate restraint when reviewing issues that entail

[4] As to this, Heathrow's apparent contention that there is no room for margin of appreciation on questions of fact (see **HAL §26**) is simply wrong: if the error must be a *"plain error"* (as HAL appear to accept by its reliance on ***RIIO-2* §3.69**) then by definition there may be factual findings which the CMA would not have reached itself, but which lie within the CAA's margin of appreciation. BA's contention that there is *"no margin of appreciation"* in the case of *"plain errors of primary fact"* (**BA §2.6.3(c)**) is tautological for the same reason.

judgements relating to predictions for the future: *RIIO-2* §3.76 **[CAA/3799]**.

34.3 Should be very slow to impugn *"educated prophecies and predictions for the future"*: (and not to miscategorise as an *"error of fact"* what is in reality a disagreement about predictions for the future): RIIO-2 §3.79 **[CAA/3800]**.

35 It bears emphasis that the reason why price controls are necessary is because HAL does not operate in a competitive market, with the benefits to consumers which competition brings. The CAA's task is to replicate, so far as is reasonable, the disciplining functions of a competitive market. That is an evaluative and hypothetical exercise, which the CAA as expert sectoral regulator is uniquely well-suited to conduct.

36 That is particularly so in the context of the present H7 process, where a particular challenge was presented by the impact of the covid-19 pandemic and its profound but, in many respects, still uncertain impact on the aviation industry, as well as the Russian full scale invasion of Ukraine in February 2022 and its impact on the wider economy. The CMA is invited to consider the unique circumstances of the pandemic, both on the ground and insofar as they made future predictions and the analysis of trends difficult, when it decides whether a particular decision or finding fell within the CAA's margin of appreciation (see e.g. *JD Sports v Competition and Markets Authority* [2020] CAT 24 at §140 **[CAA/3454]**, where the CAT held that the CMA was required to acquaint itself with relevant information about the impact of the covid-19

pandemic in order to make decisions about its effect on the consequences of a proposed merger). In particular:

36.1 As the Second Witness Statement of Jayant Hoon (**"Hoon 2"**) §7.3 explains, the calculation of the asset beta required the CAA to consider the (inevitably uncertain) issue of the likelihood of another pandemic.

36.2 Calculating the cost of new debt "*has proven particularly challenging due to the impact of the pandemic and the macroeconomic shocks following the Russian invasion of Ukraine. These developments have made forecasting the future trajectory of the notional entity's debt costs highly uncertain and undermined the confidence we have been able to place in recent market data*" (**Hoon 2 §12.2**).

36.3 The determination of the passenger forecast used for the Final Decision has required the CAA to exercise its judgement in the context of an uncertain factual background where the underlying data used was and is constantly changing, and the economic forecasts against which the forecast is made are continuing to evolve, as explained in French 1.

37 Further, the H7 process was marked by unusually detailed consultation, described in more detail below. It is respectfully submitted that where the CAA draws upon a particularly detailed consultation process, particular respect is due to its margin of appreciation.

E. Interlinkages

38 The CMA should seek to avoid Appellants being able to *"cherry pick"* issues, while also following its practice in previous cases by not taking an *"in the round"* view of the price control decision that is not viewed through the lens of the specific errors alleged.

39 To that end, the CMA should adopt the approach taken in *RIIO-2* to balance its role as an appeal body and recognising that price control decisions are complex and consider interlinkages where appropriate on a case-by-case basis in the particular circumstances of the H7 price control: *RIIO-2* §3.86 **[Core/3802]**.

F. Materiality

40 The CMA should adopt the approach taken in *RIIO-2* that an error will not be a material error where it has an insignificant or negligible impact on the overall level of the price control set by the CAA and that it should only consider the cumulative effect of immaterial errors where the cumulative effect of those errors could have a highly significant impact on the price control: *RIIO-2* §§3.91 – 3. 97 **[Core/3803-3804]**.

III. THE PROCESS LEADING UP TO THE FINAL DECISION

41 The paragraphs below set out an overview of the process leading up to the decision that is the subject of this appeal. Further detail of that process is set out in Toal 1 (see, in particular, §§**4.1-4.57**).

42 The process leading to the Final Decision began in 2017, with its origins in the first regulatory settlement (**"Q6"**) included in the Licence on its grant to HAL in

February 2014. In developing the H7 price control, the CAA adopted a process that built on:

42.1 Its previous price controls, including Q6 (as extended in the years 2018-21);

42.2 Its work on the expansion of Heathrow Airport (referred to in this Response and supporting documents as the **"expansion"**);

42.3 Its work on the **"RP3"** price controls in the licence issued to NATS (En Route) plc (**"NERL"**), the provider of UK en route and other air traffic services, under the Transport Act 2000; and

42.4 Price controls set by other regulators (such as Ofwat's water price control **"PR19"** and GEMA's **"RIIO"** price controls).

43 The decision-making process has involved a comprehensive and transparent process of consultation and discussion with HAL, airlines and other stakeholders, as summarised in the following paragraphs. At every stage, the process was conducted with regard to and in light of the CAA's duties under CAA12 described above. The CAA's Board took an active part in this process, carefully and thoroughly considering these issues on many occasions, supported by the work of the team, and gave stakeholders the opportunity to present their positions to it on multiple occasions.

A. iH7

44 The process for setting the H7 price control began in 2017. The Government had recently decided to adopt the findings of the Airports Commission that Heathrow should be the location of new runway capacity in the Southeast of

England (Toal 1, §4.8). The initial focus was therefore on how best to adapt the regulatory framework to support expansion.

45 In order to enable stakeholders to focus on these issues, the CAA extended the Q6 price control successively to cover 2018 and 2019 and then, in November 2019, put in place an interim price cap (**"iH7"**) for the two years (2020 and 2021), while work continued on the detail of expansion. The general approach to these price caps was firmly founded on that adopted in the Q6 price control, with relevant amendments made over time, for example to allow for the recovery of some planning costs associated with expansion, and to accommodate a commercial traffic rebate agreement between HAL and airlines for 2020 and 2021.

B. Expansion Paused

46 In 2020, two key developments caused HAL to pause its plans for expansion:

46.1 In the first quarter of 2020, the global aviation industry started to be affected by the impact of the covid-19 pandemic. The pandemic had a very significant impact on the number of passengers passing through Heathrow airport and a similarly significant impact on its revenues, costs and profits.

46.2 The Court of Appeal ruled that the Government's decision to support the new runway at Heathrow had not been lawfully made (*R (Plan B*

Earth) v Secretary of State for Transport [2020] EWCA Civ 214, [2020] P.T.S.R. 1446) **[CAA/2804-2805]**.[5]

47 In those circumstances, the decision was taken to pause expansion (and it remains paused). That decision amounted to a significant shift in the underlying assumptions on which the price control work to date had been based. In April 2020, the CAA therefore consulted on whether the H7 price control review should focus instead on a two-runway airport, with the intention of having a new price control in place from 1 January 2022 **[CAA/2806-2830]**. It decided to adopt this approach in June 2020 **[CAA/2831-2947]**.

C. RAB Adjustment

48 In July 2020 HAL made a request to the CAA for a very significant upward adjustment to its regulatory asset base (**"RAB"**) from 2022 to help protect it from the impact of the covid-19 pandemic **[CAA/3008-3050]**. The CAA considered detailed representations on this matter through two rounds of consultation (in October 2020 **[CAA/3366-3401]** and February 2021 **[CAA/3499-3547]**) before deciding in April 2021 that making a targeted adjustment of £300 million to HAL's RAB was a transparent and proportionate intervention that was needed at that time **[CAA/3548-3636]** (**"the April 2021 RAB Adjustment Decision"**). The CAA considered that this adjustment would:

[5] Overturned by the Supreme Court on 16 December 2020: [2020] UKSC 52, [2021] 2 All E.R. 967 **[CAA/3498.1-3498.58]**.

48.1 Support HAL 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

48.2 Secure that the "notional company"[6] could finance its activities and avoid higher costs of debt finance that could increase charges for passengers in the future. The reason for approaching the exercise through the lens of a notional company (representing a hypothetical efficiently financed alternative airport operator that is identical in most respects to HAL, but whose financial structure and level of gearing may be different to HAL's actual structure) is to ensure that only efficient financing costs are passed to consumers.

49 In the interim, HAL issued a revised business plan (**"RBP"**) in December 2020 **[JH2/462-463]**. The RBP base case implied a very significant increase in airport charges compared to the iH7 price control period due in part to lower passenger volumes expected in the H7 period. HAL's RBP base case for H7 assumed an average charge of £30 per passenger (2018 prices) compared to an average of around £22 (nominal prices) for 2020.

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[6] As discussed in the Final Decision (at paragraph 78 of the summary **[Core/2072]**), the CAA, like other economic regulators conducts its analysis using a "notional company". This is consistent with the principle noted in Explanatory Note 36(a) to the CAA12 that "*the financing duty [in section 1(3) 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*".

50 HAL provided an updated business plan (**"Updated RBP"**) at the end of June 2021 **[CAA/3720.1-3720.283]**. The Updated RBP noted that lower passenger numbers expected over the H7 period meant that airport charges would need to rise beyond the level identified in the RBP. The Updated RBP included two scenarios, one implying average charges over H7 of £32 per passenger, and the other implying charges of £43 per passenger (each in 2018 prices).

D. The Initial Proposals and Consultation

51 In this light and taking account of the responses to its earlier consultations, the CAA developed the Initial Proposals for the H7 price control and issued them for consultation in October 2021 **[Core/1-370]**. Given the very uncertain circumstances prevailing at that time, the CAA based the Initial Proposals on a relatively wide range of airport charges for the period 2022 to 2026 (£24.60 to £34.40 per passenger in 2020 prices). The CAA also put in place an interim holding cap for 2022 which was set at the mid-point of the range used for the Initial Proposals (£29.50 per passenger in 2020 prices or £30.19 per passenger in nominal prices).

52 The CAA followed consultation on the Initial Proposals with a subsidiary consultation on draft licence modifications to support the Initial Proposals **[Core/834-945]** and a working paper on Outcome Based Regulation (**"OBR"**) in November 2021 **[Core/763-785]**.

E. The Final Proposals

53 Having considered the responses to all of these publications, the CAA issued the Final Proposals for the H7 price control in June 2022 **[Core/946-1561**], along with the notice in relation to the proposed licence modifications.

54 The Final Proposals noted that, if strong evidence were to emerge during the period of consultation that indicated that the then forecast of passenger numbers was no longer appropriate for 2022 and beyond, then the CAA would consider adopting a new passenger forecast and revising its proposals for the H7 price control on this basis.

55 The CAA saw a larger increase in passenger numbers at Heathrow over 2022 than anticipated in the Final Proposals and considered that it would create significant distortions and bias to the first year of the price control period if it did not take account of them. The CAA also decided that other developments after the Final Proposals were such that it would be appropriate to make changes. These were to update for changes in the wider macro-economic environment and to correct for matters which the CAA regarded as computational errors and inconsistencies in the Final Proposals. The overall impact of those changes, taken together, was to change the CAA's proposals for airport charges by no more than about 5 per cent.

56 Having considered its statutory duties, the importance of using up-to-date information, the likelihood of new information emerging and the consultation requirements under CAA12, the CAA took the view that the interests of consumers would be best served by proceeding directly to its Final Decision without a further round of consultation on the basis that, taken in the round, the CAA did not consider that the changes made since the Final Proposals

were such that the licence modifications differed significantly from those set out within the Final Proposals.

IV. THE FINAL DECISION

57 The Final Decision was issued on 8 March 2023. It consisted of a summary document **[Core/2052-2075]** supported by a number of key elements across three sections **[Core/2076-2121] [Core/2122-2188] [Core/2189-2293]**, in particular (1) a forecast of passenger numbers; (2) capex allowances; (3) opex allowances; (4) allowances for commercial and cargo revenues; (5) an estimate of the cost of capital; (6) retention of the April 2021 RAB Adjustment Decision; (7) an allowance for asymmetric risk; (8) a traffic risk sharing mechanism; (9) an OBR framework; (10) capex incentives; and (11) Other Regulated Charges.

58 Only some elements of the Final Decision are the subject of challenge in these Appeals. They are dealt with below. However, the CAA respectfully points out that those elements of the Final Decision which are subject to challenge are part of a complete package of measures, and must be considered in light of the decision as a whole. For example, the TRS mechanism set out in the Final Decision was directly reflected in both the estimate of the cost of capital and the allowance for asymmetric risk.

59 Pursuant to the CMA's order of 11 May 2023, these appeals are now joined under the grounds set out at paragraph 7 above.

V. JOINED GROUND A: RAB ADJUSTMENT

60 The Appellants appeal against different elements of the CAA's refusal to make a further very significant adjustment to HAL's RAB beyond that which

was made in the April 2021 RAB adjustment Decision. HAL says an upwards adjustment should have been made. The Airlines, by contrast, say that the CAA should have revisited the RAB Adjustment which it made in April 2021 and that the RAB adjustment was "*unsupportable*".

A. The April 2021 RAB Adjustment Decision

61 The pandemic first began to have a material impact on passenger numbers during the first quarter of 2020. In July 2020, HAL made a request to the CAA for a RAB adjustment to take into account the actual and expected impact of the covid-19 pandemic **[CAA/3008 - 3050]**. HAL's 2020 request had two parts:

61.1 The immediate announcement by the CAA of a *"regulatory depreciation holiday"* for 2020 and 2021, as a result of which no depreciation amounts would be deducted from the value of HAL's RAB for these two years when the CAA calculated the opening value of HAL's H7 RAB as at 1 January 2022; and

61.2 A further adjustment to the RAB so that the final loss of value that HAL suffered as a result of the pandemic would be capped at 8% of forecast 2020 and 2021 revenues plus 95% of the difference between actual and forecast revenues beyond the initial 8% *"deadband"*.

62 When HAL made this request, its price control was based on the Q6/iH7 price control arrangements that had come into effect in January 2020, and which essentially extended the Q6 pricing trajectory and risk allocation to cover 2020 and 2021. The starting point for the CAA's approach to making a covid-related RAB adjustment was, therefore, the decisions which had been taken at the

time of the Q6 price control review. There are two aspects of the Q6 price control settlement that are particularly relevant:

62.1 **First**, the risk allocation that was specified within the overall framework. This clearly allocated all traffic risk to HAL, but did provide for the possibility of the price control to be re-opened in exceptional circumstances. This is consistent with the approach the CAA has taken in respect of assessing HAL's request for a covid-19 related RAB adjustment and determining the £300 million RAB adjustment. HAL has argued that the discussions at the Q5 price control determination are also relevant to these considerations, in part because the same numerical value for the asset beta was adopted at the Q5 and Q6 price control reviews. In the **Final Decision,** the CAA noted at paragraph 10.24 that "*as a general remark, we note that the relevance of the CC's Q5 determination is limited by the fact that it took place over 15 years ago and has been superseded by our subsequent Q6 determination*". This relates not only to the length of time since the Q5 determination, but that it was undertaken under a different statutory framework, which was replaced by CAA12. Nonetheless, even if the discussions in the Q5 price control determination are considered relevant they do not suggest the CAA's decision on the RAB adjustment was wrong. In particular, the Q5 discussions also allocated demand risk to HAL except for cases of "*truly catastrophic risks*" which were characterised as high-impact, low-probability events that "*render[ed] the airport inoperable for a sustained period*". Such cases were to be dealt with "*outside the framework of economic regulation*", and that it was

expected that "*the CAA would intervene and a recovery plan would be agreed between the CAA, BAA, airlines and probably the Government*" but no further discussion of what action was to be taken in such cases was provided. Also no indication was given that, were a "*catastrophic*" event to take place, HAL would receive mechanistic compensation for its losses or that the CAA would act in any way other than being guided by its statutory duties – and this was the essence of the approach that the CAA did adopt in determining the RAB adjustment.

62.2 **Secondly**, the remuneration that was provided for bearing risk at the Q6/iH7 settlement. This issue was more complex. There were two principal components to the overall package of remuneration for bearing risk, which were the CAPM-derived allowed return and the adjustment to the passenger forecasts in respect of asymmetric risk. The CAPM-derived allowed return provided compensation for symmetric risks around the mean expected forecasts, whilst the *shock* factor recognised that HAL was exposed to one-sided downside risks (such as volcanic eruptions and terrorist attacks) that were not, due to the existence of the capacity constraint, matched by equal and offsetting opportunities for outperformance. Both components were calibrated based on the data that was available at the time. The impact of the covid-19 pandemic has clearly revealed new information on risks that was not available at the time of the Q6 settlement, and the CAA has now taken this new information into account on a forward looking basis for the H7 period (by a combination of its policies in relation to the TRS mechanism, the allowance for asymmetric risk and its

approach to the cost of capital). This is entirely consistent with the normal workings of the price control review process with each price control review updating the regulatory framework as appropriate for the emergence of new information.

63 The October 2020 Consultation made it clear that the CAA was assessing HAL's request in accordance with its statutory duties under CAA12. The CAA's conclusion after reviewing the submission that HAL had made was that *"the evidence that HAL has provided so far falls short of that required to justify its claims that urgent support/action is necessary"* **[CAA/3366 - 3401],** but that it would assess any further information that HAL might provide in relation to these matters: see further the First Witness Statement of Andrew Walker ("**Walker 1") [Walker 1 §4.1 to 4.12]**.

64 Following responses to the October 2020 Consultation and the provision of further information by HAL **[Walker 1 §9.6]** the CAA published the February 2021 Consultation **[CAA/3499 - 3547]**. This explained:

> *13. Since the October 2020 Consultation, we have further developed our own approach to considering the issues around the impact of covid-19 and appropriate intervention. We have assessed three broad approaches to guiding the development of possible regulatory interventions:*
>
> *a) focusing on compensating HAL for the impact of the exceptional circumstances and the reduction in passengers/revenues on its price control activities;*

b) using a framework based on our statutory duties to assess the broad range of issues raised by the covid-19 pandemic and considering the most appropriate package of options to address those issues; and

c) relying broadly on the allocation of risks that was made in setting the Q6 price control, noting that HAL was remunerated at the market average cost of equity and was paid an additional premium in the form of a "shock adjustment" to the traffic forecast to manage volume risk.

14. While it is very clear that the impact of the covid-19 pandemic on the aviation sector generally, and Heathrow airport in particular, represent exceptional circumstances, this does not, in itself, constitute an automatic reason to focus only on compensating HAL for the reduction in passenger numbers. Therefore, we have concluded that approach (a) as summarised above would be too narrow and would not properly reflect our broader statutory duties, including to protect consumers.

15. By contrast, approach (c) with its focus on the approach to risk allocation that was used to set the Q6 price control appears to give relatively little weight to the genuinely exceptional circumstances created by the covid-19 pandemic and the wide-ranging impacts associated with the present very difficult circumstances.

16. We have adopted approach (b) as it has a focus on our primary duty to further the interests of consumers and allows for consideration

of a broad range of issues and possible ways of intervening, not just focused on RAB adjustments. It is also consistent with what we said at the Q6 price control review that the price control could be reopened in exceptional circumstances and we would consider such a request in the light of our statutory duties and the circumstances prevailing at the time.

65 The February 2021 Consultation identified four intervention options (as to which see **Walker 1 §9.15**):

Package 1: No intervention before H7, but consider interventions as part of the H7 review;

Package 2: Targeted intervention now and consideration of further intervention at H7;

Package 3: Application of H7 traffic risk-sharing approach to 2020-21; and

Package 4: HAL's proposed risk-sharing arrangements for 2020-21.

66 The CAA gave its assessment of these proposed packages as follows:

23. … On balance, we consider that package 1 and package 2 would be appropriate to consider further in deciding how we should respond to the issues raised by covid-19 and the objectives we set out above. We are seeking views from stakeholders on our approach, with the intention of reaching final decisions on these matters in March 2021.

24. Package 1 has a number of advantages, as many of the issues that we have identified for consideration would be best considered in the round as part of the H7 price review. This reflects the important links between any RAB adjustment, the cost of capital, future charges and HAL's financeability. These should be assessed in the round to make sure that charges remain affordable and HAL faces a reasonable risk and reward package in H7.

25. Package 2 builds on this by allowing us to act now if there are issues which are more urgent that we should deal with as soon as practicable. We consider that in principle there are reasonable arguments why an earlier intervention in 2021 may provide benefits to consumers, such as through higher investment and service quality, although we recognise that there are challenges in identifying how any such intervention should be calculated. We are consulting further on whether these issues should be addressed in 2021 and, if so, how these might be best addressed and any regulatory interventions calibrated.

26. Both packages 3 and 4 would involve us committing now to the principle of a potentially large adjustment to HAL's RAB. Neither of these approaches, when looked at in the round, appears to focus sufficiently at this time on furthering the interests of consumers, which is our primary statutory duty nor to be proportionate in the light of that primary duty.

67 Following further representations from stakeholders the CAA issued the April 2021 RAB Adjustment Decision, which identified Package 2 as the preferred option and set out the CAA's view that a proportionate intervention was needed to further the interests of consumers **[CAA/3548 - 3636]**. After considering the different forms that such an intervention could take, the CAA said that it would make a £300m uplift (in 2018 prices) to HAL's RAB at the point when it modified HAL's licence to implement the full H7 price control decision. The authoritative part of the decision is at paragraphs 23 to 35 of the April 2021 RAB Adjustment Decision **[CAA/3558]**. Certain of the Appellants' arguments appear to be based on a particular interpretation of the summary in paragraph 4 **[CAA/3554]** which, by its nature necessarily gives a simplified version of the decision that the CAA made (in particular it is clear from the paragraph 32 that the trigger for any review of the RAB adjustment would be HAL's service quality in 2021).

68 The CAA reached this decision having had regard to its statutory duties to protect consumers, including the need to secure:

68.1 That all reasonable demands for airport operation services at Heathrow airport are met. The RAB adjustment was designed to incentivise additional investment by HAL during 2021 that would further the interests of consumers; and

68.2 That an efficiently (or *"notionally"*) financed company, consistent with the CAA's approach to assessing HAL's financeability in setting price controls, could finance its licensed activities at Heathrow airport.[7]

69 The figure of £300m was chosen because the financial modeling suggested that a £300m RAB adjustment would reduce HAL's projected gearing below 70% of its RAB. More detail of this is set out in **Walker 1 [§10.2 and 10.10]**). Overall, the CAA decided that this would further the interests of consumers, particularly by:

69.1 Signaling to HAL the importance of maintaining appropriate investment and service quality levels ahead of the start of H7;

69.2 Providing stronger incentives and financial capacity for HAL to be proactive in planning for potentially higher than expected traffic levels from the summer of 2021; and

69.3 Facilitating HAL in being able to continue to access investment grade debt to finance its activities, particularly if traffic forecasts are instead lower than currently forecast.

70 The CAA thus decided to allow a £300m (RPI-real, 2018 prices) addition to HAL's RAB in April 2021. Although there was a considerable degree of uncertainty and limited evidence, the CAA, in the exercise of its regulatory judgement, considered that this would improve the cost and accessibility of

[7] The assessment framework that the CAA used for this decision, including how that framework related to the CAA's duties under CAA12 was set out in chapter 2 of The April 2021 RAB Adjustment Decision and described in Walker 1 at paragraphs 9.1 to 9.37.

capital and facilitate investment that might be needed to support a potential recovery of traffic in the summer of that year. These issues were forward-looking in nature and were very explicitly considered within the framework of the CAA's statutory duties.

B. HAL's Appeal

71 HAL alleges that the CAA has erred in law and/or in the exercise of discretion in two respects:

71.1 **First**, by failing to act consistently with the terms of the previous price control settlement and make a RAB adjustment that would allow Heathrow *"a fair opportunity to recover its invested capital and a return on that capital"*; and

71.2 **Secondly**, by failing to calibrate a RAB adjustment to compensate for depreciation of the RAB during the pandemic.

General Response

72 By its appeal, HAL suggests that, because the CAA did not provide specific *ex ante* compensation for bearing the risks of the covid-19 pandemic, it is incumbent on the CAA to provide that compensation *ex post*. This is misconceived. The CAA has, by the steps it has taken in respect of the RAB adjustment, re-opened the price control and made an adjustment appropriate to the circumstances of the covid-19 pandemic, all of which is consistent with what was envisaged at the Q6 price control in terms of re-opening the control in exceptional circumstances. To go beyond this and apply mechanistic and retrospective compensation is unlikely to achieve anything more for

consumers. In particular it is unlikely to reduce the cost of capital, since the CAA has taken appropriate steps as part of the H7 review to introduce a TRS mechanism and an allowance for asymmetric risk, and adjusted its approach to estimating the cost of capital. HAL's proposal would be very largely a value transfer from consumers to investors and to permit this would not be consistent with the CAA's statutory duties.

Alleged Risk Sharing Mechanism

73 HAL argues that the impact of the covid-19 pandemic fell outside the risks allocated to investors under the Q6 settlement and that, for this reason, intervention was required lest the CAA *"fails to respect the terms of previous regulatory settlement and hence reasonable investor expectations"* (**HAL §40.1, D(4)**).

74 This sub-ground is based on two premises, both of which are unsustainable:

74.1 **First**, that the impact of the covid-19 pandemic (and events like it) was not allocated to HAL under Q6. This is simply wrong. All volume risk was allocated to HAL, with the only proviso being to re-open the price control in exceptional circumstances, as was done by assessing HAL's request for a covid-19 related RAB adjustment.

74.2 **Secondly,** that previous regulatory settlements somehow support a mechanistic approach to compensating HAL for its covid-19 related losses. As noted above, the relevance of the Q5 determination is limited by the fact that it took place over 15 years ago but, even if the discussions in the Q5 price control determination are considered

relevant, they do not suggest the CAA's decision on the RAB adjustment was wrong. In particular, the Q5 discussions allocated volume risks to HAL except for "*truly catastrophic risks*". Such cases were to be dealt with "*outside the framework of economic regulation*" and it was expected that "*the CAA would intervene and a recovery plan would be agreed between the CAA, BAA, airlines and probably the Government*" **[CAA/89 – 399]**. No further discussion of what action was to be taken in such cases was provided, nor was any suggestion made that the CAA should act in any way other than being guided by its statutory duties: this was the essence of the approach that the CAA did adopt in determining the RAB adjustment.

75 HAL may wish the settlement in Q6 had been different since an unlikely but major risk crystallised during the Q6 period. But that provides no basis for challenge to the CAA's determination of the H7 RAB adjustment.

Under Previous Settlements

76 HAL argues that prior regulatory settlements did not allocate the risk of covid-19 (or a similar pandemic) to HAL. Those settlements are of limited relevance (for the reasons given above) but in any case do not support HAL's view that its investors were entitled to expect mechanistic compensation for the losses that HAL might incur.

77 As to the prior settlements, each of them allocated volume risk to HAL.

77.1 HAL relies on the Competition Commission's 2002 report on the price control for **Q4**, which stated that "in the event of major disruption (for

which there is also the scope for interim review) any such disruption would also be taken into account in the next review" **[CAA/1-88]**. The approach which the CAA has taken to the RAB is entirely consistent with this. The process that led to the April 2021 RAB Adjustment Decision was in broad terms the sort of interim review for which the Competition Commission considered there to be scope.

77.2 HAL then also relies on the Competition Commission's and CAA's final reports and decisions on the **Q5** price control in 2008. They stated that they:

> *"would not expect divergences between outturn and projected costs to justify an interim review of the Price Control, save in the case of a truly catastrophic event that rendered much of Heathrow or Gatwick unusable for a significant period of time"* **[CAA/354 §E.70]**.

Once again, the approach which the CAA has taken to the RAB – conducting an interim review – is entirely consistent with this.

78 In truth, the price controls which predated Q6 did in fact allocate the risk of covid-19-like events to HAL, but included an escape valve: the possibility for interim review in the event of a *"catastrophe"*. The very existence of this possibility shows that – absent intervention – HAL would be expected to bear the risk of such events. This could not give rise to any kind of expectation that the risk of such catastrophic events would never lie with HAL, or that intervention would always be forthcoming and if it were to be forthcoming it would provide mechanistic compensation for the losses that HAL might incur.

79 The prior settlements are silent on what should happen if there is such a *"catastrophe"*. Whether intervention would follow or not would be a matter of regulatory judgement, in the circumstances prevailing at the time the CAA was called upon to make a decision. This is entirely unsurprising, given the infinite varieties of *"catastrophic"* crises and potential solutions which could arise, and the general principle that economic regulation should seek to emulate a competitive market (under which, by definition, there would be no entitlement to be fully indemnified by consumers against catastrophic events).

80 HAL's exercise of seeking to persuade the CMA that the covid-19 pandemic was a *"catastrophic event"* is, therefore, misguided (even assuming that the covid-19 pandemic should be categorised as a *"catastrophic"* event in the manner the Competition Commission envisaged). If the covid-19 pandemic was not a catastrophic event (which, on one view, given the Competition Commission's definition of *"business risk"* as including communicable diseases, it was not: **Final Decision §10.27 [Core/2238]**), then that is the end of HAL's case on this point. But, as the above analysis shows, even if the covid-19 pandemic were such an event, it would not follow that the CAA was required to intervene to reallocate a very large majority impact of covid-19 to other actors (which is what HAL seeks): **Final Decision §§10.28 – 10.29 [Core/2239]**.

81 Indeed, this case is a good example of the need for regulatory flexibility in responding to crises. As serious as covid-19 was, so far as HAL was concerned (see **Walker 1 §9.15**):

81.1 HAL remained financeable throughout the period of the pandemic and retained an investment grade credit rating;

81.2 The ultimate shareholders of the airport provided no new equity to the group of which HAL is a part during the period of the pandemic or afterwards (in contrast to the shareholders of a number of other entities in the aviation sector); and

81.3 At no point did the airport close or become inoperable and demand started to recover during the second half of 2020.

82 HAL says that its investors had a "*reasonable expectation*" that the CAA would, as soon as the crisis became a *"catastrophe"* (however defined), automatically shift a significant proportion of the costs and risk of the pandemic onto airlines (and indirectly, consumers). However, it is unclear what HAL means by this: at **HAL §105**, it disavows any claim that there was any legitimate expectation "*in the classic public law sense*", which would suggest that HAL accepts that it and its investors had no expectation sufficient to generate any duty on the CAA to act or not act in a particular way, either because such an expectation was not grounded on clear representations or because it was not relied on. To the extent that the claim is coherent, it is an unreal construction of the Q4 and Q5 settlements, designed to engineer for HAL's shareholders an exemption from the consequences of a risk that was allocated to them and which then eventuated.

83 The Q6 settlement was the price control underpinning the price control applicable to HAL in 2020 and 2021, and the first price control decision by the CAA put in place after the legislative regime for price controls under CAA12

came into force. It was – quite properly – the starting point for the CAA's consideration of HAL's request for a RAB adjustment.

84 HAL places too much reliance on the Q4 and Q5 settlements, and in any case simply misconstrues what reasonable (let alone legitimate) expectation could have properly taken from these price control determinations.

Under Q6

85 Under Q6, HAL was to bear all upside and downside volume risk in exchange for the allowed cost of capital. This was basis upon which HAL and its shareholders accepted the Q6 price control settlement. The key section of the CAA's Final Proposals provides (emphasis added) **[CAA/827]**:

> *"3.13 The CAA considers that the effects of demand shocks on traffic can be split into two:*
>
> *- an expected level of demand shocks, which may be accounted in the forecast level of traffic; and*
>
> *- variations around this expected level, which may be accounted for in the cost of capital, as these constitute risk.*
>
> *3.14 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 outturn level of shocks exceeds the forecast level by*

one percentage point or more. ***The risk that the outturn is different is borne by the company and its shareholders. The CAA therefore allows a higher rate of return for the company than would otherwise be the case to compensate for this risk.***"

86 In those circumstances, HAL's argument that *"the Q6 price control settlement explicitly did not contemplate demand shocks of the scale of the Covid-19 pandemic"* **[Core/2008-2026]** is true only in the sense that it made no direct reference to covid-19 or a similar event. However, it is not true that the risk of such events was not allocated: the risk of such events was allocated by virtue of the fact that all volume risks were allocated to HAL, save for the provisio that the price control could be re-opened in exceptional circumstances.

87 HAL's arguments to the contrary are not convincing:

87.1 HAL argues at **§80** that the Q6 WACC did not include any explicit allowance for a covid-19-like event. However, there could not have been any such allowance: the Q6 WACC was set on the basis of the market risks as assessed at the time, whereas covid-19 has subsequently provided new information on the extent of volume risk in the aviation sector. Further, the Q6 WACC is an estimate: it is not a guarantee. That fact does not mean that the risk was not allocated to HAL, rather it means that with hindsight, HAL considers the allocation of risk which it accepted for Q6 constituted a bad deal. It discloses no error on the CAA's part not to rescue HAL from its (retrospectively) bad deal – this forms no part of the regulatory duty.

87.2 The reference to *"credit strength"* in the Q6 licence notice **[CAA/1140 – 1490]** (**HAL §80.5**) did not give rise to any legitimate (or "*reasonable*") expectation, for the reasons already explained to HAL at **Final Proposals §§10.30 – 10.36** (and particularly footnote 61). The *"credit strength"* came from the possibility of the settlement being reopened, not the guarantee that it would be. This is yet another example of HAL trying to turn a possibility into an entitlement.

88 HAL's submissions to the effect that covid-19 was *"not foreseen or foreseeable"* are therefore irrelevant. The mere fact that covid-19 was not foreseen does not mean the risk of it was not allocated. The possibility that, in exceptional circumstances, a regulated entity may make unexpected losses does not invalidate an allocation of risk or an approach to estimating the cost of equity based on CAPM. The CAA's approach to considering HAL's RAB adjustment request was entirely consistent with its approach in the Q6 decision that regulatory intervention was possible, but that no particular (or any) intervention was predetermined at that time. The CAA has honoured both the letter and the spirit of the Q6 settlement by taking as its starting point the position that HAL bore volume risk, and then responding to HAL's request by carrying out the review that resulted in the April 2021 RAB Adjustment Decision through the lens of its statutory duties.

89 There is, therefore, no merit in HAL's contention that the CAA was bound, by virtue of previous regulatory settlements, to adopt a particular approach to HAL's RAB in light of the covid-19 pandemic.

Statutory Duties

90 Finally, HAL submits that the statutory duties required the CAA to *"take effective action substantially to redress the consequent collapse in passenger numbers and revenue, save insofar as Heathrow was able to mitigate it"* (**HAL §§87 - 90**). This argument is without merit. It is a complaint about how the CAA weighed (a) current prices and (b) future consumer benefit from financeability, in the balance and in the exercise of its regulatory judgement. It discloses no error. HAL offers only two points in support of this direct challenge to the CAA's judgement.

91 Its **first** point is that the CAA has acted inconsistently, which is untrue, for the reasons given above.

92 Its **second** point is that *"the interests of current and future consumers require that* [HAL] *be financeable"*. This submission is wrong in law and fact:

92.1 As a matter of law, financeability is a factor which the CAA must have regard to, but the CAA is under no obligation to secure it **[Core/2486]**. Had CAA12 sought to impose such an obligation, it would have done so expressly.

92.2 As a matter of fact, the CAA did in fact adequately protect HAL's financeability through the £300 million RAB adjustment and its approach to financeability in the H7 price control review (which HAL has not sought to appeal). In particular:

(a) There is an element of judgement in setting target levels of gearing for the notionally financed company which is used for

the purposes of assessing and setting price controls. Assuming that the notional company would have higher gearing levels in the circumstances of a pandemic was an entirely reasonable assumption; and,

(b) In setting price controls (including in relation to the H7 price control) the CAA has explicitly tested for both debt and equity financeability over the five-year period of the price control.

93 The CAA's Decision to make a £300 million RAB adjustment supported both the interests of consumers and HAL's financeability: **Walker 1 §3.6**. In contrast, the approach that HAL has suggested would involve a retrospective and mechanistic adjustment to provide compensation for demand risk that HAL had previously accepted at the time of the Q6 price control settlement. It is not possible to reconcile HAL's suggested approach with the CAA's duties to protect consumers and act in a proportionate and reasonably consistent way.

Recovery of Depreciation

94 HAL argues that the CAA erred when it when it failed to make a RAB adjustment which guaranteed that HAL would recover depreciation over the pandemic (**HAL §§96-99**). It is said that this *"denies HAL the opportunity to recover its invested capital"*. This is not an entitlement which HAL has, and HAL identifies no source for this entitlement other than *"regulatory commitment"*. As set out above, there was no such commitment. The RAB does not represent any kind of guarantee. Any mismatch between regulatory depreciation and the revenues actually collected by HAL represents nothing

more than the crystallisation of the demand risk that HAL bore under the Q6 price control settlement.

95 This is consistent with the evidence cited in the Final Proposals in relation to the Competition Commission's 2008 decision in relation to Stansted Airport. In particular "*Professor Helm was not able to persuade Panel members that the return of and on Stansted's RAB is somehow 'safe' and capable of being disentangled from an airport's performance against its price cap, or that the financiers of historical investment included in the RAB would not see the value of their capital increase or diminish in line with the fortunes of the regulated business*". The key point from this discussion in respect of regulatory depreciation is that the Competition Commission makes clear that in relation to the RAB financiers should expect the "*value of their capital increase or diminish in line with the fortunes of the regulated business*". In other words, allowances for regulatory depreciation are at risk alongside other elements of price control revenue depending on circumstances and the fortunes of the business.

96 HAL then suggests that the depreciation of its RAB amounts to a *"deprivation"* within the meaning of Article 1 Protocol 1 ECHR (**HAL §100**). It is said that the RAB *"progressively removes a part of the value of the asset"*. That argument is hopeless:

96.1 The RAB is a regulatory judgement as to the value of investment in the business. It is not, itself, a *"possession"* within the meaning of A1P1. Rather, it is a mechanism to assess the value of other possessions in which HAL has invested, which is then used to impose a price cap. It

creates no entitlement nor legitimate expectation which could amount to a *"possession"* (as indeed HAL's submissions at **HAL §105** appear to accept).

96.2 It is inherent in the nature of capital investment that the value of that investment depreciates over time. It is neither a deprivation, nor a control of use, for the RAB calculation to reflect that fact.

96.3 In any event, assessing the RAB in such a way, dividing the risk of unrecovered depreciation between HAL and other actors, was a proportionate means of achieving a legitimate aim.

C. Airlines' Appeal

97 The Airlines appeal on the basis that, in their view, the CAA erred in including the RAB adjustment in the calculations that support the H7 price control at all.

98 They make two points:

98.1 The CAA erred in failing properly to review the £300m RAB adjustment that had been made on a contingent basis; and,

98.2 The overall conclusions that a RAB adjustment was appropriate are unsupportable.

Failure to Review

99 The Airlines argue that the CAA committed a *"fundamental misdirection"* by failing to appreciate that, in April 2021, it had adjusted the RAB on a

contingent basis (**BA §§4.6.1 – 4.6.12; Delta §§6.48 – 6.74; Virgin §§6.48 – 6.74**). There is no merit in this argument.

100 The April 2021 RAB Adjustment Decision stated that the intervention theCAA decided to make would:

100.1 Signal to HAL the importance of maintaining appropriate investment and service quality levels ahead of the start of H7;

100.2 Provide stronger incentives and financial capacity for HAL to be proactive in planning for potentially higher than expected traffic levels from the summer of 2021; and

100.3 Facilitate the notional company being able to continue to access investment grade debt to finance its activities, particularly if traffic levels turned out lower than forecast.

101 Alongside the decision to make the £300m adjustment to HAL's RAB, the CAA expected 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. While the CAA did not consider that HAL had made any firm commitment to make such investments, the CAA indicated that it would put in place *"additional protections for consumers"* in the following terms **[CAA/3458 – 3636]**:

> *"As noted above, 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. The existing Service Quality Rebates and Bonus scheme provides metrics that can help to give an early indication of any issues with service quality".

102 Accordingly, and as explained in **Walker 1 at §9.1 – 9.37**, the CAA did not make the adjustment of £300 million in the April 2021 RAB Adjustment Decision on a *"contingent basis"*, or in any other way dependent on HAL's performance (whether in terms of making specific capex investments, or increases in opex), except to the limited extent set out above. The wording used in the April 2021 RAB Adjustment Decision and the structure of that document simply does not support any reasonable interpretation to the contrary. The RAB Adjustment was not contingent on the CAA conducting a review, the CAA did not make a *"promise"* to conduct a review and at no point did HAL *"promise"* to make investments.

103 In the event, no evidence emerged of significant failures in HAL's provision of quality of service in 2021, and so the circumstances in which the CAA might have undertaken a review along the lines of that signalled in the passage

above did not arise. There was, therefore, no error in declining to conduct such a review.

104 The Airlines argue that there was such evidence (**BA §4.6.9; Delta §§6.50 – 6.56; Virgin §§6.50 – 6.56**), in particular relating to 2022. Because this did not relate to the trigger for a review as set out to the April 2021 RAB Adjustment Decision it was natural to put a higher threshold on regulatory intervention, beyond that automatically provided by the SQRB (Service Quality Rebates and Bonuses) arrangements.

105 The CAA was well aware of service quality issues arising during 2022, but it was also clear that these issues were by no means confined to Heathrow airport, or even the aviation sector (in particular, issues with staff absences, retention, and recruitment were an economy-wide issue in 2022). Having considered these issues, the CAA decided that the appropriate approach was for it to seek to work with the industry as a whole to address the problems that it faced, rather than allocate its resources to a specific investigation of HAL (as explained in **Walker 1 at §10.6)**. This is entirely consistent with paragraph 10.87 of the Final Proposals which said "*However, we are particularly conscious of the importance of the summer period in 2022 in terms of the potential stresses on airport and other infrastructure and service providers, the potential impact of large numbers of passengers and more broadly on the recovery of passenger numbers at Heathrow. If it is appropriate, we will review HAL's operational performance in the Autumn of this year, with a view to ensuring that the interests of consumers are properly protected*". This was a commitment to take steps to protect consumers in respect of quality of

service, not to revisit the RAB adjustment, and was carried through by the work the CAA undertook across the sector in the summer of 2022. On this basis there was no reason to carry out a further review in the autumn of 2022 and so the CAA decided that it was not appropriate to carry out the review discussed in the Final Proposals.

106 The CAA's approach can be seen from the letters to industry that it published both individually and with the Department for Transport during 2022 **[CAA/3495 – 3498]**; and see **Walker 1 at §10.8**. This was a permissible and lawful approach. The Airlines disagree with it, but that does not make it wrong.

107 Further, the CAA was concerned that reversal of the RAB adjustment for reasons beyond those set out in the April 2021 RAB Adjustment Decision would give rise to increased perceptions of investor risk: **Final Proposals §10.69 [Core/1280]**. That was a relevant and proper consideration for the CAA to take into account. Virgin and Delta state that *"it is illogical for the CAA to suggest that the reversal of the RAB adjustment would not further the interests of consumers (including as it would increase investor perceptions of regulatory risk)"* (**Virgin §6.45(e); Delta §6.45(e)**). This is not persuasive. The harm that could have been caused to investors' confidence in the operation of the regulatory regime was a key factor that the CAA needed to weigh when making its final price control. At the very least, the CAA could not be said to have erred in considering as much. The April 2021 RAB Adjustment Decision was explicitly framed as an early intervention **[CAA/3458 - 3636]**, ahead of the CAA's H7 licence modifications, in response to the issues that HAL was having to deal with as a result of the impact of the impact of the covid-19

pandemic. This was entirely reasonable when properly assessed in the exceptional circumstances of the pandemic. It would have been unreasonable for the CAA to make the commitment that it did to HAL in April 2021 only to renege on that commitment less than two years later in March 2023, as this itself could have unduly undermined investor confidence in the regulatory regime, which in turn would have damaged the interests of consumers.

108 Virgin and Delta state that the CAA erred in concluding that it would not necessarily have been in consumers' interests for HAL to undertake more capital expenditure than it in fact did in 2021: **Virgin §§6.57 - §6.66; Delta §§6.57 - §6.66**, and refer to failures by HAL to invest in summer 2021. It is important to understand that this statement was referring to significant preparatory capital expenditure ahead of a potentially strong recovery in passenger numbers ahead of summer 2021. Since this strong recovery did not in fact take place, this statement is in fact reasonable. As for the issues that took place between April and June 2022 to which Virgin and Delta refer, they are entirely separate from the observation that this statement was making.

109 The Airlines attempt to suggest that the CAA misdirected itself as to the *Phoenix Natural Gas Limited* precedent in the **Final Proposals §10.63** (**BA §4.7; Virgin §§6.67 – 6.69; Delta §§6.67 – 6.69**). That is misconceived. The approach the CAA adopted to making the RAB adjustment is fully consistent with the CAA's statutory duties, irrespective of the precedent or circumstances of *Phoenix Natural Gas Limited*. In any event, the CAA did not misdirect itself on that precedent, in respect of which the Competition Commission stated

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"* **[CAA/449 §32]**. The CAA followed an approach consistent with that contemplated by this statement: it signalled in the April 2021 RAB Adjustment Decision that it would consider evidence in relation to service quality during 2021. Had the CAA wanted to have taken a more open-ended approach, for example, to consider service quality in 2022, it would have needed to have signalled this in the April 2021 RAB Adjustment Decision. However, it did not do so and seeking to take a different approach after the event would clearly not have been *"properly signalled"*, or subject to *"fair and effective consultation"* in the manner contemplated in the quotation above. BA's attempt to suggest that the CAA directed itself that there was a *"categorical proscription"* on revoking the RAB adjustment (**BA §4.7.3**) is flatly inconsistent with the CAA's decision that it would not review the RAB, because there was no evidence this was necessary, a premise with which BA disagrees (but which discloses no error).

110 In the light of the above, it is clear that the CAA did not fundamentally misdirect itself.

Unsupportable Overall Conclusions

111 The Airlines submit that the overall conclusion that the CAA reached in respect of the RAB was unsupportable (**BA §4.8-4.12; Virgin §6.21 – 6.47; Delta §6.38**). This limb of this Ground amounts to little more than a number of policy disagreements with the CAA's exercise of its regulatory judgement, and discloses no error warranting the intervention of the CMA.

112 **First**, it is said that the £300 million RAB adjustment is not consistent with the primary purpose of the RAB (**BA §4.9**). While the primary purpose of the RAB is to support the *remuneration* of efficient investment, the RAB adjustment was consistent with this purpose. It reflects the reasonable exercise of regulatory discretion to use the RAB for a wider purpose in the special circumstances of the Covid-19 pandemic. The RAB is not a creature of statute, and does not have a defined legal purpose which limits the powers of decision-makers. It follows that, even if this use of the RAB was outside its usual use (which, for the reasons given above, it was not), it would not follow that the CAA had erred. Indeed, equivalent mechanisms to HAL's RAB have been used for a number of different regulatory purposes over time: **Walker 1 §9.19.** As such, while it might be true to suggest that the *"primary purpose"* of a RAB is to reflect the level of efficient investment made for the purposes of setting appropriate charges in the interests of consumers, this does not in any way, either as a matter of principle, or a matter of regulatory practice preclude the use of HAL's RAB in the manner implemented through the April 2021 RAB Adjustment Decision. The suggestion that, in the special circumstances of the pandemic, it was *"wrong"* for the CAA to use the RAB for this purpose – such that the CMA should quash its decision to do so – is therefore unsustainable.

113 **Secondly**, it is suggested that an adjustment was not required to encourage efficient investment (**BA §4.10**). This submission is a policy disagreement which does not adequately consider the exceptional circumstances of the covid-19 pandemic and the very real pressure on HAL's cash flow, resulting in the very significant reductions it had made to its investment programmes (as described in the April 2021 RAB Adjustment Decision §3.35-3.40). In these

special circumstances, where there was evidence of exceptional financial pressure (on both the notional company, and HAL itself), it was reasonable for the CAA to conclude that additional incentives were required at that time to encourage HAL to react flexibly to any higher than expected increases in passenger traffic. Insofar as the Airlines' suggestion is based on developments after the April 2021 RAB Adjustment Decision, it is a suggestion made with hindsight and does not show the CAA to have erred (and in any event, does not have any particular force, as the RAB adjustment was also aimed at providing broader support to HAL's financeability).

114 **Thirdly,** it is said that it was an error for the CAA to assume that HAL was at risk from an increase in debt costs (**BA §4.11**). This was an exercise in predictive, expert judgement, explained and justified in the April 2021 RAB Adjustment Decision §3.42. It does not show the CAA to have erred for the Airlines to point to alternative conclusions that might have been reached. In any event, it is clear from the public record that Standard & Poor's was considering downgrading HAL's business risk and that such a downgrade could have led to a multi-notch downgrade of the notional company's debt. Such a downgrade could reasonably have been expected to have limited the notional company's access to financial markets, as well as to have an impact on HAL itself. In this context, the appropriateness of the CAA's decision must be viewed in the broader context of the special circumstances in early 2021. This was nearly two years before the conclusion of the H7 price review. At that time there was a range of possible outcomes for HAL's requirements for new debt finance and it was entirely reasonable to assume that a muti-notch credit rating downgrade would have significantly increased the cost of HAL's

debt finance and limited its access to debt markets. Moreover, the decision to propose the RAB adjustment was based on concerns about both financeability and the provision of adequate capacity at the airport to meet demand in 2021, with both factors supporting the decision to make a RAB adjustment.

115 **Fourthly,** it is said that consumers would be harmed by the refusal to reverse the RAB adjustment (**Virgin §§6.43 – 6.46, Delta §§6.43 – 6.46**). However, the balance between the extent to which consumers would be harmed by increased perceptions of investor risk if the CAA went back on its commitment and the extent to which consumers would be harmed by increased charges following from an increase in the RAB is an exercise in regulatory judgement which the CAA is entitled to make. Merely pointing to one side of the balance does not show that the balance has been struck in a way that is wrong.

116 **Fifthly,** it is said that the RAB adjustment is unjustified (**Virgin §§6.22 – 6.29; Delta §§6.22 – 6.29**). Various reasons are presented in support of this argument, including a repetition of certain previous points (for example, the suitability of the RAB for the purpose set out in the April 2021 RAB Adjustment Decision), as well as: i) consistency with the risk allocation set out in the Q6 price control decision; ii) the supposed absence of a consumer benefit attached to the RAB adjustment; and iii) the supposed availability of preferable alternatives such as assuming an equity injection. Each of these assertions represents a simple policy disagreement which discloses no error.

117 **Sixthly,** it is said that the RAB adjustment is unnecessary (**Virgin §§6.30 – 6.42; Delta §§6.30 – 6.42**). The airline Appellants have argued that a RAB

adjustment was not needed to ensure the financeability of the notional (or actual) company; or to secure that all reasonable demands for airport operation services at Heathrow Airport are met, since a RAB adjustment cannot, by its nature, incentivise new investment. In respect of the former point, the airline Appellant's statements ignore the very real risk of a credit rating downgrade that was faced by HAL at that time. The CAA reasonably expected that its intervention would signal the limits of risk exposure to which HAL would be exposed, thereby providing reassurance to debt investors and credit rating agencies. In respect of the latter point, the Appellants have adopted an unduly narrow characterisation of the real-world factors that HAL and HAL's investors would have been weighing in 2021. It was the CAA's intention that its intervention would provide high-level reassurance that new investment, at the margin, would be profitable on an expected basis, and that HAL should therefore go ahead with rather than shun discretionary new expenditure.

118 **Seventhly**, BA makes two further points (**BA §4.12.4**): (i) that consumers would not have valued any investment above cost and/or that the real option value of the investment was limited; and (ii) in any case it would have been reasonable to assume that HAL's shareholders would have injected additional equity into the business and that such an assumption would have meant that the RAB adjustment was not necessary or appropriate. In relation to the first point, BA fails to highlight the relatively high value consumers tend to place on avoiding disruption to their journeys through Heathrow. Its failure to take account of this invalidates its conclusions about real option values. As for the second point, BA does not adequately consider the prevailing circumstances

in making such an argument. HAL had just incurred a multi-billion pound loss, and current and prospective shareholders may well have viewed an equity injection as throwing "*good money after bad*". Under these circumstances, it was eminently reasonable for the CAA to have had doubts regarding the viability of a notional equity injection.

D. Overall Conclusion

119 The CAA's treatment of the RAB was appropriate in all the circumstances and discloses no error.

VI. JOINED GROUND B: COST OF CAPITAL

120 The Appellants appeal against different elements of the CAA's determination as to HAL's cost of capital.

121 The Final Decision at Chapter 10 **[Core/2027-2485]** and the Second Witness Statement of Jayant Hoon (**"Hoon 2"**) provide a detailed explanation of how the CAA has estimated each component of HAL's weighted average cost of capital (**"WACC"**) and its rationale for doing so. Further detail in relation to the estimation of the H7 asset beta is provided in the First Witness Statement of Craig Lonie of Flint Global (**"Lonie 1"**) which the CMA is also invited to read.

A. Context

122 The CAA's assessment of HAL's cost of capital developed over the course of the H7 price control review. This period encompassed a number of very significant changes:

122.1 a change in the focus of the price control review from expansion to the continued operation of a two runway airport;

122.2 the impact of the covid-19 pandemic and the unprecedented reduction of passenger traffic at Heathrow airport during 2020 and wider economic disruption that the pandemic caused;

122.3 important regulatory determinations and appeals in other sectors (including RP3, PR19, RIIO 2); and

122.4 the macroeconomic upheavals following the Russia-Ukraine conflict, including the highest rates of UK inflation in 30 years and significant, economy-wide increases in interest rates.

123 Between December 2017 and January 2020, the CAA issued several publications that included analysis of the H7 cost of capital (CAP1610 **[RT1/273-377]**, CAP1658 **[CAA/2184-2299]**, CAP1674 **[CAA/2299.1-2299.44]**, CAP1762 **[CAA/2499-2509]**, CAP1876 **[CAA/2722-2803]**). These constituted early views, and while they endeavoured to reflect the latest developments at each stage, their conclusions were signalled as being tentative and subject to change.

124 In 2020, the CAA commissioned Flint Global to carry out further analysis of the cost of capital for a two-runway airport which was based on data up to the end of February 2020 and published alongside the June 2020 Consultation **[CAA/2948-3007]**. This represented the latest analysis of the cost of capital for H7 prior to the onset of the pandemic.

125 In the light of the covid-19 pandemic and HAL's decision to *"pause"* its plans for capacity expansion, the CAA's work on the cost of capital started to focus entirely on the operation of a two-runway airport and taking account of the impacts of the pandemic. The CAA published the April 2021 Way Forward Document to set out the CAA's initial views on how to approach the cost of capital for H7, taking into account the developments noted above **[CAA/3637-3720]**. This was followed in October 2021 by the publication of the Initial Proposals (chapter 9 of which addressed the cost of capital **[Core/136-182]**), which was accompanied by a Flint Global report on the asset beta **[Core/685-737]**.

126 In June 2022, the CAA published the Final Proposals, which took the marked deterioration in the macroeconomic situation since the Initial Proposals (following the outbreak of the Russia-Ukraine conflict, with inflation forecasts increasing to 30-year highs within the space of a few months) into account. Chapter 9 of the Final Proposals addressed the cost of capital **[Core/1186-1264]** and was accompanied by a further report on the asset beta by Flint Global **[Core/1599-1653]**.

127 Between the publication of the Final Proposals and the Final Decision, the macroeconomic situation deteriorated further, with inflation forecasts continuing to increase and economy-wide interest rates following suit. The Final Decision updated the CAA's assessment of the cost of capital to take account of these factors, but retained the estimate of the asset beta set out in the Final Proposals on the basis that asset beta would not be significantly impacted by shorter-term changes in inflation and interest rates.

B. The Need for Judgement in Estimating Costs of Capital

128 Consistent with the CAA's broader approach to the H7 price control review, the CAA's objective in estimating HAL's weight average cost of capital (WACC) is to satisfy its statutory duties under CAA12, including its primary duty to consumers, while having regard (among other things) to the need to secure that HAL can finance its activities.

129 The CAA emphasises that the question of what constitutes an appropriate WACC is far from straightforward:

129.1 With respect to the cost of equity, the fact that Heathrow's shares do not trade openly on a stock exchange, together with the lack of close, stock exchange listed comparators for HAL made the estimation of asset and equity beta values inherently more difficult and required a significant degree of judgement. The impact of the pandemic and the introduction of the TRS mechanism, which is not present in a similar form at any listed comparator airport, introduced a further challenge.

129.2 With respect to the cost of debt and the cost of equity, the CAA has applied the concept of a *"notional company"* (as explained above and in more detail in the Final Decision) as is established practice, and about which no complaint is made. While this approach has a number of advantages, including protecting consumers from undue costs associated with any inefficiency in HAL's actual financing arrangements, the cost of debt for the notional company is not directly observable and so has to be estimated. This is particularly challenging given the differences between HAL's actual financing structure and

those of comparator airports. It is also important to note that HAL's actual financing structure is relatively complex and includes:

(a) a *"Whole Business Securitisation"*, involving various protections for creditors and restrictions on management action;

(b) high leverage relative to most other airport operators;

(c) debt instruments that exhibit different levels of seniority and are issued in various currencies; and

(d) a portfolio of derivative instruments that is not fully transparent.

130 In some areas, there is very limited empirical or measurable evidence on which to base a reasonable estimate of certain inputs (although, of course, the CAA has sought to ensure that its decisions are based on market data to the extent that this was reasonable). In these instances, the CAA exercised its judgement as to what was the most reasonable assumption to apply and set out in the public consultations and decision documents the reasoning that supports these assumptions. The CAA has always endeavoured to ensure that it has adopted an approach that is unbiased and objective.

131 Finally, the current context – in particular, the marked changes in the macroeconomic situation and the fallout from the covid-19 pandemic – made the assessment all the more difficult. As already noted, the CAA was faced with a relatively fast changing situation. For example, at the point at which the Initial Proposals were published, RPI inflation was expected to be below its long-term level, which prompted concern that the use of a long-term inflation forecast could under-remunerate HAL. By the time the Final Proposals were

published, events such as the Russia-Ukraine conflict and the policies of the UK Government had resulted in inflation rates substantially in excess of that level and very significant uncertainty as to future rates. In response, the CAA's concern shifted towards prevention of over-remuneration of HAL's shareholders, as this would unnecessarily push up airport charges and not be in the interests of consumers. The extent of these macroeconomic shocks prompted careful consideration by the CAA of the appropriate basis for adjusting for inflation, which led to an approach that involved using a five-year forecast of inflation.

132 There is no single *"right"* way to deal with these methodological challenges. It requires an exercise of regulatory judgement to generate a price cap based in part on the cost of capital in these circumstances.

C. General Response to Ground B

133 None of the grounds of appeal under Joined Ground B disclose any error of law or fact or error in the exercise of discretion.

134 It is a striking feature of all the appeals that the need to exercise judgement and balance the merits of different models or approaches is largely not mentioned. It is inherent in the use of imperfect models, predictions and estimates that their precise conclusions cannot be justified on the basis of unquestionable evidence and reasoning, and that there is always room for reasonable disagreement with them. But this does not call into question the CAA's exercise of its discretion, as expert sectoral regulator, balancing the various criticisms which might be levelled at different approaches, to pick what in its judgement is the best one (see **Final Decision §9.69 [Core/2206]**). In

challenging that judgement on appeal, the Appellants cannot succeed only by identifying alternative approaches that could reasonably have been used: rather, they must show that that their preferred alternative is *"clearly superior"* such that the CAA's failure to adopt it amounts to an error in the exercise of its discretion and justifies the intervention of the CMA, as an appellate body. The Appellants fail so to do. Indeed, the approaches adopted by the Appellants are on occasion obviously inferior to those used by the CAA. Those approaches also starkly disagree with each other, and in each case consistently focus on their respective commercial interests: thus, in their responses to the Final Proposals, HAL estimated an RPI-real, vanilla WACC of 6.9% [**Core/1745.210-1745.246]**; while the airlines proposed an RPI-real, vanilla WACC of 2.4% **[Core/1745.419-1745.420, 1745.485-488]**.

D. Joined Ground B(i): Asset Beta

135 Both HAL and the Airlines allege errors in the calculation of HAL's asset beta aligned to their respective commercial interests:

135.1 Both HAL (HAL §171) and the airlines (**Delta §5.38; Virgin §5.38; BA §5.7.6**) have challenged the CAA's **pre-pandemic asset beta estimate**, on the grounds that it relies on *"out of date"* estimates from previous price control determinations.

135.2 HAL alleges that the CAA has departed from regulatory practice by not relying directly on market data and instead making certain assumptions in respect of the **post-pandemic asset beta estimate** (**HAL §159.1, §§163 - 183**). The Airlines, by contrast, allege that the CAA overestimated the pandemic effect.

135.3 HAL and the Airlines allege that the CAA erred in making the **TRS adjustment**. HAL says no such adjustment should have been made (**HAL §159.2**), while the Airlines say that the CAA should have made a greater adjustment on the ground that the CAA made a wrong assumption as to the extent to which HAL's risk is traffic-related.

135.4 HAL alleges that the CAA's approach to calculating the asset beta leads to a cost of equity that is too low, because it leads to an "Asset Risk Premium" that is below the corresponding risk premium for debt.

Benchmarks for the cost of equity overall: ARP-DRP Framework (HAL §§150-152)

136 HAL alleges that the CAA's approach to asset beta leads to a cost of equity that is too low on the basis of comparisons between the *"unlevered"*[8] cost of equity and the cost of debt. HAL indicates that this analysis is supported by a more detailed assessment of asset and debt risk premiums (the **"ARP-DRP Differential"**).

137 **Hope 1** sets out the detail of this framework as developed by Oxera **[JH2/1664-1690]**. It is based on the principle that the *"asset risk premium"*, which Oxera defines as the unlevered cost of equity, must always be greater than the *"debt risk premium"*, which Oxera defines as the cost of debt less the risk-free rate and an estimate of the expected loss on an entity's debt.

[8] Which refers to the asset beta multiplied by the equity risk premium, and is discussed in more detail in **Hoon 2 §17.1-17.13**.

138 Oxera estimates values for HAL's asset risk premium (**"ARP"**) and debt risk premium (**"DRP"**), from which it concludes that the cost of equity that the CAA has estimated must be too low, since the ARP is below HAL's DRP. It attributes this shortfall to an inadequate asset beta and reductions in the total market return since Q6.

139 However, Oxera's framework is not capable of accurately estimating these variables on a consistent basis. An important reason for this is that Oxera focuses exclusively in its analysis on data from a comparatively short period of market volatility at the end of 2022 and chooses to ignore more recent data. If more recent data is used, Oxera's analysis in fact shows that the CAA's determination provides for an adequate return. This instability in Oxera's framework demonstrates that it is not reliable in its current form for the purposes of benchmarking the cost of equity. HAL's and Oxera's analysis of the ARP-DRP differential therefore does not show that the CAA has erred in its Final Decision on the cost of equity **Hoon 2 §§17.1-17.13**.

Benchmarks for the overall H7 asset beta (HAL §155)

140 HAL puts forward a series of benchmarks that it uses to assess the CAA's H7 asset beta estimate. Based on these benchmarks, HAL concludes that the H7 asset beta is too low in the round and wrong. HAL's analysis and conclusions are not valid for the reasons set out below.

140.1 The **asset beta estimates for comparator airports put forward by HAL** place an unreasonable amount of weight on pandemic-affected data. These estimates imply that between 22% and 68% of H7 will be affected by pandemic-like equity return behaviour. This is simply not a

credible assumption and it is certainly not *"wrong"* to take the view that the pandemic was a once-in-a-generation event. HAL's estimates also represent a significant departure from its original approach **[JH2/463]** to estimating asset beta (which was based on two-year and eight-month measurement windows). This change would appear to relate to HAL's interest to include pandemic-affected data as the basis for its estimates. As **Hoon 2 §18.6** shows, if HAL had not changed the estimation windows, its approach would imply an asset beta range of 0.52-0.69: this is considerably lower than HAL's proposed values, and broadly in line with the CAA's estimate of the pre-TRS asset beta for H7 of 0.52-0.71.

140.2 The fact that the CAA's estimate of the asset beta is at the bottom end of the range for airport comparator betas estimated by the CMA in the context of its **RP3 determination** does not mean that it is wrong. Given that the CAA had previously determined an asset beta for Heathrow below the CMA's range, and has subsequently introduced additional protections for HAL from risks (in particular, the TRS mechanism), this result is entirely reasonable.

140.3 Similarly, the fact that the CAA asset beta is *"close to"* **the Q6 asset beta** does not mean that it is wrong, for the same reasons as noted immediately above.

141 These matters are discussed in more detail in **Hoon 2 §§18.1-18.15**.

Pre-Pandemic Asset Beta Estimate

Common criticisms of the CAA's Approach

142 Both HAL (**HAL §171**) and the Airlines (**Delta §5.38; Virgin §5.38; BA §5.7.6**) have challenged the CAA's pre-pandemic asset beta estimate, on the grounds that it relies on *"out of date"* estimates from previous price control determinations.

143 These statements misrepresent the process by which the CAA has estimated the pre-pandemic asset beta. These matters were dealt with at length in the Initial Proposals **[Core/138-150]** and the Final Proposals: [**Core/1191-1218]** . In particular, the approach to calculating the pre-pandemic asset beta is set out the Flint Report **§Section 4 [JH2/1710-1720[** and at §§4.24 – 4.28 of the June 2020 Consultation **[CAA/2884-2885]**. The CAA estimated this value based on fresh analysis that took into account up-to-date information. This complaint therefore discloses no error in the CAA's analysis.

HAL's criticisms of the CAA's approach

144 HAL argues that the CAA erred in estimating the pre-pandemic asset beta when it made the assumption that HAL's systematic risk exposure did not change between Q5 and the start of the pandemic period. It points to a number of factors which it considers have led to an increase in systematic risk exposure over this period, including the breakup of BAA, the increasing impact of low-cost carriers, and the UK's withdrawal from the EU. That argument is incorrect. The CAA was quite entitled to consider that these factors did not amount to a convincing reason to expect that HAL's asset beta

had increased between Q5 and the start of the pandemic: **Hoon 2 §§19.5-19.7**. In particular:

144.1 The CAA is not aware of evidence that suggests that the competitive pressure on HAL has intensified over this period, and even if it did, it would not necessarily have led to an increase in HAL's systematic risk exposure (as this would depend on precisely how HAL was impacted by any increase in competition).

144.2 Similarly, there is no reason to suggest that low-cost carriers have led to increased systematic risk exposure, given the existence until 2020 of excess demand at Heathrow and that low cost carriers do not in general operate from Heathrow.

144.3 The UK left the European Union on the 31 January 2020, shortly before the outbreak of the pandemic. Moreover, it remained within the single market and customs union until December 2020. As such, it does not seem likely that Brexit resulted in a significant increase in the asset beta prior to the pandemic. Airlines' criticisms of the CAA's approach.

145 The Airlines have set out their own estimates of the pre-pandemic asset beta for HAL, which they contend support a lower value than that which the CAA has estimated. These estimates represent a subset of the evidence considered by the CAA, and ignore other evidence that points to a higher value. The airlines' expert, Mr Holt, does not explain why the CAA should have focussed on this subset of evidence when estimating the pre-pandemic asset beta, or conversely why it was wrong to place weight on other evidence.

Once this evidence is taken into account, the CAA's estimate is reasonable in the round.

Post-Pandemic Asset Beta

146 The impact of the Covid-19 pandemic on the CAA's estimation of the WACC is discussed in more detail in **Hoon 2 §§20.1-20.41** and **Lonie 1 at Chapter 5**, which the CMA is respectfully invited to read. The CAA did not err in its approach to the effect of the pandemic on the WACC, and the Appellants' various arguments to the contrary do not show otherwise.

HAL's Arguments

147 HAL alleges that the CAA's approach is a departure from regulatory precedent and that the use of a large number of assumptions by the CAA means that market data has been effectively ignored (**HAL §§163-164**). At the heart of its argument is the view that using a weighted regression departs from what HAL considers to be objective market data (that is, an unweighted regression).

148 It is true that the CAA's approach is the first (to the CAA's knowledge) to deliberately and explicitly assign weights to different observations. Nonetheless, this approach is reasonable in the circumstances of the Covid-19 pandemic and its impact on estimates of beta values. It is also worth noting that any asset beta estimate necessarily involves implicitly assigning weights to a particular period of time, *including the approach suggested by HAL*. As set out in more detail in **Hoon 2 §§20.7-20.9**, assigning weights to historical observations in line with their expected likelihood of recurrence is less

arbitrary than assuming (as HAL does) that each observation is equally weighted.

149 It is therefore misconceived to submit that the use of an unweighted regression is the only legitimate means to estimate the asset beta for H7, or that any other representation of market evidence or investor views is *"wrong"*. It cannot be said that the CAA has erred in declining to use an unweighted regression as this simply represents an exercise of its regulatory judgement.

150 HAL also challenges certain specific assumptions underpinning the CAA's analysis:

150.1 HAL argues that the CAA was incorrect to assume that the covid-19 pandemic ended in March 2022, and puts forward a series of observations suggesting that the pandemic continued to affect HAL during the remainder of 2022. However, HAL's argument mischaracterises the CAA's approach. The assumption the CAA adopted was that the pandemic ceased to have a significant influence *on comparator airport asset betas* from March 2022 (rather than that the pandemic ceased to have any impact *on HAL*): **Final Decision §9.82 [Core/2209]; Final Proposals §9.125 [Core/1210]**. As set out in **Hoon 2 §20.16**, that assumption was supported by evidence (for example, in respect of shorter window estimates) at the time, and more recent data provides further support for this view.

150.2 HAL argues that CAA's assumptions in respect of the frequency of future pandemics are arbitrary. It is correct – indeed obvious – that the frequency of future pandemic-like events is highly uncertain. There are

some factors which may reduce the frequency or probability of pandemic-like events in the future, and there are other factors that may lead them to be more common. The CAA therefore needed to make assumptions involving a degree of judgement (as set out at **Final Proposals §§9.114-9.125 [Core/1209-1210]**). That does not make them *"necessarily…arbitrary"*. If the risk of such events is to be factored into the price cap settlement at all (and it is not suggested it should not be), then *some* view must be taken on how likely they are, as indeed HAL does. Indeed, HAL's own estimates also imply a specific frequency of such events that is less well evidenced than the CAA's: in fact and, as explained in **Hoon 2 §18.3**, HAL's approach implies that between 22% and 68% of H7 will be similarly affected by pandemic-like equity return behaviour. This is not a reasonable assumption, given that the pandemic was a once-in-generation event that seems highly unlikely to recur within the next five years (and in any case the CAA's view cannot sensibly be described as *"wrong"*, even if other reasonable views are also possible).

150.3 HAL argues that CAA is wrong to assume that the pandemic accounted for substantially all of the increases in comparator airport asset betas observed during the pandemic period. That is a broadly correct characterisation of the CAA's approach but it does not demonstrate that this approach is wrong. The CAA and their advisors, Flint, explicitly considered the impact of other events such as the Russia-Ukraine conflict, and concluded that their impact was insignificant compared with the onset of the pandemic. Moreover, recent data shows a clear

reversion of comparator airport asset betas towards their pre-pandemic level following the end of the pandemic, suggesting that the pandemic was the dominant driver of elevated asset betas previously: **Lonie 1 §§278-283.**

151 HAL's criticism of these assumptions is accordingly unfounded, and does not disclose any error of law, fact, or in the exercise of the CAA's discretion.

Airlines' Arguments

152 The Airlines challenge three aspects of the CAA's approach.

153 **First**, it is said that the CAA has assumed without evidence that the pandemic will neutralise the effect of the capacity constraint at Heathrow on HAL's asset beta (**Delta §5.43, Virgin §5.43, BA §5.7.7**). However, it was reasonable for the CAA to have assumed that (i) Heathrow will exhibit a similar level of excess demand as comparator airports in H7, even if it reaches its capacity constraint within the H7 period; and that therefore (ii) excess demand will no longer drive a wedge between comparator airports and HAL in H7. As set out in **Hoon 2 §20.30**, there was already evidence to suggest that comparator airports were starting to encounter capacity constraints prior to the pandemic.

154 **Secondly,** it is said that the CAA and its advisors Flint Global were wrong to rely on a weighted least squares (**"WLS"**) estimator, and that other, more *"efficient"* methods exist for this purpose such as the use of slope dummy variables (**Delta §5.48, Virgin §5.48, BA §5.7.11**). As to this, it was reasonable for the CAA to have used the WLS estimator:

154.1 Neither the airlines nor their expert witness, Mr Holt, actually base their asset beta estimate using slope dummy variables, but rather on their previous approach of separate betas estimates for pandemic and non-pandemic periods.

154.2 Further, the Airlines' preferred method of separate beta estimates also fails to reflect the higher market and share price volatility observed during the pandemic period, and, as such, results in a biased and inefficient estimator for the H7 asset beta. It was therefore reasonable for the CAA to have used the WLS estimator in this context.

154.3 In any event, the use of slope dummy variables has not been raised previously with the CAA despite multiple opportunities to do so. Therefore, even insofar as this analysis might have limited merit (which is not accepted), it was not before the CAA when it made its decision and cannot reasonably be considered by the CMA: see paragraph 27 above.

155 **Thirdly**, it is said that the CAA has failed to appropriately account for changes in gearing at comparator airports and, as such, have overestimated those comparators' asset betas (**Delta §5.51, Virgin §5.51, BA §5.7.12**). This argument is without merit: changes in gearing at comparator airports were accounted for when estimating the asset beta through the process of "un-levering" comparator equity betas (i.e., adjusting these to take account of differences in gearing).

Conclusion

156 Accordingly, the CAA did not err in its approach to the effect of the pandemic on asset beta or the WACC.

The TRS Adjustment

157 Both HAL and the Airlines criticise the CAA's approach to the TRS adjustment in the calculation of asset beta. The CAA's approach to this adjustment is described in detail in **Hoon 2 §§7.16-7.19** and **Final Proposals §§9.153 – 9.161 [Core/1215-1218]**.

HAL's Arguments

158 HAL makes two arguments: (i) that the CAA was wrong to consider that the TRS mechanism has the effect of reducing HAL's systematic risk exposure; and (ii) that the adjustment in fact made is arbitrary, unevidenced, and based on flawed assumptions that have been employed to calibrate the adjustment. Neither has merit.

159 It is accepted that there is a significant degree of uncertainty around the amount by which the TRS will in fact reduce HAL's exposure to systematic risk. The TRS adjustment to asset beta accordingly involved the exercise of judgement. However, it does not follow from this that the CAA was compelled to conclude that the TRS has *no mitigating impact whatsoever*. That would equally have represented a judgement, but one at odds with a reasonable assessment of expected risk. The CAA was not wrong to prefer an inevitably imprecise TRS adjustment (albeit informed by analysis) to the alternative of

fixing a zero adjustment because a positive adjustment could not be fixed with certainty.

160 The grounds upon which HAL says that it fell outside the CAA's margin of appreciation to apply an adjustment for the TRS mechanism do not withstand scrutiny:

160.1 **First**, HAL states that the TRS mechanism *"lacks the immediacy and certainty of payback that would be required"* to reduce systemic risk (**HAL §195.1**). This argument is based on a false premise as with respect to a CAPM-derived asset beta, as in general the timing of cashflows is not relevant providing that they are preserved in net present value ("**NPV**") terms. The TRS mechanism achieves this because the TRS adjustment and RAB are indexed to inflation and attract a real return equal to the WACC. The CAA has also addressed the issue of cashflows being subject to systematic and regulatory risks through the risk premium contained within the WACC.

160.2 Secondly, HAL contends that the TRS adjustment is arbitrary because it is based on assumptions that lack any evidential support (**HAL §195.2**). The CAA has always accepted that it lacked viable benchmarks with which to precisely quantify the TRS adjustment. However, this does not mean the TRS adjustment was arbitrary (any more than a court charged with assessing damages in a case where it is impossible to state more than a wide range of possible figures with any confidence is guilty of being *"arbitrary"* when it adopts a *"broad axe"* approach to the fixing of a precise figure). Indeed, the CAA clearly

set out its reasoning for the adjustment in the Final Proposals: the TRS mechanism manifestly reduces HAL's exposure to volume risk, which has consistently been identified as a key driver of HAL's asset beta. This was a key reason for applying this mechanism in the first place. Moreover, the absence of precise quantitative benchmarks does not mean that it would have been appropriate automatically to apply no adjustment, since this itself would represent a judgement regarding the effect of the TRS (namely that the TRS has no impact on the asset beta). HAL has provided no meaningful evidence to support *that* position. It is simply seeking to substitute the CAA's judgement for its own judgement (which aligns with its own commercial interests rather than the CAA's statutory duties).

160.3 **Thirdly,** HAL suggests that the CAA has failed to take into account risk-sharing arrangements at other airports (**HAL §195.2**). This statement is simply false: the Final Proposals explained that none of HAL's comparators benefit from a risk-sharing mechanism equivalent to the TRS: **Final Proposals §§9.126 – 9.128 [Core/1211-1212]**.

160.4 **Fourthly,** HAL contends that the TRS adjustment was unnecessary, and based on *"speculative adjustments to reflect how beta may change in the future"* (**HAL §196**). HAL is once again labouring under a misconception. The CAA did not introduce the TRS adjustment to *"reflect how beta may change in the future"*, but rather to reflect a material difference in risk exposure between HAL and comparator airports. The TRS is a major component of the H7 price control

framework, the purpose of which is (among other things) to reduce HAL's risk exposure. It could result in large value transfers in the event of future traffic downturns. As such, if the CAA had ignored its impact on the asset beta, this could have resulted in significant overcompensation for HAL at consumers' expense. It was entirely reasonable, and certainly not wrong, to take account of the likely impact of the TRS on asset beta.

160.5 **Fifthly,** HAL argues that the TRS mechanism lacks credibility because of a perception of regulatory risk, which HAL argues is likely to have adverse asymmetric impact on its recovery of revenues (**HAL §200 and 201**). It suggests that, in extreme circumstances, the CAA will renegotiate such mechanisms. The CAA does not accept HAL's allegation that there are in fact such perceptions of regulatory risk, for which no proper evidence is cited. HAL's example of NERL does not advance this point since the intervention was actually requested by NERL, and: (i) NERL's current traffic risk sharing mechanism includes a carve out provision in the current exceptional circumstances; (ii) the CAA's regulatory intervention was ultimately beneficial for NERL, as it enabled it to collect TRS revenues over a longer period, thereby avoiding potential under-recoveries at the time when demand was subdued during the pandemic; and (iii) since the NPV of NERL's TRS revenues was preserved, the intervention was neutral in value terms. However, and in any event, even were there such concerns, it does not follow that the TRS would have no impact on the asset beta – which is HAL's case.

160.6 **Sixthly,** it is said to follow from Mr King's analysis (**King 1 §94 and §§106-108**) that the impact of the TRS on the asset beta must be small. This takes HAL nowhere (and certainly does not show that the CAA was *"wrong"* not to concur with this analysis):

(a) The analysis does not in fact quantify the impact of the TRS on the asset beta at all. The principal mechanism through which the TRS affects HAL's asset beta is not the resulting reduction in operational gearing (as Mr King supposes), but through the amelioration of underlying demand risk. The latter is a far more direct transmission mechanism, and as a consequence is likely to have a far more significant impact.

(b) Mr King also provides analysis of the cashflows that would arise from the TRS mechanism in the event of a future pandemic-like event, which he compares to the reduction in cashflows due to the TRS adjustment to the asset beta. Mr King concludes that because the former is smaller than the latter, that the TRS adjustment must be too large. However, Mr King is not comparing like with like in this example. The estimated benefit from the TRS represents an avoided expected loss, whereas the reduction in the asset beta represents an avoided risk premium: see **Hoon 2 §21.8**.

160.7 **Seventhly**, HAL disputes the use of network utilities as a benchmark for calibrating the TRS adjustment (**HAL §§205-207**). However, it is highly likely that demand risk exposure explains a significant proportion

of the difference in systematic risk exposure between airports and network utilities: **Hoon 2 §§21.27-21.28; Final Proposals §§9.154-9.157 [Core/1216]**. Moreover, it is noteworthy that in the context of Q6, HAL's advisors, NERA, stated that, "*Our analysis placed a strong emphasis on analysis of beta risks, especially "demand risk" which we identified as the most relevant beta risk factor. Based on this analysis, it is clear that airports face a significantly higher exposure to beta risks than the other regulated UK companies that are regulated through a revenue cap mechanism and do not face volume risk"* **[CAA/638.1-638.45[9]]** (emphasis added). Despite its case that there are a *"multitude of factors"* that could explain differences in asset beta between network utilities and comparator airports, HAL has only identified three: one (changing patterns of business travel) represents a subset of volume risk; one (regulatory risk) does not convincingly explain differences in asset beta between network utilities and comparator airports since both face regulatory risk; and the other (commercial revenue risk associated with unregulated activities) is likely to be limited by the fact that network utilities also undertake commercial/ unregulated activities and HAL's commercial revenue risk is closely linked to volume risk. It is therefore reasonable to assume that volume risk represents the most significant factor explaining differences in asset beta between network utilities and

[9] NERA (2013), "A Review of the Risk Assessment in the CAA's Initial Proposals for Q6: A Report for London Heathrow", June, p.i.

comparator airport, with other factors accounting for a minority of the difference.

160.8 **Eighthly**, HAL states that "the CAA's approach entails the further unstated assumption that any reduction in volume risk leads to a commensurate reduction in the asset beta, for which there is also no support" (**HAL §209**). This statement misrepresents the CAA's approach. The CAA did not assume that a reduction in volume risk results in a commensurate reduction in the asset beta. Indeed, it was assumed that the TRS reduced volume risk by 50%, but only resulted in an 14% reduction in the asset beta.

161 Overall, no aspect of HAL's appeal on this ground provides any basis for the conclusion that the CAA was *"wrong"* to make an adjustment to the asset beta for the TRS. Indeed, HAL's argument is inconsistent with HAL's own approach to the RAB adjustment. HAL previously argued that a RAB adjustment would reduce the asset beta from 0.98 to 0.82 (roughly twice the CAA's proposed adjustment) (**HAL §3.3)**. HAL's proposals for a RAB adjustment were essentially to retrospectively address historical pandemic risk. It makes no sense to conclude that a backward-looking adjustment for pandemic risk will reduce asset beta, while a forward-looking adjustment mechanism will not.

Airlines' Arguments

162 The Airlines have also criticised the CAA's TRS adjustment, but in contrast to HAL have suggested that the downward adjustment to asset beta should be larger.

163 **First**, it is said that the CAA should not have considered that risks other than volume risks could explain the difference in asset beta between network utilities and airports (**Delta §5.58-5.61; Virgin §5.58-5.61; BA §5.7.18**). That claim is not well founded. The CAA concluded that volume risk was the *"principal* [but not only] *driver of the difference in asset betas"* (**Final Proposals §9.155 [Core/1216]**). That is obviously right: in addition to volume risk, HAL is exposed to risk associated with commercial revenues, which could also drive differences in asset beta between airports and network utilities. It was therefore reasonable to assume that volume risk accounts for less than 100% of this difference, and potentially substantially less.

164 **Secondly**, BA argues that the CAA has not taken adequate account of HAL's aggregate risk exposure under the broader H7 price control package (**BA §5.7.16**). In particular, it argues that the CAA has not taken into account the fact that the asymmetric risk allowance and the *"shock factor"* used in the passenger traffic forecast insulate HAL from risk. This argument is also without merit. In reality, neither the asymmetric risk allowance nor the shock factor will serve to reduce HAL's exposure to traffic risk. Both mechanisms are deterministic in nature, meaning that they do not influence HAL's risk exposure. Rather, they are part of the package of compensation for bearing that risk.

Conclusion

165 Neither HAL's arguments, nor those of the Airlines, demonstrate that the CAA erred in applying a TRS adjustment to the asset beta.

Conclusion on Ground B(i)

166 Overall, the CAA appropriately and lawfully estimated the asset beta in the exercise of its regulatory judgement. Ground B(i) accordingly falls to be dismissed.

E. Joined Ground B(ii): Cost of Debt

167 Both HAL and the Airlines allege errors in the calculation of HAL's cost of debt:

167.1 HAL challenges the CAA's approach to the effect of inflation on the cost of servicing debt, which relied on five-year forecasts. It says that the CAA should have used a longer-term forecast.

167.2 HAL challenges the CAA's estimate of the HAL cost of debt premium. HAL considers that a higher HAL-specific premium is warranted.

167.3 HAL argues that the measurement window on which the CAA's estimate of the cost of embedded debt is based (13.5 years) is too short and that simple average of yields over a 20-year measurement window should be used.

167.4 The Airlines argue that the CAA was wrong to apply an uplift to reflect the higher cost of index-linked debt relative to fixed-rate debt.

Treatment of Inflation

168 The CAA's treatment of inflation in calculating the cost of debt (**Final Decision §9.20 – 9.29 [Core/2199-2200]**) is described in detail at **Hoon 2 §§11.1-11.8**.

169 HAL's arguments do not support the conclusion that the CAA erred in its treatment of inflation:

169.1 **First**, HAL submits that the CAA's approach represents a *"departure from the well-established UK regime of economic regulation"* **(§224.1, §§226 – 233**). The CAA does not accept that there is a "*well-established UK regime of economic regulation*" that prescribes a single, uniform approach towards the treatment of inflation across all sectors and for all time (**Final Decision §§9.20 – 9.22 [Core/2199]**), or that HAL has provided persuasive evidence of the same. Indeed, HAL's statement omits various examples to the contrary, including the CMA's decision in respect of NIE **[JH2/935-947, 1842-1843]** and for NERL at RP3 **(Hoon 2 at Table 4) [JH2/60-61]**. The use of five-year forecasts in H7 is eminently reasonable and within the bounds of regulatory precedent. In any event, even if there were not such precedent, this alone would provide no basis whatsoever to conclude that the CAA was wrong in its treatment of inflation.

169.2 **Secondly**, HAL argues that the CAA's approach will create incentives for HAL to move towards short-term financing that will increase cost and risk in the long-run (**HAL §224.2, §§234-236**). It is not obvious why this would be the case. The CAA's approach to setting the cost of debt would not have been any different had HAL historically issued a greater proportion of shorter-tenor debt. Therefore, the CAA's H7 framework is entirely neutral in its treatment of and impact on the tenor of HAL's borrowing.

169.3 **Thirdly,** HAL goes on to imply that cashflow volatility will be higher within the H7 period itself, as well as more broadly. As to this:

(a) It is incorrect to suggest that the CAA's approach will result in greater cashflow volatility in H7 (**HAL §§235-236**). On the contrary, since the inflation assumption is fixed under both HAL's and the CAA's approach, the within-period cashflow volatility will be identical under both approaches.

(b) It is true that cashflow volatility will be higher under the CAA's approach between price control periods, due to the reset of the inflation assumption. However, total returns (measured as within-period cashflows plus indexation of the RAB) can be reasonably expected to be more stable under the CAA's approach compared with the use of a long-term inflation forecast. This result follows logically from the observation by HAL that the use of a long-term forecasts leads to a positive correlation between real equity returns and inflation. In effect, any additional cashflow volatility under the CAA's approach is offset by a compensating change in indexation of the RAB. Volatility in total returns is arguably more relevant to long-term investors than volatility in cashflows, as the latter will tend to *"even out"* over time.

(c) HAL's supposition that the CAA's approach will lead to "unavoidable" financeability issues is therefore also misconceived. The CAA's analysis did not reveal any

financeability issue for the notional company. It is therefore incorrect for HAL to claim that it will have to "divert" funds from operational budgets, with adverse impacts on service quality.

169.4 **Fourthly**, HAL argues that the CAA was wrong to be concerned about windfall gains associated with the use of long-term inflation forecasts, since they would allegedly *"even out"* over the longer-term (**HAL §§238 - 243**). As to this:

(a) Windfall gains and losses are of concern even if they supposedly even out over the longer-term. It was concern regarding the temporary, but still significant, financeability implications of low inflation that prompted the CAA to use five-year forecasts in the first place (**Initial Proposal §9.116 – 9.118 [Core/156-157]**)

(b) It is also not obvious that that windfall gains and losses will even out over the longer-term. Even if inflation eventually trends back to target, it can deviate for considerable periods (as the current inflationary period shows). There is no guarantee that such deviations will necessarily be matched by equal and opposite deviations in the future, and certainly not within any defined period. As a consequence, consumers could potentially be asked to fund windfall gains to investors (or conversely, investors could be asked to bear losses) for a very long period of time, and may never be fully repaid **Hoon 2 §24.32.**

(c) HAL does not provide any evidence of what inflation will do in the future (nor could it) – instead, the CAA had to make a judgement, which HAL's argument that inflation will even out over time does not undermine.

169.5 **Fifthly**, HAL argues that the CAA's estimate of windfall gains is exaggerated by assuming that the notional company possesses a smaller proportion of index-linked debt than HAL does in reality, and there is no justification for such an assumption (**HAL §243**). As to this:

(a) Over the preceding three price control periods, the CAA has consistently adopted an assumption that 30% of the notional company's debt will be index-linked and signalled that any use of derivatives would be at HAL's own risk.

(b) The CAA has consulted on its approach to the financial structure of the notional company during the price review process and received no evidence that suggests that the substantial amount of indexed-liked debt that has been allowed is unreasonable. HAL had a number of opportunities to justify and explain the scale and cost of its portfolio of index-linked derivatives, and separately why it is in consumers' interests to fund these costs through regulated charges, and it has failed to provide this information and explanation.

(c) One of the primary purposes of the notional approach is to shield consumers from management and shareholder decisions on what the actual financial structure of the regulated company

(in this case, HAL) should be. In ***RIIO-2*** **§14.81 - 86**, the CMA considered that GEMA's use of a notional company properly had regard to the need to secure that licensees are able to finance their activities, bearing in mind GEMA's principal objective of protecting the consumer interest and that this creates strong incentives on the part of licensees to manage company debt prudently and efficiently. Of particular note is the CMA's statement (at **§14.86**) that:

> *"We do not agree that the financeability duty requires GEMA to ensure that each licensee can recover all of the costs which it has reasonably incurred. Furthermore, as we have explained, there is in our view a sound reason for avoiding an approach which focuses on market rates, in that such an approach would not provide sufficient incentives to licensees to manage their debt costs efficiently."*

It is therefore not open to HAL to argue that it is unreasonable for there to be a difference between the actual and notional structure. That is what would reasonably be expected as part of a policy designed to protect consumers.

169.6 **Sixthly,** HAL submits that the CAA's approach does not guarantee that windfalls will not occur (**HAL §§244 - 245**). This misstates the CAA's objective. Its goal was not to guarantee the recovery of efficient costs, but rather to ensure that investors can expect (in probabilistic terms) to

recover these costs. This is a reasonable objective, and the CAA's policy can reasonably be expected to achieve this objective.

169.7 **Seventhly**, HAL argues that outturn inflation will tend to mean-revert to long-term inflation through, for example, the Bank of England's inflation-targeting mandate (**HAL §245**). By contrast, it considers that OBR inflation forecasts exhibit no such mean-reverting properties and, hence, there is scope for systematic over- or underestimation of outturn inflation. Whether or not outturn inflation reverts to a supposed long-term level in the longer term is far less relevant than whether an inflation forecast represents a "fair bet" for a company within the price control under consideration. In H7, the CAA has used a forecast for which, in the CAA's view, the likelihood that inflation will be higher than expected is broadly balanced against the likelihood that inflation will be lower than expected. By contrast, HAL is proposing a forecast where the overwhelming likelihood is that inflation will be above the forecast. This would not be a "fair bet" in any meaningful sense.

170 Accordingly, the CAA did not err in its treatment of inflation.

HAL cost of debt premium

171 HAL submits that the CAA has underestimated the spread of its debt over broad market indices (**HAL §§250-255**). The CAA's assessment of HAL's cost of debt premium is described in detail at **Hoon 2 §§9.12-9.17** and **Final Decision §§9.127 – 9.140 [Core/2217-2219]**.

172 HAL's argument is based on two mistaken premises:

172.1 HAL argues that the CAA has erred by basing its assessment on HAL's Class A debt only. It notes that this debt was rated A- throughout much of the historical period over which the cost of embedded debt was estimated. By contrast, it notes that the CAA assumed that the notional company will be rated BBB+ during H7 for *"other purposes"*. HAL appears to be labouring under a misconception. The CAA has assumed that the notional company has historically achieved (and will continue to achieve) a similar credit rating to HAL's Class A debt. Although this implies a BBB+ credit rating in H7, it also implies that the notional company could have maintained an A- rating for much of the historical period, in line with HAL's Class A debt. Contrary to HAL's statements, this is entirely internally consistent (see **Final Decision §9.139 [Core/2218]**).

172.2 HAL argues that the CAA's exclusion of Class B debt is unjustified since the CAA has never explained why this debt has been raised inefficiently (**HAL §251**). This appears to be a further misconception on HAL's part. The CAA has never sought to opine on the question of whether HAL's Class B debt is or is not efficient. Rather, the CAA has consistently taken the view over a period of more than 15 years that it should set price controls that are appropriate for a company that maintains a notional capital structure comprised of 60% debt and 40% equity. This means that any debt that HAL chooses to issue beyond 60% gearing is at its own risk, insofar as the CAA will not reflect the cost of any additional borrowing in its cost of capital calculations.

172.3 HAL's request that the CMA should correct the CAA's cost of debt estimate to account for the cost of Class B debt violates this established point of regulatory principle. HAL's Class B RAR is 77.7%, which is significantly in excess of the CAA's 60% notional gearing assumption. If the CAA were to include HAL's Class B debt in its assessment, it would effectively signal that consumers will underwrite the costs associated with high gearing. This is not in consumers' long-term interests.

173 Further, HAL has said that it is unrealistic to assume that the notional company could achieve the same credit rating as the actual company. It argues that the protections within the regulatory framework do not provide the same degree of protection as those in its Whole Business Securitisation. Analysis by the CAA's corporate finance advisors (Centrus) provided at Exhibit **[JH2/1862-1888]** sets out the relevant evidential basis for the CAA's assumption, and demonstrates that it is, in fact, reasonable.

174 HAL also argues that the CAA has made a factual error by failing to use HAL's actual cost of currency swaps in its assessment (**HAL §254**). As indicated in the Final Decision, the CAA had previously requested data on Heathrow's actual swap costs (together with supporting information that would enable it to scrutinise this data on behalf of consumers) on multiple occasions prior to the Final Proposals, but these were not provided. Moreover, the swap costs that have now been provided by HAL have been submitted in a format that does not permit reasonable interrogation of their efficiency: they are not accompanied by an audit trail or even a description of how they have been

estimated, and provide no benchmarks or discussion of efficiency, being just numbers in a table. While HAL has asked the CAA (and indeed the CMA) to accept this data uncritically as its estimate of swap costs, the CAA has no means of knowing if these (a) are efficiently incurred coasts and (b) that it would be necessary and appropriate for the notional company to incur a relevant proportion of such costs. It is therefore inappropriate to place weight on the information provided by HAL. To do so would also undermine incentives on HAL to provide accurate and evidenced information in a timely manner during the consultation process. The CAA also notes that the purpose of assuming a notional financial structure includes avoiding a situation where HAL's actual financing costs are automatically recovered from consumers.

175 The errors in HAL's analysis mean that its proposed revised estimates are defective:

175.1 HAL's estimate (**HAL §255.1**) of the HAL-specific premium based on the actual spread at issuance of Heathrow's debt, which includes its Class B debt, does not constitute an appropriate basis for estimating the notional company's cost of embedded debt. This is because, as stated in paragraph 172.3 above, the inclusion of Class B debt in the assessment is not consistent with the gearing assumption for the notional company of 60%.

175.2 HAL presents an estimate of the HAL-specific premium based on the spreads on four HAL Class A bonds over the relevant iBoxx indices (**HAL §255.2**). However, secondary market spreads are not the appropriate basis for estimating a HAL-specific premium, since

secondary market values do not provide a good representation of the economic cost that is actually paid (**Final Proposals §9.335 [Core/1246-1247]**). The best measure of these economic costs is the yield at issuance. Moreover, HAL's analysis of secondary market yields is based exclusively on four instruments that appear to have been issued prior to 2011 **Hoon 2 §25.17**. It is apparent that these instruments exhibited a considerably longer average tenor at issuance than HAL's average asset life, which is likely to imply a higher cost relative to the 10+ years index than HAL's average bond issuance. By contrast, the CAA's analysis included 33 bonds exhibiting a variety of tenors at issuance and issuance dates (which was compared to corresponding iBoxx benchmarks). This provides a far better representation of the cost of embedded debt than HAL's narrow assessment.

Averaging Period

176 HAL argues that the measurement window on which the CAA's estimate of the cost of embedded debt is based (13.5 years) is too short and that a simple average of yields over a 20-year measurement window should be used (**HAL §§259-262**).

177 The CAA's approach to the averaging period for measuring the cost of debt is described in detail at **Hoon 2 §§9.8-9.11.**

178 It was not *"wrong"* for the CAA to have used a measurement window starting in 2008 for the purposes of estimating the cost of embedded debt:

178.1 **Firstly**, a 2008 start date reflects a reasonable assumption given that the notional company can be assumed to have issued increasing volumes of debt over time to finance a growing RAB; and

178.2 **Secondly**, a 13.5-year averaging period results in a cost of embedded debt that is close to HAL's actual cost of Class A debt (whereas a 20-year trailing average would have significantly exceeded HAL's actual cost of debt). While it would not be desirable to go as far as to create a pass-through of HAL's actual cost of debt, this provides a degree of confidence (given the similarities between HAL's class A debt and the notional structure) that the CAA's chosen trailing average is not arbitrary and does not unduly over- or under-remunerate HAL.

179 HAL's arguments to the contrary are misconceived:

179.1 HAL argues that the measurement window the CAA has used is inconsistent with HAL's actual average tenor at issuance and with various other assumptions made by the CAA, including the regulatory asset life, the tenor of iBoxx indices used to estimate the cost of debt, the inflation forecast used to deflate index-linked debt and the proportion of new debt that is assumed to be issued in each year. However, this argument confuses two separate concepts: the maturity at issuance on the one hand and the period over which the notional company is assumed to issue debt on the other. It is right that the CAA has assumed that the notional company issues debt that has a maturity at issuance of 20 years. This is separate from (and fully consistent

with) the assumption that the notional company has issued debt evenly over the last 13.5 years.

179.2 HAL also argues that it has a significant amount of debt on its balance that pre-dates the 2008 start date for the measurement window used by the CAA to estimate the cost of embedded debt. For the reasons given above and in **Hoon 2 §§26.8-26.9** , it does not follow from this that the CAA was *"wrong"* to adopt a start-date of 2008 for the notional company.

179.3 Finally, HAL argues that the 13.5-year measurement window is inconsistent with the CAA's own assumptions as to the distribution of Class A debt issuance over time. HAL appears to be making arbitrary mid-point assumptions about the years in which debt for each period was issued, rather than using actual real-life issue dates. In any case, HAL's arguments fall well short of justifying its preferred 20-year trailing average.

180 Accordingly, HAL's arguments concerning the averaging period do not show that the CAA was *"wrong"* to adopt the approach it did.

Index-Linked Premium

181 The Airlines argue that the CAA was wrong to apply an uplift to reflect the higher cost of index-linked debt relative to fixed-rate debt (**Delta §§5.66-5.68; Virgin §§5.66-5.68; BA §§5.8.1 – 5.8.8**).

182 The CAA's approach to this issue is set out at **Final Decision §§9.141-9.142 [Core/2219]** described in detail at **Hoon 2 §9.16**.

183 None of the arguments raised by the Airlines have merit:

183.1 **First**, the materiality of this issue is very limited. The index-linked premium is 15 basis points, applied to 30% of the debt in the notional balance sheet. Removing the index-linked premium would reduce the WACC by less than 3bps.

183.2 **Secondly**, Mr Holt says that the CAA's approach differs from that adopted by other regulators. It is true that other regulators have not applied an index-linked premium in the context of recent determinations (specifically, RIIO-2 and PR19). However, this does not, by itself, mean that it was wrong to apply such a premium. It is not clear that Ofgem and Ofwat specifically considered this question. If they had, they might well have concluded that a similar premium was warranted in respect of the index-linked debt raised by energy and water companies. Furthermore, the absence of an index-linked premium for energy and water company debt (if a careful and considered assessment led to such a finding) does not rule out the existence of a premium for debt raised by airport companies or HAL specifically.

183.3 **Thirdly**, it is said that the CAA was wrong to use a weighted average of yield differences between HAL's index-linked bonds and the iBoxx and observes that the majority of index-linked bonds exhibit a discount (rather than a premium) to their fixed-rate counterparties. Mr Holt also observes that a comparison based on a simple average across all of the bonds suggests that HAL's index-linked debt exhibits a discount to

its fixed-rate bonds. This argument does not show the CAA's determination to have been wrong. It is never explained *why* the CAA was wrong to base its conclusions on a weighted average of yield differences. There is no obvious reason why smaller bond issues should be assigned the same weight as larger ones, and a weighted average provides a more accurate reflection of total cost across the full set of index-linked bonds.

183.4 **Fourthly**, it is said that that holders of index-linked debt in fact require a lower return than holders of fixed-rate debt, since they do not require an inflation risk premium. It is true that the absence of an inflation risk premium implies that index-linked bonds should exhibit a lower cost, all else being equal. However, this assessment omits consideration of the generally lower liquidity of corporate index-linked bonds compared with their fixed-rate counterparts. The information available to the CAA indicates that this liquidity premium has generally resulted in corporate index-linked bonds being more expensive, as described in **Hoon2 at §9.16**

183.5 **Fifthly**, it is argued that the CAA should have gone beyond an examination of HAL's index-linked debt and examined the yield differential for the market as a whole, and that doing so would demonstrate that the yield on fixed-rate debt has always been higher than for index-linked debt. This analysis is based on a comparison of government index-linked and fixed-rate gilts. As the CAA previously indicated in the **Final Proposals §9.211 [Core/2231]**, index-linked gilts

do not exhibit a material liquidity premium, whereas corporate index-linked bonds do. As such, the cost differential between fixed-rate and index-linked gilts is likely to provide a misleading view of the cost differential between fixed-rate and index-linked corporate bonds.

184 Overall, therefore, the Airlines' arguments do not show the CAA to have erred in applying an index-linked premium. In any event, this issue is not material. Removing the index-linked premium would reduce the WACC by less than 3bps. Even if these arguments have some merit (which they do not), they would not show the CAA's overall assessment of the WACC to be an *"error"* within the meaning of CAA12.

F. Joined Ground B(iii): Point Estimate

185 Both HAL and the airlines have argued that the CAA erred in its choice of the point estimate. HAL has argued for the highest possible point estimate from within the estimated WACC range, while airlines have advocated a point estimate in the bottom half of the range in alignment with the respective commercial interests. The CAA's choice of point estimate is explained at **Hoon 2 §§14.1-14.8** and at **Final Decision §§9.197 – 9.207 [Core/2229-2230]**.

HAL's Arguments

186 HAL argues that the CAA should have selected a point estimate at the top of the range. Its arguments in this regard are unconvincing and do not show the CAA to have erred:

186.1 HAL's argument that the ARP-DRP framework demonstrates that aiming up is required to ensure a sufficient cost of equity is flawed for the reasons given at paragraph 139 above.

186.2 HAL has put forward a model of consumer welfare that it considers supports an estimate at the top of the range. As to this, it is common ground between HAL and the CAA that welfare effects can represent a *prima facie* reason for aiming up. However, what that means in practice must ultimately be a regulatory judgement taking into account the relevant facts and views. The reduction of the choice of the point estimate to a mechanistic process is inappropriate and obscures certain important judgements that HAL and Oxera have presented as fact: for example in relation to consumer welfare, demand and regulatory price-setting (as to which see **Hoon 2 §22.14**).

186.3 HAL considers that it is exposed to greater systematic risk than comparator airports, requiring aiming up remedy the resulting skew in parameter estimates. The CAA's points about systematic risk are explained at paragraph 144 above and suggest there is no skew in the CAA's estimate of asset beta. Further:

(a) Asymmetry in systematic risk is addressed through the application of the shock factor to the passenger forecast and asymmetric risk allowance: **Final Decision §9.203 [Core/2230].**

(b) HAL's argument that the length of the price control period is relevant is misguided, because shorter price controls will substitute regulatory reset risk for forecasting risk.

(c) There is no evidence that exposure to domestic traffic mitigates systematic risk. On the contrary, during business-as-usual conditions, domestic travel faces greater substitution risk from alternative modes of transportation and exhibits higher elasticities than international travel. HAL has certainly not presented evidence to suggest that exposure to domestic traffic represents a material driver of higher systematic risk at Heathrow compared with other listed European airports.

Airlines' Arguments

187 The airlines argue that the CAA has failed to take into account certain considerations that they assert to be important and point towards aiming down. They also consider that the CAA has overemphasised factors that point to aiming up such as welfare effects, given what they view as the limited importance of capex in H7 (**Delta §§5.79 – 5.80, 5.90-5.101; Virgin §§5.79 – 5.80, 5.90-5.101; BA §5.9**).

188 The CAA took all relevant considerations into account. These complaints really amount to no more than disagreements with regulatory judgement:

188.1 **First**, it is said that *"in the specific circumstances of the H7 price control, there is a clear imperative to secure affordable prices for consumers"*. The CAA's primary duty is to further the interests of consumers. That is no more so now than it has been before. It does not necessarily follow that the CAA must prioritise lower prices over (e.g.) providing for capital investment in the interests of consumers in the future. Whether it should do so or not is a matter of regulatory

judgement. It is notable that Ofgem and Ofwat did not aim down on the WACC in any of their recent determinations on this basis (even though the imperative for securing affordable prices is arguably more pressing in the context of essential services such as provision of energy and water). In truth, these arguments are not ones that can be simply characterised as *"right"* or *"wrong"* – it is a matter of regulatory judgement how to balance these competing considerations.

188.2 **Secondly**, it is said that there is also *"little pressing need for large scale capital expenditure (capex) investment"* and hence welfare effects should not imply a higher point estimate. The Airlines' view in this regard does not mean that the CAA was wrong in disagreeing with the Airlines' position. In the CAA's regulatory judgement, a number of HAL's investment programmes are particularly important to consumers. For instance, the next generation security programme is critical to improving security at the airport and providing a better experience for passengers as they pass through security. While it is correct that the scale of expenditure as a proportion of the opening RAB is less than at certain other price control reviews, this does not mean the expenditure that has been allowed for is any less important, or should assume a lower prominence when considering the choice of the point estimate.

188.3 **Thirdly**, BA argues that the CAA has erred by failing to take account of the asymmetry in probabilities of a pandemic event in the asset beta. It is true that this provides a *prima facie* reason for aiming down within the point estimate that was not considered in the CAA's Final Decision.

However, the materiality of this observation is very limited: Mr Holt considers that an appropriate approach would be to adopt the 46th percentile of the WACC range as the point estimate. This amounts to a 4bps reduction in the WACC. Moreover, this asymmetry was not raised by stakeholders at any point during the H7 consultation process despite multiple opportunities to do so. This matter cannot therefore be considered by the CMA: see paragraph 27 above.

188.4 **Fourthly,** the Airlines highlight the existence of information asymmetries which they consider warrant aiming down. It is common ground between the CAA and the Airlines that information asymmetries do indeed exist in the context of the current price control, and that in some areas these can be acute. However, the CMA's determination of the RIIO-T2/GD2 price control appeal was clear that even where information asymmetries exist, this does not provide a valid reason for aiming down on the WACC or deducting any sort of outperformance wedge from the allowed return: ***RIIO-2* §5.842**. Rather, the CMA considered that any perceived asymmetries should be addressed at source: namely, within the relevant cost and revenue building blocks themselves. The Appellants have not presented sufficient evidence to warrant departing from the building block estimates set out in the Final Decision.

188.5 **Fifthly,** the Airlines argue that the TRS mechanism gives rise to asymmetric risk exposure (in HAL's favour), since it is less likely to return revenues to consumers than it is to result in consumers paying

additional revenues. That is wrong. The TRS mechanism does not result in any distortions, nor does it give rise to any asymmetry. Rather, it remedies an existing asymmetry: namely, that associated with traffic risk. The CAA has taken the TRS into account in the calibration of the shock factor and asymmetric risk allowance and WACC. It would therefore be wrong for the CAA to make a *further* adjustment to account for it.

188.6 **Sixthly,** Delta and Virgin argue that the CAA has not considered "the cumulative impact of the individual decisions it has made at the building block level when setting HAL's price control". They refer specifically to "the TRS and asymmetric risk measures as well as an overinflated WACC". As to this:

(a) The CAA has previously explained that it has fully taken into account the impact of the TRS in calibrating the WACC **Hoon 2 §§7.16-7.19**.

(b) The asymmetric risk allowance, shock factor and allowed return are deterministic allowances that do not affect HAL's risk exposure in any way, because they are fixed throughout H7. It would therefore have been wrong for the CAA to treat them as justifying a shift in the point estimate.

(c) The CAA does not agree that the WACC is *"over-inflated"*, and had it thought so, it would be incumbent on it to revise its estimate. Insofar as this is the basis for this point, it is parasitic

on the Airlines' other arguments that the WACC is too high (which are themselves devoid of merit).

188.7 **Seventhly**, Delta and Virgin argue that the CAA should have had regard to HAL's actual financial structure when estimating the WACC. We do not consider this an appropriate consideration in the context of the CAA's use of the notional financial structure to set the WACC. The CAA bases its determination of the price control on *notional* assumptions that need not align with HAL's actual financial structure, for the reasons given at paragraph 48.2 above. The corollary of this is that HAL is at liberty to deviate from the CAA's assumptions, but that the consequences of its decisions rest with shareholders and management.

G. Conclusion

189 The various submissions of the Appellants under Joined Ground B disclose no error justifying the intervention of the CMA. The appeals on this ground ought to be dismissed.

VII. JOINED GROUND C: PASSENGER FORECASTING

A. Background

190 The number of passengers using Heathrow airport is of central importance to the overall economics of the airport. The passenger forecast is a key driver of the CAA's calculation of the maximum level of allowed airport charges, since it has a direct impact on the assumed operating costs, capital expenditure and the commercial revenues to be generated by HAL that need to be set off against these costs under the *"single till"* approach.

191 Further, for the calculation of the yield per passenger in the price control, the passenger forecast is used as the *"denominator"* for translating the revenue requirement into the *"maximum yield per passenger"* which HAL is required to use when it sets airport charges.

192 The passenger forecast is therefore a key input in the CAA's work to determine both:

192.1 An appropriate level for the *"revenue requirement"* for the price control; and

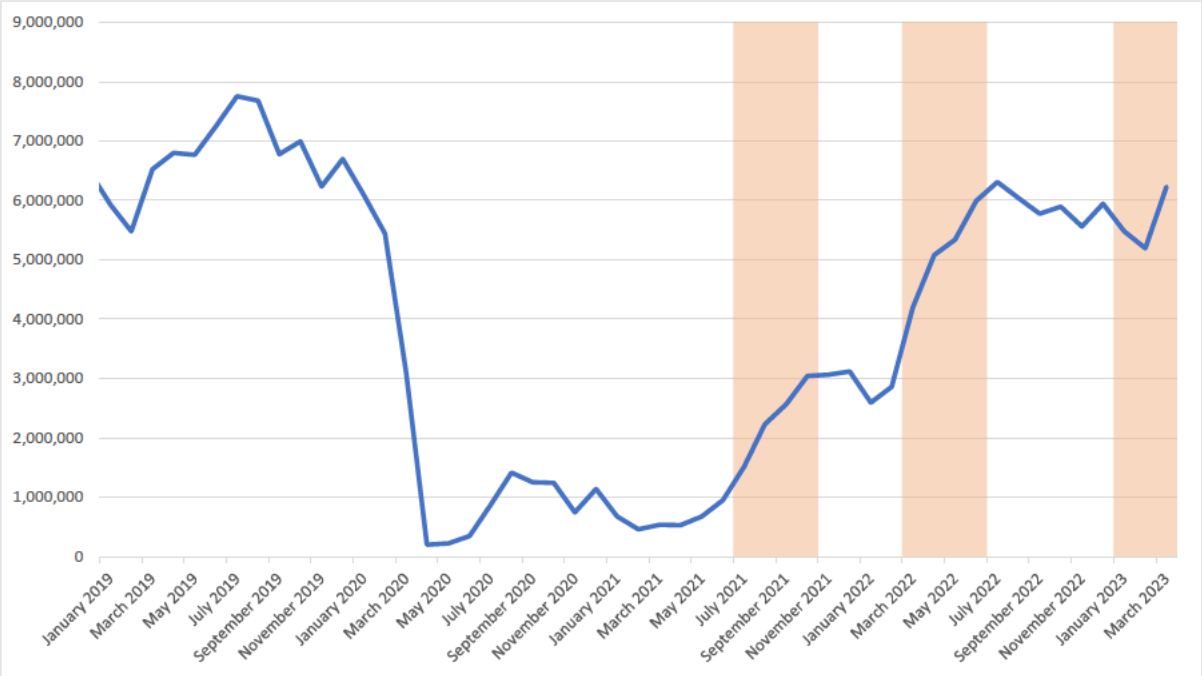
192.2 To set charges at a level that is both no higher than necessary and yet also seeks to secure that the notional company is able to finance its activities at Heathrow airport (**Final Decision §1.2, [Core/2079]**).

193 For the CAA's work on the H7 price control, the impact of the covid-19 pandemic generated very significant uncertainty with respect to passenger forecasting. There were a number of aspects of the pandemic which would affect the traffic forecast for H7 but whose impact was highly uncertain, such as (a) the duration and severity of travel restrictions, as well as the timing for those restrictions to be lifted both in the United Kingdom and overseas; (b) the speed with which passengers would return to travel as the restrictions were progressively lifted; and (c) any longer-term or fundamental changes in passenger behaviour caused by the pandemic (for example, whether greater use of remote conferencing technology would permanently reduce business travel). Consequently, passenger forecasting was inherently more difficult and uncertain and the forecasts of stakeholders and external organisations

spanned a much wider range than had been seen in the development of previous price controls for HAL.

194 Figure 1 shows passenger traffic at Heathrow airport covering the period from January 2019 through to March 2023. The bands represent the periods during which the CAA was developing its Initial Proposals, Final Proposals, and Final Decision respectively, with the right edge of the band showing the date of publication of these documents and the left edge indicating the extent of passenger data that the CAA used to inform its forecast at each key stage of the price control review process. For example, the Final Proposals were published in July 2022, but when setting the passenger forecast for it, the CAA used actual passenger data up to February 2022.

Figure 1: Traffic at Heathrow and external events up to and during preparation of the CAA's passenger forecasts



195 It can be seen from Figure 1 that the number of passengers using Heathrow airport during this period was subject to very significant fluctuation throughout

the relevant timeframe within which forecasts for the H7 period were being prepared.

B. Development of the Passenger Forecast

Initial Proposals

196 HAL shared its passenger forecasting model[10] with the CAA and the CAA's passenger forecasting team engaged with the HAL forecasting team between March and July 2021 so that HAL could describe to the CAA how HAL's model worked and answer the CAA's questions. At the end of this process, the CAA considered that it had a good understanding of HAL's forecasting model which it described in the **Initial Proposals §§2.17-2.22, [Core/48-50])**.

197 In carrying out its assessment for Initial Proposals, the CAA:

197.1 Carefully and extensively reviewed the spreadsheets in HAL's model to develop a good understanding of how the model worked and interacted;

197.2 Took account of a review by Steer that had been commissioned by HAL on coding **[GF1/0.1-0.38]**; and

[10] HAL's forecasting "model" consists of a number of spreadsheets (described in **Initial Proposals §§2.17, [Core/48]**) with names given by HAL such as "*Travel Restrictions Model*".

197.3 Ran sensitivities and checked how adjustments to the input assumptions altered the outputs.

198 The CAA decided to use HAL's model as the basis for its passenger forecast for the Initial Proposals. It also set out where its views differed from HAL's, where it had made adjustments in the model, or corrected the output to reflect the likely effect of such differences.[11]

199 The CAA carefully reviewed HAL's model, and identified areas of modelling and assumptions with which it disagreed. The CAA:

199.1 Identified and corrected for a bias arising from asymmetric distributions for the *"Monte Carlo analysis"* which HAL had used;

199.2 Disagreed with HAL's assumption that there would be fare increases in response to a reduction in business travel;

199.3 Disagreed that there should be supply capping applied to the passenger forecast;

199.4 Disagreed with HAL's fleet assumptions concerning retirement of A380 aircraft;

199.5 Disagreed with HAL's assumption that Heathrow's market share would be constrained to 2019 levels; and

[11] These amendments are described in paragraphs 2.25 to 2.43 of the Initial Proposals **[Core/50-53]**. Those paragraphs also highlight some areas where the CAA indicated that it would consider making further amendments to HAL's model for its Final Proposals.

199.6 Disagreed with the size of passenger demand shocks[12] which HAL had factored into its forecast.

200 Where the CAA identified an issue, it either made adjustments in the model or corrected the output to reflect the likely effect of such differences (the **"Initial CAA Amended HAL Forecast"**) and this was used as the CAA's passenger forecast for the Initial Proposals.

Use of HAL's Model

201 Stakeholders (including the Airlines) had, since the April 2021 Way Forward Document **[CAA/3637-3720]**, expressed their concerns with the use of HAL's model by the CAA. For example, BA indicated its discomfort with the CAA using HAL's passenger forecasting model because it had only seen the model's key assumptions and outputs as the modelling suite had not been shared with airlines **[GF1/92]**.[13] It advocated that the CAA should develop its own model **[GF/93]**,[14] but did not give any explanation for how it thought the CAA should do that other than to suggest basing it upon GDP forecasts,

[12] In the Q6 price control decision, the CAA made allowance for the asymmetry of risks around volume forecasts by applying a "shock factor" adjustment to each year of the Q6 traffic forecasts. This figure was calibrated to match the average annual loss of volumes that HAL experienced over the period from 1991 to 2012 as a result of one-off events such as the Gulf War, the 9/11 terrorism attacks, SARS and the disruption caused by Icelandic volcanic ash.

[13] British Airways' response to the April 2021 Way Forward Document, at paragraph 5.26. (british-airways-response-final.pdf (caa.co.uk))

[14] See, for example, BA's response to the April 2021 Way Forward Document, at paragraph 5.12. british-airways-response-final.pdf (caa.co.uk)

government policy, market demand, and airline supply. These concerns were reiterated in respect of the Initial Proposals **[GF1/319.51-319.52]**.[15]

202 The CAA did not disregard the Airlines' position. It sought HAL's permission to share its model with them. After a period of protracted letters, emails and other discussions (including a letter from HAL's lawyers to the CAA indicating that it would seek an injunction to prevent any such disclosure as described in the Witness Statement of Graham French **("French 1") at §4.15**),[16] it became clear that HAL was not prepared to allow the CAA to share a fully working version of the model used to produce the Initial CAA Amended HAL Forecast with airlines to enable them either to evaluate and comment on it themselves, or to allow them to conduct such review of the model as would, in their eyes, be sufficient to enable them to commission a third party to prepare a report on it.

203 As HAL did not agree to the CAA sharing a fully workable version of the model with airlines' employees, even within a *"confidentiality ring"* and airlines did not consider that the redacted and *"non-operable"* version of the model that was shared with them provided adequate transparency to enable them to comment meaningfully on it, the CAA decided to adopt a different approach to passenger forecasting for developing the Final Proposals.

[15] BA's response to the Initial Proposals, paragraphs 4.6 to 4.11 (british-airways.pdf (caa.co.uk))

[16] See 'Letter to CAA - 18 January 2022 Eversheds to CAA 18 January 2022.pdf' **[GF1/326-327]**

Final Proposals

204 The CAA explored a broad range of external forecasts for potential use in its synthesised forecast and identified seven forecasting products which it judged to be of sufficient detail, relevance, and robustness to be of use for forecasting passenger numbers for H7. French 1 provides further details of these forecasts at **§4.20** (see also **Final Proposals §§1.15 – 1.19, §1.33 [Core/987-988]**).

205 The scope of the external forecasts covered a range of metrics (passengers, flights, Revenue Passenger Kilometres) and geographies (Heathrow, UK, Europe or Global), although none of them was focused directly on passenger numbers at Heathrow. Therefore, the CAA adapted these external forecasts so that they were more comparable to the circumstances at Heathrow airport. French 1 provides further details of these forecasts at **§4.21** (see also **Final Proposals §§1.35 – 1.39 [Core/993-994]**).

206 The CAA considered that there were advantages and disadvantages both to using external forecasts and the Initial CAA Amended HAL Forecast (even if updated to reflect HAL's latest model) for the H7 price control for the following reasons (**Final Decision §1.44 [Core/2088]**):

206.1 External forecasts are more likely to be produced independently, come from reputable organisations with a history of forecasting and give a range of views on aviation's recovery from the impact of the covid-19 pandemic. However, they are not Heathrow-specific passenger forecasts and the CAA knew few details of the forecasting models used;

206.2 By contrast, HAL's forecast model took account of conditions at Heathrow airport, produced a risk-weighted output that was well understood by the CAA, and the CAA had been able to make a number of changes to the assumptions and methodology to produce the Initial CAA Amended HAL forecast. However, the methodology had not been made available for scrutiny by other stakeholders, which in the CAA's judgement meant that that methodology had to be approached with caution and that it might well be appropriate to adjust it in the light of, and cross-check its results against, other evidence.

207 The CAA developed and adopted a *"synthesised"* approach for preparing the passenger forecast for the Final Proposals, which involved comparing the results of the CAA Amended HAL Forecast[17] with a range of forecasts of aviation recovery from parties that were independent of the H7 process (referred to by the CAA in its publications as *"external forecasts"*), as well as the forecasts from HAL and the airlines. (**Final Decision §§1.5 – 1.7 [Core/2080]**).

208 In using HAL's model for the Final Proposals, the changes the CAA applied were the same as those identified above (that is, the same as it had used for the Initial Proposals) as well as:

208.1 A re-evaluated assumption (supported by a study by Skylark **[Core/1562-1598]**)[18] on the extent of any long-term, permanent

[17] The output of HAL's model after the amendments made to it in preparation for the Final Proposals (see **§209**).

[18] CAP2366A: Business Travel Trends, Skylark Consulting Group (caa.co.uk).

reduction in business travel (**Final Proposals §§1.43 – 1.46 [995-996]**);

208.2 A re-evaluated assumption on fare increases as a result of carbon pricing (**Final Proposals §§1.47 – 1.49 [Core/996-997]**); and

208.3 Reinstating the covid-19 demand overlays that had been in HAL's model at the time of the Initial Proposals (**Final Proposals §§1.50 – 1.53 [Core/997]**).

209 Unlike for the Initial Proposals, the CAA was able to run the model in full and so did not need to make its amendments by changing HAL's output forecasts. The resultant forecast was called the **"CAA Amended HAL Forecast"**.

210 As noted above the CAA compared the external forecasts to its CAA Amended HAL model over the H7 period and was reassured that the latter fell reasonably within the range of the former. Given its greater understanding of the mechanism behind the HAL forecast and that it incorporated directly both the capacity constraints and the mix of airline operations at Heathrow, the CAA decided it was appropriate to use the CAA Amended HAL Forecast as its baseline for producing its forecasts for the Final Proposals.

211 The Final Proposals were being prepared in 2022 as international travel restrictions were being lifted and passenger demand for travel increasing, and therefore the CAA had some information on airline schedules and bookings data for that year. The CAA decided to use separate forecasting processes for 2022 and 2023-26 to generate the passenger forecast in the Final Proposals.

212 At the time it set the forecast it used in the Final Proposals, the CAA had actual data only for January and February 2022 as well as a good expectation for the level of passengers using the airport in March and data for bookings stretching further into 2022. It considered how likely industry and external forecasts for 2022 were to be accurate in the light of this latest information and concluded that the forecast for 2022 should be set at the halfway point between the upper and lower bounds it had identified for 2022. The effect of this was to add 3.0 million passengers to the CAA Amended HAL forecast for 2022.

213 For the period 2023 to 2026, the CAA Amended HAL Forecast was used, with some adjustments to smooth its profile across H7 by (a) reducing the short term (2023-24) forecast to take account of more pessimistic economic forecasts at the time of the Final Proposals; and (b) increasing the longer term (2025-26) forecast to take account of traffic at Heathrow being more resilient over time.

214 The CAA then applied the "shock factor" to the combined forecast. As set out in the **Final Decision §1.16 [Core/2082]**, the shock factor covers temporary and difficult-to-predict non-economic shocks (such as adverse weather, major volcanic eruptions, terrorism events, or wars) to air travel.

215 The CAA was mindful that there was potential for the speed of the recovery in passenger numbers from the impact of the covid-19 pandemic to be quite different from the forecast used for the Final Proposals. It might have been faster, in the case of, for example, faster reopening of travel restrictions; or lower, in the case of, for example, the emergence of another covid-19 *"variant*

of concern". It therefore made clear that, if strong evidence were to emerge that indicated that the Final Proposals forecast of passenger numbers was no longer appropriate for 2022 and beyond, and that retaining this forecast would create significant bias, then the CAA would consider adopting a new passenger forecast for the Final Decision.

The Final Decision

216 The CAA decided to base the Final Decision on the forecast it had used for the Final Proposals, after updating it to reflect the actual number of passengers that used Heathrow in 2022 (which was, by then, available); forward bookings observed up to December 2022; and the change in economic outlook since the Final Proposals. (**Final Decision §1.52 [Core/2090]**)

217 All of the external forecasts the CAA used for the Final Proposals had been updated since it previously considered them, except for the ACI World Airport Traffic Forecasts of passengers at UK airports. The CAA therefore took all the updated forecasts into account except for that one. As for the Final Proposals, the CAA amended the external forecasts to reflect the circumstances at Heathrow airport. French 1 provides further details at **§§ 4.40-4.41** (**Final Decision §§1.61 – 1.62 [Core/2092-2093]**).

218 The CAA then followed a four-step process to update its (unshocked) CAA-Amended HAL forecast used for the Final Proposals as follows:

218.1 **Step 1:** It used the latest passenger data to compare the actual number of passengers using Heathrow airport in 2022 with the forecast

used for the Final Proposals (**Final Decision §§1.53 – 1.57 [Core/2090-2091]**). It found that the actual number of passengers in 2022 fell in between its forecasts for 2022 and 2023. The CAA extrapolated from this trend to amend the forecasts for the other years of H7. [French 1 **§§4.43 – 4.45**].

218.2 **Step 2:** The CAA used the latest economic forecasts to consider the change in UK GDP between the forecast used for the Final Proposals and the forecast for the Final Decision (**Final Decision §§1.58 – 1.60 [Core/2091-2092]**). To calculate the effect that this would have on the passenger forecast for H7, the CAA judged that it would have a comparable effect to the effect on the number of passengers using Heathrow when GDP declined during the global financial crisis in 2008. Since the outlook for UK GDP had worsened significantly since the Final Proposals, this led the CAA to reduce its passenger forecast for Heathrow, albeit by a smaller percentage since the evidence from 2008 was that passenger traffic at Heathrow was generally less affected by changes in GDP than the UK aviation market as a whole (**French 1 §4.46**).

218.3 **Step 3:** The CAA compared the resulting passenger forecast for H7 against the set of updated external forecasts (**Final Decision §§1.61 – 1.65 [Core/2092-2094]**). Once again, the CAA found that its forecast fitted well within the range of external forecasts. It was towards the higher end of the range at the start of H7, which was understandable since it reflected (i) the actual passengers in 2022 and (ii) the effect of

this increased demand on the forecast for 2023, which the older external forecasts were more likely to miss. The CAA's forecast was towards the lower end of the range at the end of H7, but again it considered this was understandable, since, by that stage, a number of the external forecasts were capped by the CAA to reflect Heathrow's capacity. This is because, as Heathrow's traffic reaches 2019 levels and approaches capacity, the CAA would expect growth to slow to reflect congestion at the airport, and, since the external forecasts were considering UK, European or global traffic, they will not exhibit this effect. The CAA therefore judged that no further changes to its forecast were indicated by the comparison with external forecasts (**French 1 §4.47)**.

218.4 **Step 4:** The CAA applied the same shock factor as it had done to the forecast prepared for the Final Proposals to reflect unforecastable factors that could be expected to occur over the H7 period (except for 2022 as this was no longer a forecast year) (**Final Decision §§1.66 – 1.67 [Core/2094-9095]**) **French 1 §§4.48-4.50)**

219 The outcome of this analysis was as follows:

Passengers (million)	2022	2023	2024	2025	2026	H7
CAA FP Mid (shocked)	54.9	67.3	75.4	81.0	81.6	360.2
CAA FP Mid (unshocked)	55.4	67.9	76.0	81.7	82.3	363.4
Updated for actuals and bookings	61.6	74.4	80.6	82.2	82.9	381.7
Updated for economic forecasts	61.6	73.6	79.6	81.4	82.0	378.2
Validated against external forecasts	61.6	73.6	79.6	81.4	82.0	378.2
CAA FD Mid (shocked)	61.6	73.0	78.9	80.7	81.3	375.5

C. Response to the Grounds of Appeal

220 The Airlines criticise:

220.1 The procedural fairness of incorporating HAL's model into the CAA's analysis (**BA §3.8; Delta §§4.51-4.68; Virgin §§4.48 – 4.88**);

220.2 The four steps described at paragraph 241 above (**BA §3.11; Delta §§4.69 – 4.102 ; Virgin §§4.89 - 4.127**); and,

220.3 The CAA's alleged failure to make a consequential adjustment to the asymmetric risk allowance (**Delta §4.106 – 4.108; Virgin §§4.128 – 4.130; BA §5.10.** These matters are dealt with in Hoon 1 **§§4.19-4.30**.

Procedural Fairness

221 The Airlines' claim that transparency and fairness were lacking in the CAA's forecasting exercise is unfounded. The CAA acknowledges that there were issues and difficulties with the process (as set out above) but it actively engaged with both HAL and airlines to gather industry insights and consider their perspectives and considered a wide range of information in reaching its

decisions. All consultation responses were reviewed and taken into account. The CAA adapted its approach to passenger forecasting following the Initial Proposals consultation in line with the responses it had received and put greater weight on external forecasts given the difficulties with the lack of transparency with respect to HAL's model.

222 It is common ground that the CAA made amendments to the HAL model: in particular, the CAA made use of a functional and standalone HAL model, enabling it to independently make amendments to assumptions and forecast processes without HAL's direct involvement. The CAA also benchmarked the output of that amended model against external forecasts to verify that it was a forecast in keeping with those that were being produced outside the H7 process.

223 The Airlines, however, contend that the process lacked transparency and fairness. As to that, while the CAA accepts that a greater level of transparency for the underlying HAL model may have been desirable (but was not achievable given the position taken by HAL and the need to avoid further delays to the process), the extra steps that the CAA took in terms of benchmarking the results of the modelling to external forecasts and the four-step adjustment process were conducted in an open and transparent way, with the various consultations and responses described in **Final Proposals §§1.8 - 1.19 [Core/985-988] and Final Decision §§1.20 – 1.48 [Core/2083-2089]**. The CAA also considered all the information provided by airlines as part of the H7 review process, including the forecasts that the Appellants argued were appropriate.

224 Overall, the CAA's approach was as fair and transparent as it could have been in the circumstances. It was regrettable that HAL refused to permit disclosure of a usable model to the Airlines' employees, but that decision did not rest with the CAA. In any event, HAL's failure to share the model was not so serious a procedural deficiency that the CMA *"cannot be assured that the Decision was not wrong".*

Alleged Substantive Errors

Reliance on HAL's Model

225 The Appellants contend that the CAA's continued reliance on HAL's model as an input for setting the passenger forecast for H7 is erroneous due to HAL's incentive to underestimate passenger forecasts, thereby increasing passenger charges (**Delta §4.59, Virgin §4.76**). That argument goes nowhere:

225.1 The CAA had to identify and use a starting point of some kind and the Model used by HAL was a relevant consideration which the CAA would have had to take into account in any event. Given the absence of any appropriate alternatives, HAL's model (suitably adjusted) was the correct starting point (and certainly not one that was "wrong").

225.2 Further, the CAA was fully aware of the commercial interests of HAL in relation to passenger forecasting and undertook a thorough review of HAL's model and examined the key assumptions driving the modelling results. The CAA made a range of changes to HAL's modelling

designed to ensure reasonable forecasts of passenger traffic at Heathrow airport.

225.3 The CAA's review was not solely based on HAL's model, but also incorporated external forecasts and market analysis. The CAA considered a range of factors and inputs to arrive at a forecast that appropriately balanced the perspectives of all stakeholders, including passengers, airlines, and HAL.

226 The Airlines also take the view that HAL's model is not fit for purpose, because of HAL's alleged consistent under-forecasting of 2022 and pessimistic forecasting for 2023 in the various RBP updates it has submitted (**Delta §4.61, Virgin §4.78, BA §3.8.9(c)**). However, as the CAA has demonstrated with its CAA Amended HAL Forecast **(Final Decision §§1.63 - 1.64** and **Figure 1.4 [Core/2093-2094])**, by changing the inputs and assumptions to the HAL model, it is possible to generate forecasts which are comparable with external independent aviation forecasts. It should also be noted that while the CAA-Amended HAL Forecast served as the basis for the forecast set out in the Final Decision, it underwent several additional checks and adjustments to account for more up-to-date information and intelligence available at the time. These included incorporating actual passenger data, the latest evidence from airline bookings, and updated forecasts of economic growth, all aimed at enhancing the accuracy of the CAA's forecast **(Final Decision §§1.53 – 1.67 [Core/2090-2094])**. The CAA conducted a comprehensive review of all amendments made in the model to ensure that the resulting output aligned with its expectations based on its other data

sources and expert judgement (as well as the judgement of its external advisers, Skylark **[Core/645-684 and Core/5039-5056[19]]**).

227 Finally, the Airlines assert that the adjustments made by the CAA were insufficient to address weaknesses and biases in the HAL model [Virgin **§**4.85, Delta **§**4.68], citing the material underestimation of passenger numbers for 2022 in both the Initial Proposals and the Final Proposals. This is simply incorrect. The forecasts supported by the Airlines and presented to the CAA shortly before the production of the forecasts for the Final Proposals **[Core/319.1-319.200 and Core/319.201-319.228[20]]** (which supposedly did not make this alleged error) in fact substantially overestimated the number of passengers for 2022 (72 million), which, in comparison, was significantly less accurate than the CAA's forecast for the Final Proposals (54.9 million) when compared to actual passenger numbers for 2022 (61.6 million) (**Final Decision §1.39 [Core/2087]**).

Alleged Errors in Step 1

228 The Airlines also contend that the CAA's method for setting the passenger forecast for 2023 was flawed (**Virgin §4.92, BA §3.11.5, Delta §4.56**) as (a) the 2022 baseline was wrong because of the failure to adjust for Local Rule A (b) there was a lack of transparency in the CAA's approach (c) the CAA was wrong to choose a lower bound which assumed only a one percentage point

[19] CAP2266D: H7 Forecast Review - Passenger Forecasting (caa.co.uk), CAP2366D: Review of the CAA's Approach to H7 Traffic Forecasting, Skylark Consulting Group and CAP2524I: H7 Final Decision: H7 Forecast Update Review (caa.co.uk)

[20] For example, british-airways.pdf (caa.co.uk) Table 4.1, aoc-lacc.pdf (caa.co.uk) B.2.7

growth in passenger numbers as compared to the 2019 position and (d) it was wrong to treat forward booking data for 2023 as an upper bound. As to this:

228.1 The Airlines suggest that this failure to account for the impact of **Local Rule A** ("**LRA**") resulted in an error in the 2022 figures, and that the CAA should have made an adjustment to reflect the fact that passenger numbers would have been higher in 2022 if it had not been for the capacity restrictions imposed by LRA. This submission discloses no error (**Final Decision §1.45 [Core/2088-2089]**). LRA was implemented under exceptional circumstances during the recovery from the covid-19 pandemic and in response to legitimate concerns regarding the airport and a range of service providers (including airlines) ability to maintain operational resilience. LRA therefore was not needed solely due to issues with HAL's lack of preparation for returning traffic, but also because of difficulties that airlines and other service providers had in maintaining operational resilience at that time. In other words, LRA was needed to protect quality of service to consumers and to mitigate the resourcing concerns of ground handlers and airlines as well as that of HAL. Therefore, it indicates that the CAA's decision not to adjust passenger numbers for LRA was reasonable and proportionate (**French1 §§5.88-5.89**).

228.2 As to the complaints about the **lower bound**, the Airlines claim that the CAA's reasons for using forward booking data as an upper rather than a lower bound duplicate Step 4 in which the CAA applied a shock factor to its passenger forecast (see below). However, there is no such

duplication. The CAA used forward bookings as upper rather than as lower bound was known issues relating to industrial relations and not unanticipated shocks to demand. The Final Decision also clearly established the basis for the lower bound at paragraphs 1.54 and 1.55 **[Core/2090]**.

> *"As noted above, we know that 61.6 million passengers used Heathrow airport in 2022 and that, in November and December 2022, passenger numbers were at 89 per cent of the level observed in the same months in 2019.*
>
> *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."*

228.3 The CAA did not err when it treated **forward booking data** for 2023 as an upper bound. In particular:

(a) In December 2022, forward bookings for 2023 amounted to 94% of 2019 levels which the CAA considered to be a suitable upper bound for 2023 passenger numbers. As Virgin correctly notes [ref Virgin 4.105], the CAA had used forward booking data as a lower bound in the forecast for the Final Proposals. This was reasonable at that time because when the forecast for the Final Proposals was made, travel restrictions were being eased as the

covid-19 *"Omicron"* variant wave subsided and, therefore, the CAA expected bookings to accelerate. However, that environment had changed by the time that the CAA made the forecast for the Final Decision, and it considered it to be important to account for this change in order not to misinterpret the forward booking data. Specifically, in December 2023, there were no longer any *"accelerating"* effects from the easing of travel restrictions. Moreover, and as explained in the Final Decision, the CAA observed that there was considerable potential for bookings to decelerate in 2023 in the light of anticipated industrial disputes in the UK and across Europe and sector resourcing not having recovered to pre-pandemic levels.

(b) The Airlines claim that December 2022 forward bookings are likely to have been depressed as a result of the threatened capacity caps for the winter of 2022. However, the CAA considered that threatened capacity caps would not have made a significant difference to the observed booking data unless airlines were specifically not selling seats or had reduced their capacity, which, to the CAA's knowledge, was not the case.

(c) The Airlines claim that ticket sales are cyclical with sales significantly rising early in the year, and January historically being the largest month for bookings, and conclude that the December 2022 booking data the CAA used was an inaccurate representation of booking data for the whole of 2023. This claim

is incorrect. The level of booking data the CAA used was relative to the booking data in December 2019, and hence reflected the historical seasonality patterns on which the Airlines base their argument. In fact, the CAA had monitored bookings during 2022 and for 2023 relative to the 2019 booking curve, exactly as this information has been supplied by airlines. Comparing the booking curves of each year, shows that the CAA's method captures the cyclical pattern of ticket sales **(French 1 §5.101)**.

(d) The Airlines raise issues with the treatment of possible economic constraints. As explained above and in the **Final Decision §1.56 [Core/2090]**, the CAA considered booking data to be a suitable upper bound due to non-economic constraints to passenger traffic, and mainly because of likely industrial action. This is unrelated to the economic impact on consumer demand which the CAA accounted for under Step 2.

229 As to the alleged **lack of transparency**, in light of the above, the concerns about a lack of transparency and bias created by the 2022 baseline fall away, in that the approach to deriving the 2023 forecast was clearly explained, a reasonable range of potential outcomes was established, and the CAA exercised judgment in deciding on a credible point within this range.

Alleged Errors in Step 2

230 In Step 2 of its passenger forecast, the CAA applied a downward adjustment to account for the worsening economic outlook which was evident when it set

the forecast. The Airlines do not agree with this approach, but none of their arguments comes close to showing it to be erroneous:

230.1 The Airlines claim that the way the CAA has accounted for this is untransparent and unjustified (**Virgin §4.116, BA §3.11.29, Delta §4.94**). The CAA maintains that this adjustment is transparently explained in the Final Decision and reasonable (**Final Decision §§1.58 – 1.60 [Core/2091-2092]**). Passenger demand at Heathrow has previously fallen during recessions (for example, the falls in demand following the economic crisis that started in 2008). For the CAA not to have accounted for the predicted worsening economic outlook would not have been reasonable.

230.2 The Airlines claim that the CAA failed to have proper regard to the evidence suggesting that Heathrow is reasonably robust to UK macroeconomic factors (**Virgin §4.116(a), BA §3.11.29(a), Delta §4.94(a)**). There is no merit in this complaint. It is precisely because it did have regard to this evidence that the CAA analysed the GDP impact on passenger numbers during the financial crisis in 2008/9 *at Heathrow specifically*. This ensured that its adjustment accounts for the extent to which Heathrow is more robust to changes in GDP than other airports.

Alleged Errors in Step 3

231 In Step 3 the CAA cross-checked its forecast results against external forecasts and found that those external forecasts validate its approach. The Airlines disagree with the CAA's assessment (**Virgin §4.118(a), BA**

§3.11.31(a), Delta §4.97(a)), arguing that its forecast is *"if anything, strikingly low compared with external forecasts"*. This statement, however, assumes that the forecast comparison is on an exactly *"like for like"* basis. As explained in the Final Decision, the comparison is not on an exactly like for like basis since the CAA's forecast is a risk-weighted forecast **(Final Decision §1.64 [Core/2093])**. Furthermore, the external forecasts are not Heathrow-specific and as such do not fully account for Heathrow-specific factors, such as future capacity constraints at the airport. It was therefore reasonable for the CAA forecast to be in the bottom half of the range. Accordingly, this argument does not show that the CAA's assessment in Step 3 was *"wrong"*.

Alleged Errors in Step 4

232 In Step 4, the CAA applied a shock factor to cover temporary and difficult-to-predict non-economic shocks to passenger numbers, (such as adverse weather, major volcanic eruptions, terrorism events, or wars). The Airlines make a number of criticisms of this adjustment, none of which is well founded.

232.1 **Firstly**, it is said that the CAA already accounts for the potential of industrial action in Step 1 (Virgin **§**4.122, Delta **§**4.100). This is wrong. As explained above, the shock factor is not duplicative of the way the CAA accounts for industrial action in Step 1. The shock factor is supposed to capture any unforeseen risks to passenger numbers. The prospect of industrial action at the time the CAA set its forecast was expected rather than being an unexpected shock.

232.2 **Secondly**, it is said that the adjustment is duplicative because the CAA already accounts for these risks elsewhere, specifically in the cost of

capital (Virgin §4.123, BA §3.11.36). That is wrong. The cost of capital does not take account of known asymmetric risk. Instead, the shock factor is based on an established pattern of shocks created by events such as those listed in paragraph 218.4 above and so deals in a focused and proportionate way with these known asymmetric risks.

232.3 **Thirdly**, it is said that the adjustment is incorrectly applied because the CAA applies the shock factor for the whole of 2023 despite the Final Decision having been published partway through 2023 (Virgin §4.124, BA §3.11.37, Delta §4.101). However, that is no ground for complaint. It would have been incorrect to apply the shock factor only partially for 2023. The passenger forecast for the Final Decision used actual data for the whole of 2022, but no data on passengers actually using the airport for 2023 was available at that time. Hence, the whole of 2023 was subject to potential downward risks and the CAA's application of the shock factor to the whole of 2023 accounts for this.

232.4 **Fourthly**, it is said that the calculation of the shock factor seems arbitrary and not supported by evidence (Virgin §4.124, BA §3.11.37, Delta §4.101). This ground is also misconceived. The CAA's calculation of the shock factor is not arbitrary, but rather based on reasonable evidence. As explained in the Initial Proposals §2.40, to calculate the shock factor, HAL has taken the 30-year average of the impact of unexpected disruptions to passenger volumes. In Q6, this

was calculated to be 1.2% **[CAA/782-1139[21]]**. Discounting the pandemic, the shock factor was calculated by HAL to be lower (1.07% - Initial Proposals **§**2.41) at the time of the Initial Proposals, and lower still for the Final Proposals and Final Decision (0.87% - Final Proposals **§**1.77 **[Core/1004]**, **Final Decision §**1.66 **[Core/2094]**). The CAA considers this to be reasonable and in line with historical precedent.

Consequential Adjustment to Asymmetric Risk Allowance

233 This point is dealt with in Hoon 1 **§§4.19-4.30**.

D. Conclusion

234 The CAA has explained in paragraphs 193 to 195 above the difficult circumstances that it faced in circumstances that it faced in passenger forecasting and in paragraph 227 that its approach compared favourably with the forecasts put forward by stakeholders during the H7 process. For these reasons and the other reasons stated above, Joined Ground C is without merit and should be dismissed by the CMA.

VIII. GROUND D: AK-FACTOR

A. Introduction

235 The CAA's H7 Final Decision included a mechanism (introduced through the AK term in HAL's Licence Conditions C1.4 and C1.5, and defined in

[21] CAP1103: Economic regulation at Heathrow from April 2014 : Final Proposals (caa.co.uk) paragraph 3.20

Conditions C1.22 and C1.23) designed to return HAL's over-recovery of price control revenues from 2020 and 2021 to consumers.

236 In 2020 and 2021, HAL recovered more money through its airport charges than was allowed by its price control. In 2020, HAL recovered around £91 million more and in 2021 around £162 million more than it should have done, largely as a result of a mismatch between its forecast of passenger numbers and those that actually used the airport. In total, HAL recovered around £253 million more revenue than it was entitled to under the price control for those two years, notwithstanding the impact of the covid-19 pandemic.

237 The over-recovery or under-recovery of price control revenue is not unusual. It is normal regulatory practice to include a correction factor mechanism that provides for an appropriate adjustment (in the case of over-recovery through lower charges in future years and in the case of under-recovery through higher charges in future years). It is also normal regulatory practice for the correction factor to roll-over from one price control period to another. Otherwise, the licensee would have incentives to overcharge consumers, and consumers' interests would be damaged by the failure to return the over-recovery of revenue. The CAA's Final Decision document explained that *"if the AK term were not to be included in the price control, there would be no mechanism"* to return HAL's over-recovery of revenue from 2020 and 2021 to users (**Final Decision §14.31 [Core/2290]**). The mechanism by which over-recovery was determined in HAL's case is described in the Second Witness Statement of Robert Toal ("**Toal 2**").

238 The CAA has consistently corrected for over- and under-recoveries against the price cap over a period stretching back two decades. Its decision to do so as part of the H7 price control should be entirely unsurprising and cannot be said to be "*wrong*".

B. Response to Grounds of Appeal

239 HAL alleges that the inclusion in Heathrow's licence of an additional correction factor in respect of the years 2020 and 2021, in the form of the AK factor, is unreasonable and wrong. This ground has no merit. The rolling over of correction factors is an entirely appropriate regulatory response, which is necessary properly to protect the interests of consumers (**Final Decision §§14.28 – 14.37 [Core/2289-2291]**).

Application of AK Factor

240 The central premise of HAL's argument is that the underlying purpose of a correction factor is to correct for any under- or over-recovery of revenue relative to efficiently incurred costs and to avoid excess returns (**HAL §275**). HAL also states that it suffered substantial operating losses in 2020 and 2021 and that it is *"divorced from reality"* to argue against this backdrop that a K factor in respect of these years is *"necessary to protect consumers against windfall gains"*.

241 However, this is a conflation of two distinct issues in this appeal: the question of how best to safeguard the integrity of HAL's 2020 and 2021 price cap; and the separate question of whether HAL should be entitled to some form of exceptional financial relief in light of the impact of covid-19. The CAA applied the K factor in order to ensure that HAL was held to its 2020 and 2021 price

cap and that the interests of consumers were protected. The factor ensures that HAL ultimately receives an average revenue (yield) per passenger from 2020 set equal to M_{2020} and an average revenue per passenger from 2021 set equal to M_{2021} rather than a different average yield of HAL's own choosing (the question of whether HAL should receive compensation for the different total yield caused by the serious reduction in passenger numbers over the covid-19 period being an entirely separate question, discussed in detail in previous sections on the RAB adjustment).

242 The CAA's intervention in this regard - to ensure that HAL was held to its Q6 price cap – is no different to the actions that the CAA has taken on multiple previous occasions. As Robert Toal explains in Toal 2, the K factor has been a regular feature of Heathrow's charges calculation over a period of more than 15 years (since at least the start of Q4 in 2003/04) (**Toal 2 §2.4**). It has always been calculated in broadly the same way, which entails adjusting formulaically for over-/under-recovery of airport charges revenue in Year t-2. This is neutral since it deals with scenarios of higher than expected passenger numbers as well as lower than expected passenger numbers. In each price control, the charges calculation formula changed to reflect policy changes, but the K factor, in its original form, has always been there, year after year, both within and across price controls. There is a simple, straightforward one-to-one relationship between excess yield per passenger and over-recovery of airport charges revenues.

243 Importantly, this has also been the case even when a price control formally comes to an end and the CAA issues a new price control decision. Toal 2

provides details of the approach the CAA has taken to including the K factor in every price control calculation since 2003/04. Based on this clear track record, the only reasonable expectation that HAL and its investors could have formed is that the same true up mechanism will apply to any over-/under-recovery of airport charges revenues in the years 2020 and 2021.

244 The question of whether HAL should be entitled to recoup some of its losses in 2020 and 2021 is – as observed above – a different question. The CAA was perfectly entitled to consider this issue independently from its enforcement of the price cap. The CAA's position on this matter was set out in the series of decisions it made on the adjustment of HAL's RAB, with the CAA ultimately finding that HAL should receive a RAB uplift of £300 m.

245 It is a straight-forward case of 'double dipping' for HAL now to claim that it should be entitled to a *de facto* exemption from its 2020 and 2021 price caps and the £300 m Covid-19 RAB adjustment. Had HAL considered that the CAA was bound to permit it to depart from its agreed price cap, HAL should have raised this point back in 2020 when it first approached the CAA and airlines with a request that the CAA make a regulatory intervention to address the exceptional circumstances of the covid-19 pandemic. As it was, no such request was made until much later, in August 2022, when HAL first questioned the need for the new AK(t) term that the CAA had inserted into the draft price control conditions for the H7 period.

246 If HAL is to succeed on this ground, therefore, it would have to show not only that the CAA was *"wrong"* not to permit HAL to recoup losses in the sum HAL seeks; but also that the CAA was *"wrong"* to consider that refraining from

enforcing a prior price cap was not an appropriate way to achieve that. HAL comes nowhere near showing that. It was appropriate to take steps as part of the H7 decision to ensure that HAL was held to its 2020 and 2021 price cap and that the interests of consumers were reasonably protected. This is what the AK factor achieves. Issues relating to the impact of the covid-19 pandemic on HAL's financial position were appropriately and reasonably dealt with by the CAA in considering and implementing the RAB adjustment.

Did HAL over-recover?

247 HAL submits that its financial results in 2020 and 2021 *"cannot be described as over-recovering revenues in any meaningful way"* (**HAL§278**). That is simply, factually, incorrect. Objectively speaking, HAL over-recovered because its OY_t (the *"Outturn Yield"*) was higher than M_t (the *"MaxYield"* calculated by means of the formula for those years). The AK-factor is applied to ensure that HAL is held to its price cap, just as it has been held, and will be held, to its price cap in all other years. This is the primary function of the regulatory intervention to address HAL's substantial market power.

248 HAL's suggestion that it did not in fact over-recover is completely at odds with its approach in earlier stages of the H7 process. It raised no concerns on the K factor at the Initial Proposals stage, included the K factor in its own 2022 charges consultation in August 2021 **[RT2/907]**,[22] published over-recovery of airport charges revenue in 2020 and 2021 in terms of yield per passenger in

[22] See e.g. HAL, Airport Charges for 2022, consultation document, August 2021, at paragraph 2.8 **[RT2/907]**.

the Regulatory Accounts for 2020[23] [**RT2/899.1 – 899.35]** and 2021 [**RT2/974]**,[24] and in its 2022 airport charges consultation, HAL consulted on an airport charge of £37.63 per passenger, based on its Revised Business Plan assumptions and using a correction factor formula consistent with previous years' calculations **[RT2/903]**.[25]

Capex adjustment, business rates and other contributing factors to over-recovery

249 HAL submits that its over-recoveries in 2020 and 2021 arose as a result of its failure to anticipate the value of certain of the values in the M_t formula, principally: the value of capex adjustment term; the value of the business rates adjustment term; and the number of passengers, Q_t (**HAL §§279-286**).

250 This is all irrelevant. The fact of the matter is that HAL voluntarily agreed with airlines as part of the commercial deal accompanying the iH7 price control (discussed in **Hoon 1 §§3.24 to 3.31**) that the maximum yield it would receive in 2020 and 2021 would be fixed in accordance with the M_t formula. It has exceeded that maximum yield, for which there must now be a correction. It does not matter why HAL over-recovered.

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[23] HAL, Heathrow (SP) Limited Regulatory Accounts, Year ended 31 December 2020, April 2021 [**RT2/899.1 – 899.35]**.

[24] HAL, Heathrow (SP) Limited Regulatory Accounts, Year ended 31 December 2021, April 2022 [**RT2/974]**.

[25] See HAL, 2022 Airport Charges consultation document, August 2021, at the executive summary **[RT2/903]**.

251 HAL makes a series of misguided submissions on this point, to which the CAA responds as follows (without prejudice to its overarching position that it was entitled to treat all of this as irrelevant to the application of the AK Factor):

251.1 **First**, it is said that the CAA has made no assessment as to whether the original capex budget remained appropriate in the light of revised passenger numbers, or whether there were sufficient outturn revenues available against which to set the expenditure. However, in fact, the capex adjustment term in the M_t formula was consciously inserted into the licence at the start of the Q6 period to ensure that airlines would benefit from lower charges if HAL, for whatever reason, chose not to proceed with planned capital investments. While the CAA acknowledges that there was a potential need for HAL to revise its capex programme in light of reduced passenger volumes during 2020 and 2021, HAL has not provided any justification for overriding the agreed allocation of capex risk and, in effect, deleting the D_t term in the Licence, nor did HAL raise this issue at any stage of the H7 process.

251.2 **Secondly**, it is said that the fall in revenues in 2020 and 2021 makes it illogical to think that HAL could have over-recovered on its business rates. However, the allocation of risk was entirely clear. During the Q6 period, HAL was able to negotiate a reduction in the rates that it pays. The CAA at the time decided that the benefit HAL had secured should be shared with airlines in the form of a lower M_t price cap and inserted the BR_t/Q_t term into the licence to give effect to this policy [**RT2/603 –**

605].[26] HAL gives no reason to think that this decision was wrong or that the agreed allocation of risk should not stand and the BR_t term should, in effect, be set to zero on a retrospective basis.

251.3 **Thirdly**, it is said that the remaining over-recovery arose because airlines made a commercial decision to fly planes with fewer passengers on board, and this means that it is inappropriate to require HAL to return the additional charges to the airlines. This is irrelevant: the importance of ensuring that over- and under-recoveries arising from HAL's failure to calibrate airport charges in such a way as to be consistent with the M_t price cap has always been at the heart of the reasons for having a correction factor. While 2020 and 2021 were exceptional years, in that passenger numbers turned out to be significantly lower than forecast, this does not in itself provide a reason that HAL should be allowed to retain charges that were significantly in excess of that allowed by the price control.

Retrospectivity

252 Finally, HAL suggests that the AK factor is retrospective and would require HAL to return revenues it never earned, or revenue that was rightly raised to recover actually incurred costs (**HAL §287**).

253 This is misguided. As set out above, the K factor/AK factor mechanism exists to true up the difference between outturn yield per passenger OY_t and the

[26] CAA, CAP1103 Economic regulation at HAL from April 2014 Final Proposals, October 2013, at pages 29 – 31 [**RT2/603 – 605]**.

actual maximum allowable yield M_t, consistent with long established regulatory precedent. For practical reasons, adjustments can occur no earlier than two years after the year concerned. This is because the calculation of actual M_t requires actual inputs that become known only after Year t, and the earliest opportunity to true up is through the inclusion of the difference between OY_t and the actual M_t in the calculation of the forecast M_{t+2} to be implemented in Year t+2 through the K factor. The CAA's decision is not therefore *"retrospective"*. Rather, it gives effect at the first reasonable opportunity to the price cap that HAL agreed to adhere to in 2020 and 2021.

254 The AK factor addresses the omission of a K factor mechanism in the interim price caps for 2022 and 2023. HAL's wish to have the AK factor removed from the charges condition in its licence, if granted, would prevent the full implementation of the iH7 and price control, which would be inconsistent with reasonable expectations and would be contrary to the interests of consumers.

C. Conclusion

255 HAL therefore comes nowhere near showing that the decision to maintain the AK Factor was *"wrong"*. This ground of appeal accordingly falls to be dismissed.

IX. GROUND E: CAPEX INCENTIVES

A. Introduction

256 Ground 5 of HAL's Notice of Appeal (**HAL §288ff**) relates to the CAA's decision to insert a modified condition F1.1(a) into Heathrow's licence. HAL is challenging the requirements relating to the introduction of delivery obligations ("**DOs**"), which need to be agreed with airlines at Gateway 3 (G3) of the

project governance framework, as part of the H7 *ex ante* capital expenditure (capex) efficiency framework.

257 The purpose of these requirements is to ensure that there are appropriate incentives in place for HAL to make capital investments efficiently. The CAA's view is that forward-looking (*"ex ante"*) incentives, where HAL shares a proportion of the benefits of delivering capex projects below a set budget and shares a proportion of the costs of any over-spend against that budget, is the best way to create such incentives **(Final Decision §7.22 [Core/2168])**. This approach provides incentives for HAL to improve the efficiency of its capital spending such that users of air transport services should not end up paying for inefficiently incurred costs, that otherwise might be added to HAL's RAB.

B. Background

258 The CAA first consulted on moving from a framework of *ex post* efficiency assessment of capex to an *ex ante* framework in its June 2017 consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow **[CAA/2106]**.[27] In the CAA's May 2018 working paper on the cost of capital and incentives, the CAA identified, in relation to *ex ante* capex incentives, the need to define the deliverables associated with different capex allowances, so that it could identify any underspends that were due to non-delivery rather than improved efficiency **[CAA/2184]**.[28]

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[27] CAA, CAP1541 consultation on the core elements of the regulatory framework to support capacity expansion at Heathrow, June 2017 **[CAA/2106]**.

[28] CAA, CAP1658 Economic regulation of capacity expansion at Heathrow, policy update and consultation, 30 April 2018 **[CAA/2184]**.

259 The CAA published two further consultations in March 2019 **[JH1/1888]**[29] and January 2020 **[CAA/2637]**[30] which provided further detail on its thinking in relation to *ex ante* capex incentives, in the context of the capacity expansion programme.

260 In response to covid-19 and Court of Appeal's decision (see paragraph 46 above), HAL decided to pause its expansion programme in March 2020, stopping nearly all work and spending on preparing its application for planning consent and early construction activities. In June 2020, the CAA published a H7 policy update and consultation **[CAA/2831],**[31] which explained that although expansion was paused (which meant much less capex would be needed for the H7 period than previously anticipated), the challenges facing the whole aviation sector reinforced the importance of efficient spending and ensuring value for money. Accordingly, the CAA restated its intention to introduce *ex ante* incentive arrangements for H7 at paragraphs 3.1 – 3.2 **[CAA/2831]**.

261 The CAA followed this consultation with a working paper on capex efficiency incentives in August 2020[32] [**CAA/3313]** and April 2021[33] **[CAA/3637]**, ahead

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[29] CAA, CAP1782 Economic regulation of capacity expansion at Heathrow, policy update and consultation, 29 March 2019 **[JH1/1888]**.

[30] CAA, CAP1871 policy update and consultation on early expansion costs, 19 December 2019 **[CAA/2637]**.

[31] CAA, CAP1940 Heathrow Economic regulation policy update and consultation, June 2020 **[CAA/2831]**.

[32] CAA, CAP1951 Economic regulation of HAL captial expenditure efficiency incentives, August 2020 [**CAA/3313]**.

[33] CAA, CAP2139 Consulation on the Way Forward, April 2021 **[CAA/3637]**.

of publishing Initial Proposals in October 2021, and Final Proposals in June 2022.

262 The First Witness Statement of Alexandra Bobocica ("**Bobocica 1**") summarises the H7 *ex ante* capex incentives framework (**Bobocica 1 §§4.1 - 4.28, Table 1)**, and the reasons why the CAA chose to impose it, as set out in the Final Decision document. Alongside the Final Decision, the CAA also published a consultation on draft guidance on capital expenditure governance, to support the introduction of the H7 *ex ante* capex incentives framework **(Bobocica 1 §§3.47 - 3.54)**.[34] Bobocica 1 also sets out a detailed overview of the lengthy consultation process in relation to *ex ante* capex incentives undertaken by the CAA **(Bobocica 1 §§ 3.1 – 3.54)**.

263 HAL has consistently opposed the CAA's proposals in relation to *ex ante* incentives since the CAA started consulting on these matters in 2017, as described in further detail in Bobocica 1 **(Bobocica 1 §§ 3.1 – 3.54**).

C. Response to HAL's Appeal

264 HAL's appeal against the capex incentives framework is nothing more than disagreement with the CAA about the exercise of its regulatory judgement. Its grounds of appeal identify what HAL considers to be a number of arguments against the decision the CAA eventually made, many of which have been previously aired. None of this comes close to showing that the decision was

[34] See guidance at: CAA, CAP2524G - Draft guidance on capital expenditure Governance, March 2023 **[Core/2450].**

"wrong", rather than an exercise of regulatory judgement with which HAL disagrees.

265 HAL's appeal is based on two key arguments (neither of which has any merit):

265.1 That the design of the framework is flawed and **inconsistent with the CAA's statutory duties** (i) to have regard to the need to promote economy and efficiency (**HAL §§309 - 338**) and (ii) to further the interests of users of air transport services (H**AL §§339 - 346**).

265.2 That the design of the framework is inconsistent with the **Principles of Better Regulation** (**HAL §§347 – 367**).

Economy and Efficiency

266 The capex incentive framework discloses no breach of the duty to have regard to the need to promote economy and efficiency.

267 HAL has entirely misstated this duty. Its argument is based around the premise that the CAA has a direct obligation to *"promote economy and efficiency"*. It has no such obligation. Its obligation is to further the interests of consumers, *having regard to* the need to promote economy and efficiency.[35] That is a key distinction. None of HAL's submissions show that the CAA failed to have regard to this need. Nonetheless, the CAA considers that its proposals will, in practice, promote economy and efficiency in the delivery of capital projects.

[35] The approach that the CAA takes when assessing capex with reference to this obligation is described in Section 5 of the First Witness Statement of Jon Clyne ("**Clyne 1**").

268 **Firstly**, HAL argues that the *"capex incentives Decision fails to recognise Heathrow's existing Q6 incentives to deliver investment projects efficiently"* (**HAL §§309 – 314**). It is not disputed that there are such incentives under the Q6 framework. However, the CAA's analysis of capex projects during Q6 identified several issues which suggested that the incentives on HAL to deliver efficiently were misaligned and relatively weak, particularly on the more complex projects:

268.1 While the CAA's Q6 capex review found that lower-value projects were generally delivered efficiently, airlines argued that all four of the sample of more complex projects that the CAA assessed were developed and/or delivered inefficiently;[36]

268.2 The CAA's analysis of that sample did not lead to it to conclude that these more complex projects had been developed or delivered efficiently (consistent with the precedent established previously by the CMA and used in the RP3 price review of NERL the relevant test used at the Q6 *ex post* review was whether spending was demonstrably inefficient and wasteful, see **Final Proposals, appendix D**);

268.3 The CAA's analysis also showed that *ex post* assessment of projects is often difficult due to (in particular) (**Final Decision §7.22**):

(a) The passage of time, which makes it difficult to identify, quantify and then attribute inefficiencies; and

[36] CAA, CAP1966 Consultation on HAL RAB adjustment, October 2020, at chapter 1 **[CAA/3379]**.

(b) Asymmetry of information - noting that HAL's information on project completion and *post-hoc* evaluation was particularly weak.

269 The CAA was entitled to take the view, against this background, that further incentives were required. It is nothing to the point that there was some *"success"* under Q6 (as developed at **HAL §311**). While Clyne 1 explains why the CAA has some scepticism about the extent to which those matters might be described as *"success"*, including significant cost overruns, that is strictly irrelevant. The CAA has formed the view that HAL could do better – it would be nothing to the point if HAL were (allegedly) already doing well.

270 HAL also draws attention to a report by Steer submitted with Heathrow's Initial Business Plan submitted to the CAA in December 2019 which reviewed the CAA consultation documents at that time and proposed that there should be no changes from the Q6 model.[37] The fact that the Steer report (which was prepared before expansion was paused) disagrees with the CAA's eventual conclusion discloses no error: it is apparent that the Steer report considered that there should be more emphasis on flexibility (**HAL §312.3 [CAA/2348]**);[38] while the CAA takes the view that a higher degree of clarity and certainty on project outputs and timescales would be beneficial for all stakeholders. It lay well within the CAA's margin of appreciation to differ from Steer on that point.

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[37] HAL, Steer report on NERLs forward-looking capital programme and expenditure efficiency, February 2019 **[CAA/2300].**

[38] See e.g., *Ibid,* paragraph 4.35 **[CAA/2348]**.

271 In any event, there is no explanation in HAL's appeal, nor could there be, of how further incentivising efficiencies might be a breach of a duty to have regard to the need to promote efficiency.

272 **Secondly**, HAL describes the capex incentive framework as imposing *"unworkable complexity"* (**HAL §§315-322**). This is mere disagreement and discloses no error. The CAA's decision is practical and proportionate, even if HAL disagrees with it. The CAA relies on the following:

272.1 The CAA has sought to build on existing HAL-airline governance arrangements, and not introduce new decision points in the process. This is why the CAA specified that DOs and baselines should be agreed at G3, the point at which HAL already needs to obtain airline agreement for the investment decision. The CAA considers that the existing discussions which take place leading up to and as part of the G3 investment decision can readily be extended to include the definition of DOs, and that, in fact, a stronger discipline around clearly defining (and recording) the scope, quality and timescales for each project will make the G3 discussions more effective, rather than hindering them.

272.2 HAL is exaggerating the differences between the existing framework and the proposals for *ex ante* incentives, in terms of the governance arrangements between HAL and airlines. Elements of what is delivered (output) and quality (to what standard) are typically covered as part of signing off triggers, albeit only in relation to a subset of projects. Therefore, the CAA does not agree with the comparison between

triggers and DOs set out in (**HAL Table [2] of its NOA).** The CAA submits that in defining triggers, HAL necessarily has to engage with airlines on what will be delivered (both in terms of scope and quality), and these parameters are also recorded as part of the Trigger Definition Sheet ("TDS"),[39] which forms the basis of the trigger. HAL has considerable scope to manage the process to ensure it is effective and efficient, and does not unduly delay projects.

272.3 In terms of HAL's arguments around the additional complexity due to the need to agree weightings, as explained in the draft guidance on capital expenditure governance,[40] for the purpose of streamlining the process of setting DOs, in the first instance, the CAA expects weightings to be evenly allocated across DOs. As the parties gain experience with the new framework, the CAA expects HAL and airlines will be able to make the judgements necessary to assign broad weightings to the importance of different deliverables.

272.4 HAL provides some information around the average time spent in Q6 drafting a TDS (**HAL Table [3] of its NOA**) and argues that this is an indication of the level of effort that would need to be applied to each DOs in H7. On the basis of this information, HAL extrapolates that the introduction of DOs would result in an increased workload, by

[39] As per HAL's submission (§310.2 footnote 272).

[40] See guidance at: CAA, CAP2524G - Draft guidance on capital expenditure Governance, March 2023 **[Core/2450]**.

comparison with the work involved in administering triggered Q6 projects, by approximately 90-times. However, this analysis is flawed.

272.5 As triggers applied to the largest and most important projects (by HAL's own account), the CAA would expect the time taken to agree triggers in relation to these projects to be longer than for smaller and more routine projects. So the CAA would expect the time required to agree DOs for the majority of projects in HAL's portfolio to be much lower than the time needed to agree DOs for larger ones.

272.6 Further, the CAA notes that understanding what a project will deliver is inherent to the proper assessment and planning of any project. Presenting this in a straightforward and transparent way to airlines should promote effective dialogue and strengthen both relationships and engagement. Overall, this should promote effective and efficient decision making, rather than hinder or obstruct the process as HAL appears to be suggesting.

272.7 The CAA has also engaged extensively with HAL and airlines following the publication of the Final Proposals, to develop guidance for implementing the H7 *ex ante* capex incentives framework in the most effective and proportionate way. To this end, the CAA established a programme of engagement with HAL and airlines (workshops) to work through some of the practical implementation issues associated with its proposals, as set out in more detail in the witness statement of Bobocica 1. The work the CAA has done with HAL and airlines (which has been taken forward by HAL and airlines on a bilateral basis since

the publication of the Final Decision) to define standard information that should be provided at G3 (and before) in relation to each project, will significantly streamline the process of agreeing budgets / baselines and DOs at G3, and overall improve the engagement between HAL and airlines as part of the capex governance process.

273 There is accordingly no merit in the argument that the capex incentives framework is *"unworkable"*. It is a legitimate policy choice, within the scope of the CAA's margin of appreciation, to ensure a higher degree of clarity and certainty on project outputs and timescales.

274 **Thirdly**, HAL alleges that the CAA has failed to have regard to how complex capex projects are managed in practice at Heathrow (**HAL §§323 – 333**). That is not true. The CAA has had regard to this consideration, but has drawn different conclusions from it, in the exercise of its regulatory judgement, from those HAL would have liked. The CAA's framework is designed to be sufficiently flexible to accommodate projects of varying size and complexity. As to this:

274.1 The CAA is entitled to expect HAL to manage and plan its portfolio of projects in an efficient, transparent manner that recognises the need for flexibility around operational constraints and variable demand patterns – in common with other airport managers/owners and other infrastructure managers in the transport sector in particular.

274.2 The framework recognises that the scope of projects may change after G3 approval, while providing enhanced certainty for all parties through the use of DOs[41].

274.3 HAL argues that the new framework will introduce unnecessary delay and uncertainty into its procurement of suppliers for project delivery. As explained above the new framework will not introduce unnecessary delay and **Clyne 1 Section 7** explains that some of the flexibilities under the existing framework undermine the accountability HAL should have for the efficient delivery of capex projects. **Clyne 1 Section 7** also explains that the new arrangements are consistent with an efficient contracting process, which should have a reasonable focus on project deliverables and efficient change control. Currently, G3 is the approval gateway at which HAL commits with airlines to a firm price for a project – and that will not change in future. Similarly, the change control process (used when project scope or cost changes after G3) will be retained in the new framework.

275 **Fourth**, HAL argues that the regime does not promote efficient incentives (**HAL §§334-338**). This claim is misguided (and in any event would indicate no breach of the duty to have regard to the need to promote efficient investment). In particular:

[41] See guidance at: CAA, CAP2524G - Draft guidance on capital expenditure Governance, March 2023 at paragraph 3.52 **[Core/2467]**.

275.1 HAL suggests that the design of the *ex ante* incentive framework will incentivise airlines to be inflexible during the process of agreeing DOs. However, there is no evidence that this is a likely risk **(Final Decision §7.22 [Core/2168])**. DOs should be objective measures of what a project is going to deliver, by when and to what standard, in accordance with the guidance set out in the draft guidance on capital expenditure governance.[42] In any event, the CAA will act as ultimate arbiter in cases where HAL and airlines cannot agree a DO (or a baseline) at G3, which will ameliorate any (alleged) risk of airlines acting deliberately inflexibly.

275.2 HAL argues that inclusion of knife-edge scope requirements *"incentivises Heathrow to be more risk-averse and encourages Heathrow to focus on delivering exactly what was set out in the DOs"* (**HAL §336**). This argument is based on a misunderstanding of DOs being "knife-edge" (i.e. either they are met or not met in full). The framework does not specify knife-edge DOs "by default", as the CAA explicitly explained to HAL ahead of its submission of the Notice of Appeal (including at a meeting on 6 April 2023), and as stated in the Final Proposals[43] where the CAA said that when agreeing indicators to establish whether a DO has been met, these can include indicators for "partial" delivery. At every stage, the CAA has made it clear that it is

[42] See guidance at: CAA, CAP2524G - Draft guidance on capital expenditure Governance, March 2023 **[Core/2450].**

[43] See CAA, CAP2365G - Economic regulation of Heathrow Airport - Final Proposals Appendix D-K, June 2022 at Appendix F, page 35 **[Core/1511].**

open to HAL and airlines agreeing DOs that suit the circumstances of each particular project, rather than seeking to set out a prescriptive approach for DOs.

275.3 HAL argues that the *ex ante* capex incentives will drive HAL to break projects down into smaller projects, to seek to carry out more works earlier in the project life cycle to identify any issues (i.e. asbestos, or ground works issues), and therefore minimise its risk of overspend. There may be occasions where proceeding on the basis of smaller projects is an efficient and reasonable approach. But there is no evidence the *ex ante* arrangements will create an undue incentive for HAL to behave in this way (and it cannot reasonably be assumed). As part of good-practice project development, HAL should seek to identify and manage relevant risks (in a proportionate way), including when preparing cost estimates to be submitted for G3 approval. HAL's G3 cost estimates should, in accordance with its own governance framework and protocols, be calculated on a P50 basis (i.e. a reasonable central estimate). This approach should allow for the reasonable management of uncertainty, as over its portfolio of projects it will be able to manage risk and should not expect to make windfall losses or gains.

Consumer Interest

276 HAL alleges that the imposition of capex incentives inappropriately prioritises the commercial interests of airlines, and in doing so fails to promote the

interests of consumers. It does so on two bases, both of which are misconceived.

277 **Firstly**, it is said that the requirement to secure the agreement of the airlines for DOs inappropriately prioritises the commercial interests of airlines (**HAL §§340 – 343**). It does nothing of the sort. While DOs will need to be agreed for each project under the H7 framework (subject to any grouping of projects), airlines already had a role in agreeing the budget for each project, at G3, and this has overall been working well in Q6/iH7, including by HAL's own admission (see **Maxwell 1 §§5.19 – 5.20**).

278 Further, it is not possible to reasonably agree a budget for a project without understanding what it is intended to deliver, to what standard and by when. As such, the CAA submits that the H7 *ex ante* framework puts in place a framework (and the need to record what is agreed) around a process that already exists, which provides HAL and airlines the flexibility to evolve the capital portfolio to meet the needs of users of air transport services (rather than having a fixed baseline set at the start of the period).

279 For projects that are more complex, or more costly, or which have a greater impact on airline operations (either during construction or post-delivery), the CAA considers that there is likely to be benefit from a more robust and holistic review where this provides airlines with assurance around the process followed by HAL to reach the solution chosen, and the impact of the option on costs. The CAA understands that since its recent draft guidance on capital

expenditure governance,[44] which was published alongside the Final Decision, HAL and airlines have been working together to agree a trial scope for an independent assurance provider. The CAA expects this to further streamline the process of reaching agreement on baselines and DOs at G3, given airlines will have more confidence in the information provided by HAL and the solution chosen.

280 Overall, the H7 *ex ante* capex incentives framework is designed to promote efficiency of HAL's capex, and to ensure that only efficient capex enters the RAB. The H7 *ex ante* capex incentives framework seeks to incentivise HAL to be more efficient in how it delivers its capex portfolio during the period, which is ultimately in the interest of consumers, because it means that they do not pay for inefficiently incurred costs. HAL has provided no concrete or convincing example of airlines failing to act as effective proxies for consumers, or where they have systematically sought to prioritise their own commercial interests in agreeing what capex projects should proceed. And in any case, the CAA will act as ultimate arbiter in cases where HAL and airlines cannot agree a DO (or a baseline) at G3, which will ameliorate any (alleged) risk of airlines acting inappropriately.

281 **Secondly**, it is said that the capex framework confers a disproportionate degree of control on airlines in respect of issues on which they have no special technical or commercial expertise (**HAL §§344 – 346**). This claim is a reiteration of points previously made in HAL's Notice of Appeal, and which

[44] CAA, CAP2524G - Draft guidance on capital expenditure Governance, March 2023 **[Core/2450].**

have been responded to above. Insofar as this is different point, it is an argument that airlines lack relevant expertise. As to that, airlines are currently required to give approval for G3 budgets in relation to all projects, not just ones where they have expertise. The move towards more standard information provision, coupled with more systematic and transparent recording in relation to DOs, will facilitate a more streamlined process of airlines giving their approval than is currently in place. In any event, for projects where airlines do not themselves have expertise, and which are more complex, costly, or which have a greater impact on airline operations, the CAA anticipates a role for an independent assurance provider as noted above.

282 There is therefore no merit in HAL's argument that the CAA has failed to advance the interests of consumers by imposing the capex incentives framework. Further, the approach that the CAA has adopted is broadly consistent with the approach used in other regulated sectors, including energy and water, and there is no evidence that such approaches are inconsistent with the interests of consumers (see the First Witness Statement of Richard Druce of NERA Economics ("**Druce 1**").

Principles of Better Regulation

283 HAL submits that the H7 *ex ante* capex incentive framework is contrary to the CAA's duty to have regard to principles of better regulation by introducing a new regime which is not necessary, targeted or proportionate, transparent, accountable or consistent with regulatory best practice (**HAL §§347 – 367**). There is no merit in this ground. The CAA has had regard to the principles of

better regulation (see for example Appendix H to the Initial Proposals **[Core/356]** and Appendix G to the Final Proposals **[Core/1528]**), and in doing so, has reached a conclusion that HAL does not like. That does not show the CAA to have acted unlawfully or erred.

284 HAL's arguments that the framework is **unnecessary** and **not targeted or proportionate** are a reiteration of its complaint about the alleged complexity of the framework, and view that the Q6 system works well. That has no merit, for the reasons given above. HAL's case does not get any stronger by recasting these points as a better regulation issue: the decision still fell squarely within the CAA's margin of appreciation. HAL also argues that the CAA failed to engage with alternatives, including its alternative proposal in May 2022 (**HAL §355**). That is untrue. Despite its lateness, the CAA considered this proposal on its merits, and disagreed with it, for the reasons given in the Final Proposals **(**at **§§7.110 – 7.113 [Core/1148])**.

285 HAL's argument that the framework is not a **"fair bet"** is a simple policy disagreement that discloses no error:

285.1 HAL's argument that DOs are by nature 'penalty only' and that this implies that *ex ante* capex incentives are not a fair bet is without merit. The purpose of DOs as part of the *ex ante* capex incentives framework is to ensure that the baseline originally agreed in relation to each project can be adjusted to reflect what HAL has actually delivered, to incentivise HAL to deliver that to which it originally committed, and reduce the risk of HAL de-scoping elements of projects in order to avoid being penalised under the incentive (if it becomes apparent that

actual costs will be higher than the baseline). HAL will incur no penalty under DOs if it delivers more output or quality or delivers a project early. If HAL would like to increase the level of output / scope, quality or deliver a project early and it expects that this would have cost implications, it is able to discuss and agree this with airlines as part of the change control process (used when project scope or cost changes after G3), which as explained in paragraph 274.3 above will be retained in the new framework. HAL also has the potential for upside by delivering capex projects efficiently.

285.2 HAL's argument that the risk associated with the typical distribution of cost estimates for capex projects is asymmetric is irrelevant. The Final Decision explained at paragraph 7.7 that the capex baseline to be applied for projects under the H7 framework should reflect an agreed reasonable central estimate of costs. While it is true that the distribution of cost estimates for many capex projects is typically asymmetric, the baseline for each project should be specifically developed to aim to ensure that HAL's risk exposure represents a "fair bet". HAL is responsible for ensuring that its cost estimates contain a reasonable allowance for risk when proposing a baseline, and for managing delivery of projects to ensure that project costs are (as far as practicable) controlled. If HAL believes that a particular project is likely to have a higher than average risk of relatively high cost over-runs, then it should propose additional allowances for that exposure, consistent with good practice.

285.3 It is simply inaccurate to characterise the decision as giving rise to a risk of *"double jeopardy"*. The Final Proposals considered the existence of DOs alongside the OBR regime. The nature of the OBR framework means that the outcomes and measures captured within it are of HAL's performance across the range of activities and services it undertakes (i.e. both operational and infrastructure provision), and often they reflect both in one measure (e.g. security queues). The focus of the OBR is HAL's service delivery, which has a primary focus on the operating efficiency of the business. The role of DOs is not to penalise HAL in terms of its service delivery but to adjust the original capex baseline for a project to reflect what was actually delivered. HAL will only be penalised financially if its actual spend is higher than the adjusted baseline. Even if HAL ends up being penalised for a capex overspend (by not being allowed to add 25% of the overspend in relation to that project to its RAB) and through the OBR regime (because it did not deliver a part of the scope of a project which has an impact on its performance against an OBR metric), that is not *"double jeopardy"*. It is an appropriate functioning of the regulatory framework. Otherwise, HAL would have no incentive to make up for shortcomings in its capex delivery by deploying different and potentially more costly operating arrangements and services.

286 HAL's argument that the framework is **not transparent or accountable** is based upon:

286.1 The absence of a regulatory impact assessment. This discloses no error. While the CAA has not carried out a regulatory impact assessment, the CAA did, alongside the Initial Proposals, carry out an assessment of the proposed H7 framework against its statutory duties **(Initial Proposals, Appendix H [Core/356])**. HAL did not respond to this assessment.

286.2 The alleged lack of meaningful engagement with HAL's alternative proposals. This is simply wrong. In relation to the alternative proposal HAL submitted as part of its RBP, the CAA undertook a detailed assessment of this as part of Appendix M to its to the April 2021 consultation.[45] The CAA also considered the proposal submitted by HAL in May 2022 (as part of engagement on capex incentives) and responded to this in detail in our Final Proposals (at **§§7.110 – 7.113 [Core/1148])**, particularly where HAL raised new points or issues not previously raised in its responses to CAA consultations.

286.3 The alleged *"unfinished"* nature of the framework. This goes nowhere. The CAA has set out a significant amount of detail about the H7 *ex ante* framework in the Final Proposals and the Final Decision, including all the key elements of the framework, what capex projects it will apply to, the need to specify DOs, and the incentive rate (as set out in more detail in Bobocica 1). It is entirely normal (and indeed good practice) for regulators to then work with industry (in the CAA's case HAL and

[45] CAA, CAP2139A - Appendices to Economic regulation of Heathrow Airport Limited Consultation on the Way Forward, April 2021, at Appendix M **[AB/1595].**

airlines), to implement proposals of this nature in the most appropriate and proportionate way.

287 Finally, it is said that the CAA has acted inconsistently with **regulatory best practice**. This, on its own, discloses no error, if what the CAA has in fact done fell within its margin of appreciation. In any event, HAL's citation of comparators provides no basis for the conclusory statement that what the CAA has done in this case – bearing in mind that Heathrow is *sui generis* and has no direct comparators – is inconsistent with best practice. At best, it shows that different decisions have been taken in respect of different airports where different circumstances obtain (Druce 1 addresses the specific comparators cited). That falls a long way short of showing any error on the CAA's part. Notwitstanding these points, as per the findings of section 3 of Druce 1, it is clear that a number of different airport regulators apply some form of *ex ante* incentives on capital expenditure, and the CAA's introduction of *ex ante* capex incentives is also consistent with regulatory precedent in the UK, for example Ofgem and Ofwat's approaches to regulating the energy and water sectors respectively (**Druce 1 §§130 – 131).**

D. Conclusion

288 HAL's appeal on this ground amounts to a series of policy disagreements with the CAA's exercise of its regulatory judgement. It discloses no error and the CMA is respectfully invited to dismiss it.

X. OVERALL CONCLUSION

289 The CMA is, for the reasons given above, respectfully invited to dismiss the appeals on all grounds and uphold the CAA's Final Decision in full.

Statement of truth

I believe that the facts stated in this witness statement are true. I understand that proceedings for contempt of court may be brought against anyone who makes, or causes to be made, a false statement in a document verified by a statement of truth without an honest belief in its truth.

Signed: 

Name: [✂]

Date: 31 May 2023