

Written submission from the UK Civil Aviation Authority (AAS0047)

The UK Civil Aviation Authority (CAA) is providing this supplementary evidence to the Transport Select Committee to aid its current inquiry into the recovery of the aviation sector in the UK. This evidence deals with our economic regulation of Heathrow Airport Limited (HAL), and our responsibility for setting the maximum charges that HAL can charge its airline customers for using the airport.

The CAA's responsibility for the economic licensing of airports derives from the Civil Aviation Act 2012 ("CAA12"). The regulatory regime under CAA12 applies only to the operators of "dominant airports" that the CAA has found to have "significant market power". There are currently licences in place in respect of Heathrow (operated by HAL) and Gatwick (operated by Gatwick Airport Limited). CAA12 places a primary duty on the CAA to carry out its functions under this regime in a manner that it considers will further the interests of present and future users of air transport services (who we refer to as "consumers") regarding the range, availability, continuity, cost and quality of airport operation services.

CAA12 also sets out the matters that we must have regard to in discharging this duty. These include:

- the financeability of the regulated airport operator;
- ensuring that the reasonable demands of consumers for airport operation services are met;
- the need to promote economy and efficiency of the airport operator;
- enabling the airport operator to take reasonable steps to mitigate its adverse environmental impact; and
- principles of good regulation.

In undertaking our economic regulatory activity, and as an active member of the UK Regulators Network, we also take account of approaches used by other regulators across different sectors to help make sure we are adopting best practice.

A central part of our work is to set a price control for HAL to address the risk that it engages in conduct that would amount to an abuse of its market power. The present price control arrangements in HAL's licence expire at the end of 2021.

As the Committee may be aware, the CAA is currently consulting on our Initial Proposals for the next price control at Heathrow Airport, which we expect to be in place by summer 2022. We have also consulted on an interim price control arrangement to apply during the first part of 2022 until we make our final decision on the price control to apply from 2022 to the end of 2026 (the "H7" price control period). Given this, we are limited in what we can say in either oral or written evidence about the proposals, beyond our previous public statements, which are available [here](#). The price control will be implemented through modifications to HAL's licence, and such licence modifications will be made in accordance with the statutory procedure set out in the CAA12. The CAA12 sets out regulatory "checks and balances" by requiring the CAA to consult stakeholders on proposed licence modifications before making a decision and also by giving HAL and airlines the right to appeal against a licence modification decision if they consider that it is "wrong" in fact, in law, or in the exercise of the CAA's discretion. Any such appeals by HAL (as the licence holder) and airlines [whose interests are materially affected by the decision] will be heard by the Competition and Markets Authority (CMA)."

Our Final Proposals for the full price control (which will include our decision on the modifications to be made to HAL's licence which will implement the Final Proposals) will be published in the spring of

2022. Any appeal against our licence modification decision may be made within 6 weeks of publication of our decision.

In this submission, we have set out for the Committee details about how we developed the initial proposals, and outline the opportunities interested parties have had, and continue to have, to engage with us throughout the process for setting the price control.

Following a one year extension to the previous price control period (“Q6”), the process for setting HAL’s next (“H7”) price control began in 2017. Initially the focus was on how best to adapt the regulatory framework to support the expansion of Heathrow airport. This led to an interim price cap (“iH7”) being put in place for the two years (2020 and 2021) following the end of the Q6 price control period (2014 to 2019), while work continued on the detail of capacity expansion.

HAL’s Initial Business Plan (“IBP”) for the H7 price control period was issued in December 2019. Shortly afterwards, HAL paused its plans for expansion in the light of the Court of Appeal’s decision to set aside the basis that the Government had provided for expansion under the Planning Act 2008, the Airports National Policy Statement (“NPS”). While the Court of Appeal’s judgment was subsequently overturned by the Supreme Court, expansion was quickly overtaken by the impact of the covid-19 pandemic. As a consequence, we confirmed in April 2020 that the H7 review would focus on the “two-runway” airport, with the intention of having a new price control in place with effect from 1 January 2022.

During this process, we have considered representations made by HAL in 2020 that its regulatory asset base (“RAB”) should be increased by £2.5bn to compensate it for its covid-19 related losses, with these costs to be recovered from the beginning of the new price control. While the CAA was not persuaded that an increase of this magnitude would be in the interests of consumers, we made a targeted adjustment of £300 million to reflect particular matters in relation to financeability and investment that we considered would further the interests of consumers, particularly in supporting timely re-opening of airport capacity during this year.

In the light of the impact of the covid-19 pandemic, HAL also issued a revised financial forecast and accompanying narrative in July 2020 which it referred to as a building block update (“BBU”). This was intended to update the baseline set out in its IBP to reflect the pausing of expansion and its initial assessment of the impact of the covid-19 pandemic. After HAL issued the BBU, a period of Constructive Engagement (“CE”) with airlines started, which ran between August 2020 and October 2020. CE is a process for engagement between HAL and its airline customers to enable them to discuss and review HAL’s plans and to provide a forum for airlines to set out their preferences on issues such as charges, costs, investment and service quality.

Following CE, HAL issued a revised business plan (“RBP”) in December 2020. HAL’s RBP “base case” implied a very significant increase in airport charges compared to the iH7 price control period. HAL’s 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.

In April 2021, we published our Way Forward Document, which provided an update on our overall approach to the price control review, our initial assessment of HAL’s RBP, our latest thinking in key policy areas and our proposed approach to developing projections for each of the key price control building blocks.

HAL then provided an updated business plan (“updated RBP”) at the end of June 2021. The updated RBP noted that lower levels of 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 (in 2018 prices).

Stakeholders are given the opportunity to engage with the CAA throughout the process as we develop our proposals for the price control, both through being able to respond to formal “set piece” consultations as well as through bilateral meetings between the CAA and each of airline representatives, individual airlines and HAL. The responses to our consultations are published alongside our consultations on our website, and both HAL and the airline community have been invited to present their views to the CAA’s Executive and board at key stages throughout the process.

The Initial Proposals we published in October set out a range for airport charges per passenger of between £24.50 and £34.40 (in 2020 prices) for the next price control. This range, among other things, reflects the continuing uncertainty facing the aviation sector from the ongoing impact of the covid-19 pandemic. Over the coming months, we will discuss our approach and the range of possible charges with the industry, while continuing to monitor the sector's recovery. This means we will be able to hone our assumptions and narrow this range as we set a final level for HAL’s price control next year. However, in this context, we are mindful of the fact that each of HAL and airlines are commercial operators with their own shareholder and business perspectives. As our statutory duty is to consumers, our role is to protect the interests of passengers and freight owners, rather than to arbitrate between the positions of particular constituencies of stakeholders.

As HAL's current price control expires on 31 December 2021 and the final decision and licence modifications for a new five-year control period will not be made and take effect until the summer of 2022, we are introducing an interim price control to ensure the interests of consumers are protected in the period until the H7 licence modifications take effect. We have recently consulted on these interim arrangements and will be notifying stakeholders of our approach as soon as we have taken the final decision on these matters (which should be around the middle of December 2021) and will publish our decision document shortly afterwards. We intend the holding cap to apply to HAL’s charges from 1 January. There is a six-week process from the publication of any final licence modification during which eligible parties can start an appeal process.

We do hope this supplementary evidence is helpful and are happy to engage further with the Committee on this matter as the process progresses.

December 2021